# To my Jane

*O, know, sweet love, I always write of you,*
*And you and love are still my argument;*
*So all my best is dressing old words new,*
*Spending again what is already spent:*
*For as the sun is daily new and old,*
*So is my love still telling what is told.*

# INTRODUCTION AND WHAT'S NEW

*Scope of this book*

There are three themes to this book:
(1) Taxation of foreign domiciliaries
(2) Taxation of non-residents on UK assets; and
(3) Taxation of UK residents on foreign assets.
To attempt to cover all these topics is ambitious, and this book is in danger of bursting, particularly because often foreign aspects can only sensibly be discussed in a wider context. But one cannot address the first topic without the second and third: in taxation, as in life, everything is connected to everything else. I hope as a result that the book will help with all offshore aspect of UK tax issues.

Thus what started as a book on foreign domiciliaries has become a book on offshore taxation. I have revised the title accordingly.

*The year 2010/11 in review*

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

HMRC have issued a new version of HMRC6 (residence) and guidance on trustee residence (25 pages). They have ceased to give rulings on domicile. Their new statement on interaction of GWR and excluded property settlements vindicates the views expressed in the earlier editions of this book.

The most important development of the year, as far as this work is concerned, is the European Commission action requiring the UK to amend the transfer of asset rules and s.13 TCGA to make them EU law compliant. Reform is inevitable though it is not likely to come any time soon.

Another positive development is the author's success in establishing the principle that HMRC skeleton arguments should be disclosed on request.[1] Justice should be seen to be done by exposing the arguments to public scrutiny. This should also lead to greater understanding of HMRC's position and consistency of practice.

*The state of UK tax legislation*

The chancellor stated in the Budget speech 2011 "our tax code has become so complex that it recently overtook India to become the longest in the world.."[2] Since then Parliament has added an additional 400 pages in the FA 2011.. Set against that, the Office of Tax Simplification has achieved little, and as matters stand it is unrealistic to hope for much.[3]

These have been bad times for tax policy. The CIOT expresses itself strongly: "the way tax law is developed and effected in the UK is deeply flawed."[4] Two recent publications shed a good deal of light on what has gone wrong with tax legislation in recent years. Firstly, Demos:

> The centralisation of [tax policy-making power] is a particular problem because of the lack of institutional accountability of the Treasury on taxation policy and the lack of accountability of chancellors themselves in matters of taxation. ... The concept of checks and balances in tax policy is nonexistent.
>
> ... the current relationship between the Treasury and HMRC was 'very dysfunctional', had 'almost gone as wrong as it could have gone'...
>
> At the moment, pursuing a career only in tax policy is not valued within the Treasury hierarchy. Officials pass through the tax teams rather than making tax policy a career choice. ... High turnover results in a lack of experience in the tax section and little institutional memory...
>
> ... There are traditional areas that are ring-fenced as not for consultation,

1 *R v HMRC ex p. Kessler* (unreported); see*/www.kessler.co.uk/FoI.*

2 The comment is probably based on CIOT, "The Making of Tax Law" (June 2010) para 3.3, *www.tax.org.uk/attach.pl/9328/10960/CIOT_tax_law_Jun10.pdf*. It is hard to empirically assess a claim that the UK has the longest tax code in the world, but there seem to be no other serious contenders for that title.

3 "[The OTS] cannot be an effective solution to the problem of over-complication without the Treasury allowing it a far more fundamental role." Ussher and Walford, *National Treasure* (Demos, 2011) accessible *www.demos.co.uk/files/National_treasure_-_web.pdf?1299511925*.

4 Letter from CIOT to George Osborne, 19 May 2010 *www.tax.org.uk/showarticle.pl?id=9279*

> including tax rates and anti-avoidance measures. ...
> ... 'at the moment [anti-avoidance] works like a drive-by shooting. You might hit your objective but you also hit a lot of other people.'
> At present, policies are frequently changed without understanding the impact the policy has initially had in practice.[5]

Along with a decision not to consult is a government policy which is not so much deaf to the views of the tax profession as vociferous in their rejection. The Director of the HMRC Tax Avoidance Group 2004-2009 records:

> ... I was never happier than when a new tax avoidance initiative was greeted with howls of protest from the tax avoidance quarter.[6]

This confirms what anyone could have inferred from a variety of provisions, that preventing avoidance - a term which HMRC do not construe narrowly or technically - has been a priority that trumps all other policy considerations such as certainty, workability and the rule of law; and listening to the tax avoidance quarter - a term which includes STEP, the CIOT, and any practitioner who said what HMRC did not want to hear - has been ruled out.

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

*Panaceas to improve the tax system*

There is one route and one route only to a good tax system: sound tax policy devised by those with a sound understanding of the current tax system; a leisurely timetable of consultation and legislative drafting; and the 10 tax tenets of the ICEAW.

That is not an easy prescription, and it is tempting to look for an easier solution. Recent attempts include the tax law rewrite and (perhaps) the HMRC charter.

The 2010/11 edition of this work did not have much time for the charter:

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

6 Tailby, "Some reflections on Tax Avoidance" [2011] PCB 41.

> HMRC have published a charter called (absurdly) "Your Charter".[7]
> Dicey's comment on constitutions also applies to charters:
>
> > ... any knowledge of history suffices to show that foreign constitutionalists have, while occupied in defining rights, given insufficient attention to the absolute necessity for the provision of adequate remedies by which the rights they proclaimed might be enforced. ...[8]
>
> An unenforceable charter is a cross between a PR exercise and a sermon.

I have not noticed any significant references to the charter since its publication, and "Your charter" died even sooner than the taxpayer's charter produced by John Major in 1990 (which was never, as far as I recall, publically withdrawn).

As to the Rewrite, last year I wrote:

> Parliament have passed the final two Bills from the Tax Law Rewrite project: CTA 2010 (which should not have been given the same title as CTA 2009) and TIOPA. This brings the 14 year project to an end, and it can now be seen to be a disappointment which has not met its founders hopes of a substantially improved tax system.[9]

The MORI review of the rewritten income tax legislation confirms that this is a widely held view.[10]

The big idea on the agenda for the forthcoming year - not a new one - is a GAAR. Comment will have to wait for the publication of the report of the General Anti Avoidance Rule Study Group, promised October 2011.

*Thanks ...*

I am very grateful to my colleagues Robert Venables QC and Stephen Brandon QC for discussions on many aspects of tax. I owe a great debt to Jane Hunt who works patiently on an intractable manuscript thoughout the year, and to Shabaz Ahmed and Shaoai Wang, who undertook the

7 Presumably "Taxpayers charter" was rejected because HMRC do not currently like to use the word "taxpayer".

8 Introduction to the Study of the Law of the Constitution, Dicey, (LF ed.) (1915) part II, The Rule of Law, chapter 4.

9 "... it would have been better to put the effort into simplifying the system rather than just the wording. The Institute believes that bringing the Rewrite to a close is correct." (CIOT, 20 Nov 2009.)

10 See *www.hmrc.gov.uk/research/report104.pdf*. See too 31.1 (Offshore funds – Introduction).

daunting task of proofreading.

*... and request for help*

Comments from readers would be of the greatest value and interest to the author. In the 9th edition of this work I said it has taken 2 years to complete a *preliminary* analysis of the provisions in what the House of Lords Economic Select Affairs Committee called the "absolute shambles" of the FA 2008. Now, 3 years after introduction of 2008 rules I am still making new discoveries and do not believe that a full analysis could ever be written.

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. It seeks to state the law as at 1 August 2011.

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## OBTAINING FURTHER ADVICE - AND DISCLAIMER

*Further advice*

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

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

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*Disclaimer*

The CIOT issued new guidance on professional conduct in relation to taxation in 2011. It is a sign of the times that the CIOT issue *professional guidance* with a disclaimer:

> While every care has been taken in the preparation of this guidance the Chartered Institute of Taxation, the Association of Taxation Technicians and all those involved in the preparation and approval of this guidance do not accept any responsibility for any loss occasioned by reliance on this

guidance.[1]

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

## *A note to the lay reader*

This book is not intended as a self-help guide, and is addressed to tax 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 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.

## *Edition history*

First Edition 2001
Second Edition 2003
Third Edition 2004
Fourth Edition 2005
Fifth Edition 2006
Sixth edition 2007
Seventh edition 2008
Eighth edition 2009
Ninth edition 2010

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

ISBN: 978-1-901614-53-4

1 CIOT, *Professional Conduct in Relation to Taxation* (4 Jan 2011), para 1.10, [2011] STI p.215, accessible *www.tax.org.uk*.

# TABLE OF CASES

# TABLE OF STATUTES

*The text of the statute is set out where the reference is bold*

# TABLE OF STATUTORY INSTRUMENTS

# TABLE OF EU AND FOREIGN STATUTES AND INTERNATIONAL CONVENTIONS

# TABLE OF HMRC CONCESSIONS & STATEMENTS

# TABLE OF HMRC MANUALS AND PUBLICATIONS

*Note: HMRC 6 is included in the Table of HMRC Concessions and Statements*

**International Tax Handbook**

# TABLE OF DOUBLE TAX TREATIES

*Note: Reference is to a Income and Capital Gains Treaty unless specified as "IHT DTT".*

# TABLE OF ABBREVIATIONS

**Statutes, Statutory Instruments, Treaties**

| | | |
|---|---|---|
| CA | : | Companies Act |
| CTA | : | Corporation Tax Act |
| ECHR | : | European Convention on Human Rights |
| FA | : | Finance Act |
| FB | : | Finance Bill |
| FSMA | : | Financial Services & Markets Act 2000 |
| ICTA | : | Income and Corporation Taxes Act 1988 |
| IHTA | : | Inheritance Tax Act 1984 |
| ITA | : | Income Tax Act 2007 |
| ITEPA | : | Income Tax (Earnings and Pensions) Act 2003 |
| ITTOIA | : | Income Tax (Trading and Other Income) Act 2005 |
| OFTR | : | The Offshore Funds (Tax) Regulations 2009 |
| 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 |
| TFEU | : | Treaty on the Functioning of the European Union |
| TIOPA | : | Taxation (International and Other Provisions) Act 2010 |
| TLATA | : | Trusts of Land and Appointment of Trustees Act 1996 |
| TMA | : | Taxes Management Act 1970 |
| VTA | : | Variation of Trusts Act 1958 |

**Periodicals**

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

**HMRC Manuals and Publications**

| | | |
|---|---|---|
| BI Manual | : | Business Income Manual |
| CG Manual | : | Capital Gains Manual |
| CT Manual | : | Company Taxation Manual |
| EI Manual | : | Employment Income Manual |

EUSD : European Savings Directive 2003/48/EC
IR20 : Residence and Domicile
INT Manual : International Manual
IPT Manual : Insurance Policyholder Taxation Manual
ITH : International Tax Handbook (*withdrawn*)
NI Manual : National Insurance Manual
OFM : Offshore Funds Manual
PI Manual : Property Income Manual
RDR : Residence Domicile and Remittances Manual
SAI Manual : Savings & Investment Manual (*HMRC sometimes call this the Savings & Investment Income Manual*)
SALF : Self Assessment: The Legal Framrwork
TAH : Transfer of Assets Handbook
TSE Manual : Trusts Settlements and Estates Manual

**Other**
AIP : Accrued Income Profits
AUT : Authorised unit trust
BiK : Benefit in Kind
BPR : Business property relief (for IHT)
CFC : Controlled foreign company
CGT : Capital Gains Tax
CIOT : Chartered Institute of Taxation
DDS : Deeply discounted security
DRs : Depository receipts
DT : Discretionary trust
DTT : Double taxation treaty
EN : Explanatory Notes
ESC : Extra-statutory concession
EC : Commission of the European Communities
FoE : Freedom of establishment
GB : Great Britain
GWR : Gift with reservation of benefit
HMRC : Her Majesty's Revenue and Customs
IHT : Inheritance tax
IME : Investment manager exemptions
IOV : Instrument of variation
IP : Interest in possession
IPDI : Immediate post-death interest
IT : Income tax
LLC : Limited liability company
LLP : Limited liability partnership

| | | |
|---|---|---|
| MS | : | Member State |
| NAV | : | Net Asset Value |
| NICs: | : | National insurance contributions |
| NOR | : | Not ordinarily resident |
| NPO | : | Non-profit organisation |
| OEIC | : | Open-ended investment company |
| OIG | : | Offshore income gain |
| PE | : | Permanent establishment |
| PET | : | Potentially exempt transfer |
| POEM | : | Place of Effective Management |
| POA | : | Pre-owned assets |
| PRs | : | Personal representatives |
| RFI | : | Relevant foreign income |
| RI | : | Revenue Interpretation |
| SDLT | : | Stamp Duty Land Tax |
| SP | : | Statement of Practice |
| TAA | : | Transfer of Assets Abroad |
| TDSI | : | Tax deduction scheme for interest |
| TNR | : | Temporary non-residence rules |
| TSI | : | Transitional Serial Interest |

CHAPTER ONE

# FOREIGN DOMICILE: TAX POLICY AND REFORMS

## 1.1 Introduction

The topics of this chapter are:

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

(2) A history of foreign domicile tax reforms

(3) An assessment of the 2008 reforms

The chapter concludes with a glance into the future.

## 1.2 Economic arguments

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

(1) directly, from tax paid by the foreign domiciliaries (including VAT); and

(2) indirectly, from investment and expenditure in the UK which is more

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1 Also, UK firms competing for expertise in the international labour market will find recruitment easier if the tax regime for foreign employees is lighter. Some potential employees would not choose, or could not afford, to come if the UK tried to tax them as it does its own domiciliaries.
For discussion on policy issues, see 'Residence and Domicile: Response to Background Paper' (STEP, 16 June 2003); 'Reviewing the Residence and Domicile Rules' (CIOT, 1 August, 2003); PBRN18 (Residence & Domicile Review), CIOT, 20 November 2007; all accessible on *www.kessler.co.uk*.

likely to be made by UK residents.

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

### 1.2.1 *Assessing the strength of foreign tax competition*

The argument requires an assessment of the strength of international tax competition.

In principle there are many low-tax or preferential tax regimes to which wealthy individuals can move. Switzerland, for instance, has a lump sum taxation regime for non-Swiss citizens specifically targeted for this purpose.[2]

In assessing the tax competitiveness of the UK relative to other countries, several points must be borne in mind.

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

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

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

> Frequent changes in legislation, particularly where there has been an absence of consultation, can have an adverse impact on the taxpayers and

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2 Though this is currently politically controversial and it was abolished in Zurich in January 2010.
The OECD study "Engaging with High Net Worth Individuals on Tax Compliance" para 34 (May 2009) singles out Ireland, France, the Netherlands and the UK for what it terms "preferential regimes for specifically defined groups of taxpayers"; see http://www.oecd.org/document/5/0,3746,en_2649_33749_42902277_1_1_1_1,00.html

their advisers trust in the tax system.[3]

But there are others: can a tax authority subject an individual to an expensive and intrusive tax investigation without any evidence to justify doing so? Certainty is very important. Perception matters as much as reality. By many of these measures, the UK scores poorly.[4]

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

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

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

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

> The UK tax system is largely[5] based on the rule of law rather than informal practice and discretion.

To the extent this is true it is something to boast of,[6] and a feature which makes the UK an attractive choice for anyone choosing where to reside. However, it is far less the case than formerly, due to:

(1) over-wide, over-complex, or wholly vague anti-avoidance provisions mitigated by informal practice, discretion or oversight.[7]
(2) an increasing use of retrospective legislation.[8]

### 1.2.2 *Attitudes to the economic argument*

The debate about international tax competition is very long standing.[9]

Most though not all commentators would accept that the economic argument is a powerful consideration.

Where the UK faces tax competition, those making the law sometimes acknowledge it expressly:

> The [investment manager] exemption enables non-residents to appoint UK-based investment managers without the risk of UK taxation and is one of the key components of the UK's continuing attraction for investment managers.[10]

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5 But see 9.23 (Forward tax agreements).

6 Blackstone agrees: Commentaries (1765) vol 2 chap 37 ("a country like this, which boasts of being governed in all respects by law and not by will...").

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

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

9 See the evidence of Lord Vestey to the 1920 Royal Commission, accessible *www.kessler.co.uk*.

10 SP 1/01. Another example is the IHT exemption for OEICs and AUTs:

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

Press Release 16 October 2002 (OEICs and AUTs) para 6. The text continues (inaccurately):

> "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".

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

> In recent years too many businesses have left the UK amid concerns over tax competitiveness. It's time to reverse this trend.[11]

However what will be the overall economic effect of any reform is almost always hard to predict; ascertaining the effect of reforms after they are made is scarcely less difficult.

Those opposed to the consequences of this line of argument deride it as a "fiscal race to the bottom" but more sober commentators recognise that the UK could not act alone, as if there were no such thing as international tax competition.

### 1.2.3 *EU and international law aspects*

The freedom of the UK to enter into tax competition against other countries is subject to certain constraints of EU and international law and politics. International fiscal co-operation in this area at present operates only to a limited extent, but it has made some progress in a (non-binding) EU code of conduct on business taxation[12] and may in the future become a more important aspect of tax policy.

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

Another example:

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

Another example is the exemptions granted to sports performers: see s.68 FA 2006 (Olympic Games 2012 ); sch. 20 FA 2010 (Champions League 2011). These events would not be held in the UK in the absence of a tax exemption.

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

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

The EC has expressed disapproval of the remittance basis:

> The Commission does not advocate remittance base taxation, as it may lead to double non-taxation.[13]

That expression of disapproval does not seem to have had any effect on UK domestic politics.

Since tax competition extends beyond the EU, and there is (to say the least) limited enthusiasm for increasing EU powers in relation to tax, those hoping for reform tend to look to the OECD.[14]

### 1.2.4 *"Customers" of HMRC*

It does not seem to me to be wholly coincidental that the change of terminology from taxpayers to "customers" of HMRC has come at a time which has seen a substantial increase in HMRC's powers and in its desire to use them to impose civil and criminal penalties.[15]

In the 2010/11 edition of this work I concluded:

> Where there is tax competition, the term "customer", which HMRC have (controversially) applied to taxpayers since 2001[16] is slightly less

13 László Kovács (EU Taxation and Customs Commissioner) IP/07/445 (30 March 2007).

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

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

16 A press release at the time provided: (14/06/01) "M and C Saatchi, a leading advertising agency, has been appointed by the IR to rebrand the department. Branding and design consultants, Corporate Edge, will also be working with the IR and M and C Saatchi to 'create a customer driven department.'"
In 2003 Sir Nicholas Montagu (then Chairman of the Board of Inland Revenue) said that the reason for the change was to remind Revenue staff that the needs of the consumer of public services should be considered first: see "The Customer is always right" Tax Advisor February 2003.

> inapt. UK resident foreign domiciliaries are in principle more free than other taxpayers to take their "custom" elsewhere.

As far as I am aware, no other Revenue department in the world has adopted this terminology. It will not cease to give rise to derision as long as the current generation of tax practitioners remain in practice.[17] It is conceivable that the terminology will last until a future generation sees nothing to laugh at in expressions such as *"penalties designed to change customer behaviour"*[18] but I think that unlikely.

The present Archbishop of Canterbury sees the issue in a wider context, and his objections to the terminology are more profound:

> The language of customer and provider has wormed its way into practically all areas of our social life, even education and healthcare, and we forget that it is a metaphor when we call a student, a patient or a traveller a "customer". The implication is that the most basic relation between one human being and another or one group and another is that of the carefully calibrated exchange of material resources; the most basic kind of assessment we can make about the actions of another, from the trader to the nurse to the politician, is the evaluation of how much they can increase my liberty to negotiate favorable deals and maximize my resources.[19]

## 1.3 Fairness

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

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

18 *www.hmrc.gov.uk/e-learning/New_Penalties_Awareness/Inaccuracy_Pen_ext/HTML/Inaccuracy_Pen_ext_106.html*

19 Williams, "Knowing our Limits" in Williams and Elliott (ed), *Crisis and Recovery* 2010, p.20.

### 1.3.1 *What is fairness?*

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

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

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

Economists have developed these concepts with considerable sophistication[20] but their limitations are painfully exposed when one tries to apply them in a real life context, such as an assessment of the fairness of the taxation of foreign domiciliaries. The concept of horizontal equity is not so much a definition of fairness as an approach to identifying the issues in any serious discussion of fairness. In deciding whether one group (foreign domiciliaries, say) is fairly taxed, one needs to identify another group by way of comparison (UK domiciliaries, say) and ask if they are relevantly equal.

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

In the author's view, domicile is in general a useful and practical measure of UK linkage, and to regard UK and foreign domiciled residents as completely equivalent is facile. Or put the other way, foreign domicile does constitute a significantly weaker UK link than UK domicile. Accordingly conferring a lighter UK tax regime on foreign domiciliaries, such as a remittance basis, is indeed fair. This is especially so bearing in mind that mere residence does not require a very close connection to the

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

UK – merely passing the 183 or 91 day tests or (under HMRC 6) having vaguer and more remote connections.

Further, a foreign domiciliary may not have had a fair opportunity to arrange their affairs with UK tax in mind; for instance creating settlements from which they were 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.

This view is not universally held. Some maintain that any distinction (for IT or CGT) between UK residents based on domicile is unfair. The two are relevantly equal.

It is difficult to see how the dispute between the rival views can be judged, or what either side could do or say to convince the other. The concept of fairness is insufficiently precise to resolve the dispute. Or one might say that it comes down to a matter of impression, which is to say the same thing.

Many of those who advocate this view most strongly are not tax practitioners, and I think would be surprised to find how little is required to be UK resident: their views may based on a paradigm of a foreign domiciliary who is a very long-term UK resident.

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

### 1.3.3 *Is a remittance basis fair?*

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

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

(1) *Short-term residents* who are:
  (a) wealthy individuals, who can elect for the remittance basis and are able to retain significant foreign income/gains abroad, and
  (b) less wealthy individuals for whom the remittance basis is not

attractive since they cannot afford to retain foreign income/gains abroad.

(2) *Long-term residents*

(a) ultra-wealthy individuals, who can elect for the remittance basis and are able to retain significant foreign income/gains abroad, and

(b) less wealthy individuals for whom the remittance basis does not justify the £30k.

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

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

So far as they have introduced the £30k remittance basis charge, the reforms have targeted the benefit of the remittance basis at a small number of ultra-wealthy individuals. That may make some sense under the economic argument, but from a fairness point of view it is difficult to justify.

## 1.4 Suitability of domicile as a fiscal test

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

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

Other concepts are sometimes used:

(1) Long term residence, of which UK tax uses a variety of tests:

   - (a) IHT deemed domicile rule: 17 years residence.
   - (b) Long-term residence rules: 8 years residence.
   - (c) Temporary non-residence rules: 4/7 years residence and 5 years absence.
   - (d) Ordinary residence (vague but like a 3 year residence test)

(2) Citizenship (not much used in UK domestic tax law but used in some IHT DTAs and in the OECD model treaty.

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

## 1.5 Approaches to reform of foreign domiciliary taxation

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

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

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

## 1.6 History of reform of foreign domicile taxation[21]

### 1.6.1 *1974-2002*

The 1974 Finance Bill included a provision (clause 18) that an individual ordinarily resident in the UK for five out of the preceding six years of assessment should be deemed UK domiciled for IT and CGT purposes. This was withdrawn from the Bill.[22]

In 1987 the Law Commission published recommendations for minor

21 See too 9.4 (History of the remittance basis).

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

reforms of the general law of domicile[23] but despite initial acceptance by the Government, there was no change in the law. In 1996 the proposals were formally abandoned.[24]

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

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

> It seems more likely than not that, apart from tinkering changes, the present regime will continue for the foreseeable future. But "the major distinguishing feature of the British tax system is its instability".[25] There is also the possibility of EU pressure for reform. If what has been a backwater acquires political prominence, perhaps due to no more than a campaign by a single newspaper, there will certainly be major changes.

### 1.6.2 *2003 background paper on residence and domicile*

In 2002 a newspaper campaign emerged[26] which pressed the Blair Government into action, or at least into the appearance of action. The Budget of April 2003 delivered a "background paper" called "Reviewing

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

24 According to Hansard HC, 16 Jan 1996 Col 487:
"The Government have decided not to take forward these reforms on the basis that, although they are desirable in themselves, they do not contain sufficient practical benefit to outweigh the risks of proceeding with them and to justify disturbing the present long established body of case law on this subject."
This was the right reason for the right decision. However, the true reason for the decision may well have been pressure of the foreign domicile lobby: see "Rules for Determining Domicile", Law Reform Commission of Hong Kong (2005) para 4.28 accessible *www.hkreform.gov.hk*.

25 This was noted in Steinmo, *Taxation and Democracy*, (1993) p.44 but the instability has markedly increased since then.

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

the Residence and Domicile Rules as they affect Taxation".[27] This was a facile document[28] but it may be unfair to criticise its (unnamed) authors. Their instructions may have been to be uncontroversial; by saying nothing, there was nothing in the document to which anyone of any political view could object.

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

> The review of the residence and domicile rules ... is ongoing.[29]

It is clear that the review of foreign domicile tax did not follow the normal course of consultation, decision and implementation. In the absence of a frank explanation of what went on, it is tempting to speculate. The likely explanation is that the Blair Government wanted to do nothing, but prevaricated to avoid an announcement which would have lead to a furore from those in favour of reform.[30] Blair resigned in June 2007. A change of power led to an unannounced U-turn from that unannounced policy.

## 1.7 2008 reforms: assessment

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

> [1] should be fair;
> [2] should support the competitiveness of the UK economy; and

27 See *www.kessler.co.uk*

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

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

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

[3] should be clear and easy to operate.[31]

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

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

(1) The £30k remittance basis charge for long-term residents
(2) The withdrawal of personal allowances for all remittance basis claimants
(3) The extension of anti-avoidance provisions to remittance basis taxpayers (in particular, the ITA remittance basis, the s.720, s.13 and s.87 remittance bases, and the AIP remittance basis).

### 1.7.1 *Clear and easy to operate*

It will be evident to anyone who skims this book that by this criteria the 2008 rules are an abject failure. The rules are unclear, often difficult and sometimes impossible to operate. In these respects they are unquestionably worse than the pre-2008 rules. The terms of the 2012 review suggest that this is tacitly accepted.

Government policy normally requires an impact assessment.[32] None was carried out in relation to any of the 2008 reforms. Many features of the reforms could not have survived if it had been.

### 1.7.2 *Competitiveness of the UK economy*

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

(1) Tax and investment lost from individuals who leave the UK, and those who (because of the reforms) decide not to come.
(2) The loss to the economy that the new rules in many cases prevent investment in the UK and prevent use of UK services (to a much greater extent that is necessary from the concept of a remittance basis).

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

31 The paper might have cited Adam Smith *The Wealth of Nations* (1776) Book 5 chapter 2, accessible *www.bibliomania.com/2/1/65/112/frameset.html*
The paper did not point out (though Adam Smith did) that these objectives are to a substantial extent irreconcilable.

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

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

This view is now supported by a number of surveys.

A KPMG survey found that as a result of the 2008 changes, 24% of foreign domiciliaries were planning to leave the UK within two years, with an additional 24% hoping that the rules will be changed and looking to review their position in the medium term. More than nine out of ten said that the changes had damaged the UK's competitiveness.[33]

A Knight Frank survey found that up to 7% of foreign domiciliaries left UK in the months following the tax announcements and a further 31% were planning or actively considering departure.[34]

Stonehage research suggests that the changes will produce an initial tax gain diminishing to a tax loss beginning from a date between 2014 and 2018.[35]

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

It is of course difficult if not impossible to disentangle the 2008 reforms from other disincentives to coming to the UK, such as the increase in income tax rates to 50%, the enormous uncertainties caused by the transfer of asset abroad changes in 2005, and corporation tax changes.

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

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

34 *www.knightfrank.com* Press Release, 20 June 2009.

35 "Non Doms and the UK Economy", March 2010, accessible *www.stonehage.com*.

not to come are almost totally unmeasurable.

HMRC offer the following statistics:

| | Non-doms | Tax paid | RBC payers | | Total RBC paid |
|---|---|---|---|---|---|
| | *Total no* | *Total £billion* | *Average per person* | | |
| 2004-05 | 110,000 | 3.3 | £30,000 | | |
| 2005-06 | 111,000 | 4 | £36,036 | | |
| 2006-07 | 117,000 | 5 | £42,735 | | |
| 2007-08 | 140,000 | 6.9 | £49,286 | | |
| 2008-09 | 123,000 | 5.9 | £47,967 | 5400 | £162m |

The figures are interesting but it is impossible to draw any economic conclusions from them.

### 1.7.3 *Fairness of 2008 reforms*

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

The £30k remittance basis charge distinguishes between short term and long-term residents, and taxes the latter more heavily, the connecting factor here being an 8/10 year residence test. One cannot categorise that distinction as unfair.

On the other hand, among long-term foreign domiciliaries, the charge distinguishes between the extremely wealthy (to whom the remittance basis is still attractive) and others (to whom it is not). This offends against the principle of vertical equity, which suggests that people with higher incomes should pay more tax. That is not fair, though it is an unfairness arising directly out of a decision to maximise the economic advantage by targeting the remittance basis to the wealthiest.

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

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

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

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

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

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

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

### 1.7.4 *Process of implementation*

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

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

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

On the date of publication the Treasury announced that the Finance Bill was incomplete and amendments covering almost every aspect of the rules[36] would be made in the course of progress of the Finance Bill.[37] Thirty pages of amendments duly emerged in mid June – far too late in the Finance Bill timetable to give them any serious consideration. Forty eight more Report Stage amendments were published on 26 June. The report stage and third reading (after which no further amendments could be made) were held on 1 and 2 July 2008. John Avery Jones notes that "Report Stage amendments are usually a disaster."[38]

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

The former editor of *Taxation* is blunt:

> The standard of strategic policy making at the Treasury has been unacceptably poor in recent years, but this must surely have been one of its lowest ebbs ever.[39]

The CIOT say:

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

and their example to illustrate the point is the non-domicile rules in the FA 2008.[40]

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

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

38 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* (Vol 1 2004) accessible on *www.kessler.co.uk*.

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

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

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

> Our private sector witnesses would not have used words like "a real shambles" if they did not feel strongly about this. ...
> 176. We recommend that, if they have not already done so, HMT and HMRC should carry out a full review of the reasons why there were so many difficulties in the development of this policy initiative. They should ensure that the lessons are learned so that these problems do not emerge in other initiatives.
> 177. We also recommend that if another policy initiative gets to the point where the legislation cannot be finalised for inclusion in the Finance Bill, that initiative should not be included in the Bill, or, if feasible, the part which is not finalised should not be included. We cannot support the approach of the Finance Bill's still being subject to much amendment at the time it is published, particularly when the proposals come into effect from the beginning of the tax year, as in this case. [41]

No review has been carried out.

Does it now matter? Readers may think it pointless to cry "foul" in a game which has no referee, and whose result has now been declared. But I think the story deserves to be recorded as what a working party lead by Lord Howe described as "an object lesson in how not to legislate".[42]

The charity tax reforms of the F(No.1)A 2010 suggests that no lesson has been learned. There are some signs that the present coalition government would like to be less cavalier in enacting tax legislation. Whether the government can ensure that this happens remains to be seen.

## 1.8 The future

The announcement of policy changes a year ahead of implementation, to allow for consultation, is a welcome development. The 2011 Budget contains two such announcements which affect the themes of this book.

The June 2010 budget provided:

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

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

> 1.98 As announced in the Coalition Agreement, the Government will review the taxation of non-domiciled individuals. This will assess whether changes can be made to the current rules to ensure that nondomiciled individuals make a fair contribution to reducing the deficit, in return for greater certainty and stability for those bringing skills and investment to the UK.

Of course just as in the review over period 2003-2008, the outcome of any review will turn primarily on the views and political power of those carrying out and ultimately implementing the review. The result of this review appears in the 2011 budget:

> **3.7 Review of non-domicile taxation —** At the June Budget 2010, the Government confirmed that it would review the taxation of non-domiciled individuals. There is currently a beneficial tax regime for non-domiciles regardless of how long they have been resident in the UK. However, the rules mean that foreign income and gains are taxed if they are brought to the UK and this is a disincentive to inward investment. The Government will introduce the following reforms:
> • remove the tax charge when non-domiciles remit foreign income or capital gains to the UK for the purpose of commercial investment in UK businesses;
> • simplify some aspects of the current tax rules for non-domiciles to remove undue administrative burdens; and
> • increase the existing £30,000 annual charge to £50,000 for non-domiciles who have been UK resident for 12 or more years and who wish to retain access to the beneficial tax regime (the remittance basis). The £30,000 charge will be retained for those who have been resident for at least seven of the past nine years and fewer than 12 years.
> The Government will be consulting on the detail of this measure. It will issue a consultation document in June. The Government intends to implement these reforms from April 2012.[43]

The other important change on the horizon is a statutory residence test.

43 HMRC "Overview of Tax Legislation and Rates" (23 March 2011).
The Budget 2011 predicts that these reforms will have the following effect:

| *Year* | 2011/12 | 2012/3 | 2013/14 | 2014/15 | 2015/16 |
|---|---|---|---|---|---|
| *Yield* | £0 | £0 | £110m | £70m | £50m |

I find it difficult to see how these figures could be derived and doubt if they should be taken seriously.

## 1.9 Stability?

Alistair Darling (then Chancellor of the Exchequer) said in his budget speech 2008:

> There will be no further changes to this regime [for foreign domiciliaries] for the rest of this Parliament or the next.[44]

This was only lip-service to the desideratum of stability and no-one seriously believed it.[45] In the 2008/09 edition of this work I said:

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

The FA 2009 did just that, with more tinkering in the F(no.1) A 2010 and a rewrite of the offshore fund rules.

The 2011 budget has another promise of stability:

> There will be no other substantive changes to these rules for the remainder of this Parliament.[46]

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

45 The House of Lords Economic Affairs Committee said:
"227. In his Budget Statement, the Chancellor promised that the rules in this area would not be substantially revised for the rest of this or the next Parliament. We do not take this to mean that there will not be legislation in coming Finance Bills to address defects in the current legislation. We think it inevitable that, given the evident pressure under which this legislation was produced, there will be such defects." 2nd Report of Session 2007–08, The Finance Bill 2008
*www.publications.parliament.uk/pa/ld200708/ldselect/ldeconaf/117/117i.pdf*.
In the Consultation Document "Modernising Powers, Deterrents and Safeguards: Tackling Offshore Tax Evasion" 9 December 2009 para 4.43 HMRC tactfully misquoted the then Chancellor, saying "At Budget 2008, the Chancellor of the Exchequer gave a commitment that there would be no *significant* changes to the *policy underlying* the remittance basis for the lifetime of that Parliament and the next."

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

The coalition government (correctly) does not promise to bind the next Parliament. The promised period of stability is therefore for three years, from 2012 (assuming the proposed 2012 changes are enacted on schedule) until 2015 (assuming Parliament lasts the full 5 year period).

CHAPTER TWO

# DOMICILE

## 2.1 Why does domicile matter?

Domicile is fundamental for many tax purposes, of which the most important are:
(1) The remittance basis for IT and CGT.
(2) IHT on foreign situate assets.

Domicile is also important for many non-tax purposes including aspects of family law jurisdiction and succession law.

The RDR Manual has lengthy guidance. For 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 most often cite. For an important reminder of the need for legal realism in this area, see Fawcett, "Result Selection in Domicile Cases" (1985) OJLS vol 5 p.378.[1]

For IHT deemed domicile, see 52.1 (Deemed domicile for IHT).

## 2.2 The concept of domicile

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

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

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

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

(1) "Domicile" in civil law jurisdictions.[2]

(2) "Domicile" in EU regulations and international treaties (where a definition generally overrides the UK law sense of domicile).

(3) "Domicile" in ordinary English usage.[3]

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

A person must be domiciled in a single legal jurisdiction. The expression "**UK domiciled**" is in a literal sense inapt because a person must be domiciled in England, Scotland or Northern Ireland. It is, however, universally used to describe someone who is domiciled in England, Scotland or Northern Ireland.[4] For tax purposes it makes no difference where in the UK one is domiciled, though for general law purposes that may be important.

## 2.3 Domicile of origin

Dicey states:

> Rule 9 – (1) Every person receives at birth a domicile of origin:
> (a) A legitimate child born during the lifetime of his father has his domicile of origin in the country in which his father was domiciled at the time of his birth;

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

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

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

> (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.[5]

This is one of the few areas of English law where legitimacy still matters. The position in Scotland is slightly different: see 2.13 (Child's domicile of dependency).

## 2.4 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.[6]

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

### 2.4.1 *"Residence"*

"Residence" here means "residence as an inhabitant" which is something more than "presence as a traveller".[7] This is not necessarily the same as residence for tax purposes but in practice it ought to come to the same thing, since tax residence is supposed to represent the ordinary meaning of the word residence. If at all possible it would be best to avoid having two concepts of residence, one for tax and one for domicile.

Assuming a person resides as an inhabitant, there is no minimum period of residence required: residence commences immediately on arrival if the

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5 Dicey & Morris, *Conflict of Laws* (14th ed.., 2006), para 6R-025.

6 Dicey & Morris, *Conflict of Laws* (14th ed., 2006), para 6R-033.

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

intention is to stay.[8]

### 2.4.2 *"Permanent or indefinite" residence*

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

"Indefinite" (in short) requires that the individual intends to reside in a country "until the end of his days". It seems to me that "indefinite" is an unfortunate word to use because in its normal sense it is used to describe any period whose duration is not known exactly, even a short period. For instance the duration of a strike is indefinite;[9] so is the duration of a contract of employment. That is not the meaning here. However there is no single English word which neatly encapsulates the intended meaning. "Unlimited" is sometimes used and is more apt, but this too needs clarification. *IRC v Bullock* 51 TC 522 commented on the classic statement 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.[10]

Buckley LJ said at p.540:

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

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

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

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

> 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.

And crucially:

> 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.[11]

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 hoped to return home to 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.[12]

This may be contrasted with *Furse v IRC* where the taxpayer intended to live in England for the rest of his life except 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 held to be too insubstantial:

> That contingency is altogether indefinite. It has no precision at all. A man's idea of an active physical life is likely to contract with the years. At the age of 80, after 40 years in England, the testator was still living at West Hoathly and, although he had been ill, he had no firm plans at all for leaving England.
>
> The testator's expressed intention, it seems to me, depended entirely on his own assessment of whether an ill-defined event had occurred. I think it really amounted to no more than saying, 'I will leave England when I feel I want to leave England'. That is substantially the same as Buckley LJ's example of the man who says he will leave 'when I've had enough of it'.[13]

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

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

13 [1980] STC 596 at p.604.

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

> 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.[14]

Tax may be relevant to 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, they 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 continues to allow a remittance basis, they would not acquire a domicile of choice here.

### 2.4.3 *Proof of intention*

In the event of a dispute the court must determine what is or was the individual's intention. In order to do so the court will have regard to every factor which might shed light on the individual's intention – except registration and voting as an overseas elector (which will be ignored in a tax appeal unless the taxpayer wishes otherwise).[15]

The burden of proof lies on HMRC to show that an individual has acquired a UK domicile of choice. The courts regard the acquisition of a domicile of choice as a serious matter which is to be found only on clear and compelling evidence.[16] However, "the importance of onus of proof is easily exaggerated. While the burden of proof always exists, few

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14 [1980] STC 596 at p.604.

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

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

substantial cases turn upon it and in making their factual findings the judge is usually expressing their considered judgment as to what in truth occurred".[17] If that is right, the reform often proposed of amending the burden of proof in domicile cases will have no practical effect.

## 2.5 Retaining foreign domicile of origin while UK resident

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

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

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

The individual should if possible retain ties with their country of origin. There are many ways by which they might do so and they 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.[18] 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 if appropriate express a desire to be buried in that country. The declaration should be drafted in accordance with the individual's specific circumstances; a standard form declaration of domicile is inadequate.[19]

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

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

19 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

Conversely, the individual's social and business commitments in the UK should be minimised. The purchase of a home in this country might indicate a greater degree of permanence than rented accommodation, but purchasing a property may imply nothing more than an intention of medium-term residence. The development of other long-term commitments to the community, such as changing one's 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 country. If that is the country of residence it might indicate an intention to remain in that country for the rest of the individual's life. If the burial plot is in the country of origin it provides some evidence of an intention to return home in due course. However, this is not necessarily a matter which carries much weight and if done at the suggestion of a tax advisor, it carries no weight at all.

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

### 2.5.1 *Involvement in politics*

The general rule is that involvement in UK politics is compatible with a non-UK domicile though it is a factor to be taken into account in ascertaining domicile. However, MPs and members of the House of Lords are deemed UK resident and domiciled[20] and the position of other foreign domiciled politicians is politically fraught.[21]

The rule that only a UK resident and domiciled person may make a gift

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precedents, see Kessler & Sartin, *Drafting Trusts & Will Trusts* (10th edn, 2010) para 18.23 (Best form of will for foreign domiciled testator).

20 See App2.1 (Tax status of MPs and members of the House of Lords).

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

(above a nominal amount) to a political party[22] is a further restriction on the rights of non-residents and foreign domiciliaries to engage in UK politics.

## 2.6 Acquisition of foreign domicile of choice

The domicile rules are favourable to foreign domiciliaries since they 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 their UK domicile of origin by the acquisition of a foreign domicile of choice. Such a person must not only reside in that other country; they must maintain and manifest their intention to remain resident there permanently.

An individual cannot shed their 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 must not be the chief residence

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

> ... Sir Charles was ... unhappy in Monaco and often said that he would really like to return to England permanently and accept the tax consequences. [A witness] asked him why he had decided to go there when all his interests were elsewhere. Sir Charles said that he did not know and that he was thinking of changing his mind and returning to live in England... he did not feel at home in Monaco.[23]

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

In order to acquire a domicile of choice in a jurisdiction, one must *want*

22 Section 54 Political Parties, Elections and Referendums Act 2000 (as amended by the Political Parties and Elections Act 2009).

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

to live there. If a UK domiciliary has plans of a business or personal nature which lead them to want to settle abroad, then acquiring a foreign domicile may be feasible. Links with the UK must be kept to a minimum, particularly at first, and the facts must be clear. Fawcett concluded in 1985 that an unspoken policy of not allowing individuals with a UK domicile of origin to escape UK taxes was influential in determining the result in domicile cases[24] and subsequent cases suggest this is still true.[25]

## 2.7 Loss of domicile of choice

Dicey states:

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

For the meaning of "reside" and "indefinitely" see 2.4 (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.[26]

The concern of a person who has a UK domicile of origin but has acquired a foreign domicile of choice is that they may lose their domicile of choice. They must:

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

## 2.8 Dual residence and domicile

The tests of residence and intention to reside are straightforward if a

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

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

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

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

### 2.8.1 *Acquisition of domicile of choice by dual resident*

In *Udny v Udny* 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.[27]

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

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

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

> ... 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.[28]

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27 (1869) LR 1 Sc & Div App 441 at p.458. (Emphasis added.)

28 "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 where the expression used is "principal home". The concept is similar to the OECD tie-breaker test of "centre of vital interests."

## 2.8.2 *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 2.8.1 (Acquisition of domicile of choice by dual resident).

(2) *Loss of domicile of choice.* There are two ways to "lose" a domicile of choice:
   (a) by acquiring a new domicile of choice;
   (b) by abandonment without acquiring a new domicile of choice.

The judge here is considering acquisition of a new domicile of choice.[29] The passage (so far as it relates to a domicile of choice replaced by a new domicile of choice) correctly states the point made at 2.8.1 (Acquisition of domicile of choice by dual resident) above.

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In *IRC v Duchess of Portland* 54 TC 648, Nourse J said that the test was, in which of the two countries did the individual reside "as an inhabitant". That comes to the same thing, but to ask which of the two countries is the chief or principal residence is a much clearer and more direct way to approach the question.

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

What is the test for abandonment of a domicile of choice (without acquiring a new domicile) in a dual residence context? It is considered that 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) they cease to reside there as their chief residence; and

  (b) they cease to intend to reside there as their chief residence.

(3) T does not acquire a domicile of choice elsewhere.

This is consistent with the test of acquisition of domicile: see 2.8.1 (Acquisition of domicile of choice by dual resident).

### 2.8.3 *Which is the "chief" residence?*

The next question is exactly how one ascertains which of two competing residences is the chief one. There is 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 days:

> [Counsel for the taxpayer] submitted that the commissioners paid no regard to anything except the relative amounts of time which the taxpayer spent in England and Guernsey during the years in question. They ignored the quality of her presence in each country: the fact that she was in England solely for the purpose of education and in Guernsey because it was her family home. I do not think that this is a fair reading of the commissioners' decision. They set out at length the taxpayer's ties with Guernsey and her reasons for remaining in England. In deciding whether the house in St. Peter Port had become her chief residence, they said:
>
> > "We accept the [taxpayer's] evidence that she likes Guernsey and enjoys the amenities of the island when she is there, quite apart from enjoying the company of her family ... We do not underestimate the part which Guernsey plays in her thinking.."

> Nevertheless they said that these considerations did not outweigh the fact that the taxpayer had resided for the greater part of the year in England and that there had been no "break in the pattern" which would justify a finding that she had ceased to have her chief residence in England. She had not, to use the language of Lord Hatherley in *Udny v Udny*, LR 1 Sc & Div 441, settled in Guernsey.
> I think that this was a conclusion to which the commissioners were on the evidence entitled to come. I go further and say that in my judgment it was the right conclusion. If the taxpayer had in 1980 broken altogether with England and settled in Guernsey like her mother and sister and then, even after a relatively short interval, returned to England for study, the quality of her presence here might have been such as to prevent a revival of her domicile of origin. But the fact is that she has not yet settled in Guernsey, and the reasons why she has been unable to do so are in my view irrelevant. When there is no competing place of continuing residence, settlement may be established by presence for a very short time; even for a single day. But an inference of settlement from a short stay is difficult to draw when the person in question divides his physical presence between two countries at a time. To treat the house in Guernsey as her chief residence simply because it is the sole residence of her mother and sister would in my view be attributing to her a kind of quasi-dependent domicile for which there is no legal justification. And the fact that the taxpayer may intend to settle in Guernsey after her education and training are completed and then to remain permanently is not sufficient to give her a proleptic domicile of choice.[30]

## 2.9 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

30 Likewise *Barlow Clowes International v Henwood* [2008] EWCA Civ 577 at [104]: "[The] test of chief residence ... cannot simply be a reference to the main home in terms of size or amenities. Nor can it be a reference to the home in which the subject spends the most time. The court has to look at the quality of the residence in order to decide in which country the subject has an intention to reside permanently."

> 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.[31]

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 they 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.[32] If, say, an individual comes to England who is housebound and needs long-term care, or because the weather in Bournemouth is better for their health than Falkirk,[33] the individual may acquire an English domicile; it depends of course on intention in each case.

## 2.10 Domicile and citizenship

### 2.10.1 *Retention of existing citizenship*

In *IRC v Bullock*, the court said:

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

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31 (1863) 10 HLC 272 at p.292. In *Udny v Udny* (1869) 1 LR Sc & Div 441, Lord Westbury said at p.458:

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

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

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

> of the circumstances properly to be taken into consideration in deciding whether he acquired a UK domicile.[34]

Similarly, in *Gaines-Cooper* the Commissioners noted that the taxpayer retained British citizenship, and did not apply for citizenship in the Seychelles.[35] Perhaps more significantly, his wife applied for British citizenship.

2.10.2 *Change of citizenship*

Similarly the House of Lords have said:

> Naturalisation is one thing; change of domicile is another: it is not the law either that a change of domicile is a condition of naturalisation, or that naturalisation involves necessarily a change of domicile.[36]

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

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

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

> his intentions are such that, in the event of a certificate of naturalisation as a British citizen being granted to him, his home or (if he has more than one) his principal home will be in the UK.[37]

A person whose intention is that *their home will be in the UK* will generally acquire a UK domicile of choice. Although conceptually the requirement that ones "home is in the UK" is distinct from, and might fall

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34 51 TC 522 at p.540. The point was also made in *Udny v Udny* 1 Sc & Div 441 at p.452: "The question of naturalization and of allegiance is distinct from that of domicile;" similarly at p.457.

35 *Gaines-Cooper v HMRC* [2008] STC 1665 at [141].

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

37 See Sch 1 British Nationality Act 1981.

short of, an "intention to reside in the UK permanently or indefinitely" (in the domicile sense) the gap is exiguous and for practical purposes someone who has the one intention will have the other.

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

(1) In *F v IRC*[38] the individual lied in his naturalisation application; in the circumstances he did not acquire a UK domicile of choice.

(2) A person who intends to their home to be in the UK might not have decided whether to reside in England, Scotland or Northern Ireland: one cannot acquire a UK domicile of choice unless and until one intends to reside in one specific jurisdiction. However, in practice this will rarely if ever arise, since a person who intends their home to be in the UK (and by the time that they have made an application for naturalisation) will normally have decided where in the UK that home is to be.

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

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

In some cases an applicant for naturalisation is not required to intend that their home will be in the UK. This was the case under the pre-1981 law and is sometimes the case under the present law.[39] In these cases it is strictly speaking consistent to say that the individual, though a naturalised citizen, may not necessarily have acquired a UK domicile of choice. However the fact of naturalisation still tends to suggest that the individual has formed the intention to live in the UK permanently: the issue is one for the Tribunal to decide in the light of all the facts.

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

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38 [2000] STC (SCD) 1.

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

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

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

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

See Sch 1 British Nationality Act 1981.

mislead.

*Wahl v Attorney-General* concerned an individual naturalised under the Naturalization Act 1870. Naturalisation then required an intention to reside in the UK. However in his application he went further and declared that he intended to reside permanently in the UK and had no intention of permanently leaving the UK. The House of Lords somewhat implausibly[40] found nevertheless that he did not intend to make his home in the UK and did not acquire a UK domicile of choice. But that was a finding of fact (not law) which depended on all the facts of the case.[41]

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

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

And again:

> Now, it is true that in *Wahl v Attorney-General* a similar application and a statement in somewhat similar terms were regarded by the majority of the House of Lords as not affording any strong evidence of intention to reside permanently in England; but Lord Macmillan, in a dissenting speech, was of opinion that considerable weight should be attached to these matters, and Lord Atkin, who was one of the majority, said, at page 385: "I am far from saying that an application for naturalisation is not a

40 (1932) 147 LT 382; [1938] All ER 922 accessible *www.kessler.co.uk*. Lord Macmillan dissented and the failure of the mainstream law reports to report the case may be taken as tacit disapproval.

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

> matter to be carefully considered as part of the evidence in a case of domicile"; and the opinion of Lord Atkin was entirely concurred in by Lord Dunedin. In those circumstances, it appears to me that the Special Commissioners acted entirely properly in taking into account the fact of the application for naturalisation, to which they indicated that they did not attach great weight, and further in taking into account the statement made as to the applicant's intentions as to residence.[42]

### 2.10.5 *Commentary*

Naturalisation involves entering into a reciprocal relationship by which an individual offers loyalty to the state in exchange for protection.[43] It is suggested that there should be a rule that naturalised citizens are deemed to be UK domiciled for UK tax purposes. On this point tax exemption for foreign domiciliaries could without difficulty be better targeted. Of course this would only affect the minority of naturalised citizens (I do not know how small but there are apparently some[44]) who are not UK domiciled under general principles.

This would also reverse the unsatisfactory result in *F* (who was held not UK domiciled because he lied about his intentions in his naturalisation application).[45]

## 2.11 Refugees, illegal immigrants and temporary visas

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

A person in a country illegally may become domiciled there, though the illegality is a factor in deciding whether they have a genuine intention of remaining there.[46]

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42 49 TC 13. For completeness, *Wahl* was cited in *F v IRC* [2000] STC (SCD) 1 but *Steiner* was not cited and *F* has nothing to add.

43 See *Citizenship: Our Common Bond* (the Goldsmith report), 2008, accessible *www.justice.gov.uk/reviews/docs/citizenship-report-full.pdf*.

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

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

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

In *Barlow Clowes International v Henwood*:

> He was not able to live there on a permanent basis without the permission of the Mauritian government. His residence was ... in that sense precarious. This does not make it impossible for him to acquire a domicile of choice in Mauritius but makes it less likely that he did so.[47]

## 2.12 Married women

### 2.12.1 *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.

Although a wife does not automatically acquire the domicile of her husband, the decision to marry 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.[48]

### 2.12.2 *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:

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47 [2008] EWCA Civ 577 at [119].

48 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* [2008] STC 1665 at [46] [47].

> 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 wife's domicile of dependency was held unconstitutional[49] and it is an interesting question whether the English transitional provision is consistent with the Human Rights Act 1998. In practice the issue may never arise.

### 2.12.3 *Marriage ended before 1 January 1974*

In *Re Wallach*[50] a widow died five days after the death of her husband. The judge held that a married woman retained her domicile of dependency when the marriage ceased, unless and until she changed it (by abandonment or by acquisition of a new domicile of choice).

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.[51] 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.

49 *JW v JW* (1992) 4 Irish Tax Reports p.437.
50 [1950] All ER 199.
51 *IRC v Duchess of Portland* 54 TC 648 at p.655.

### 2.12.4 *Woman a US national*

The US/UK DTA[52] undoes the domicile of dependency for a woman who is a US national. Article 4(6) of the treaty provides:

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

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

> under UK law, a female US citizen who married a UK domiciliary male before January 1, 1974, does not have the same opportunity to prove a domicile outside the UK as does a male US citizen who married a UK domiciliary female before January 1, 1974. Paragraph 6 of the Convention equalizes the treatment of male and female US citizens in this situation.[53]

Perhaps this reflects a cultural difference, a greater sensitivity to gender equality issues in the US. This rule does not however apply where a *UK* woman marries a *US* man before 1 January 1974. In that case the woman keeps her domicile of dependency. In this situation a woman is in a better position than a man.

## 2.13 Child's domicile of dependency

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

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52 The USA IHT DTA does not contain the same rule.

53 Department of the Treasury Technical Explanation of the Convention.

### 2.13.1 *Child's domicile in England and Northern Ireland*

Dicey states:

> Subject to [s.4 Domicile and Matrimonial Proceedings Act 1973 discussed below] the domicile of an unmarried child under sixteen is determined as follows:
> (1) the domicile of a legitimate child is, during the lifetime of his father, the same as, and changes with, the domicile of his father;
> (2) the domicile of a legitimated child is, from the time at which the legitimation takes effect, during the lifetime of his father, the same as, and changes with, the domicile of his father;
> (3) the domicile of an illegitimate child and of a child whose father is dead is, in general, the same as, and changes with, the domicile of his mother;
> (4) the domicile of a legitimate or legitimated child without living parents, or of an illegitimate child without a living mother, probably cannot be changed;
> (5) the domicile of an adopted child is determined as if he were the legitimate child of the adoptive parent or parents.[54]

Section 4 Domicile and Matrimonial Proceedings Act 1973 provides:

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

54 Conflict of Laws, 14th ed, para 6R-090.

independent domicile.
(6) This section extends to England and Wales, Scotland[55] and Northern Ireland.

### 2.13.2 *Child's domicile in Scotland*

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

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

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

It is an interesting, important and unresolved question whether this reform of the law of domicile applies for the purposes of taxation. It is considered that it does not, since the Scottish Parliament has (with immaterial exceptions) no jurisdiction in relation to taxation. It might be argued that a reform of the general law, which merely has an incidental consequential effect on taxation, is within the power of the Scottish Parliament.[56] But then what is the position of a person who is UK domiciled under English law principles but not under Scots law (or vice versa)? Probably the tax position would depend on whether the case were litigated before a Scots or an English Tribunal; or else some system of

55 Schedule 3 Family Law (Scotland) Act 2006 repeals this section in relation to Scotland. However see below on whether this has effect for the purposes of taxation.
56 Note that when the Scottish Parliament amended the Scots law of charity, it provided that the new law did not apply for taxation purposes: see Kessler & Brown, *Taxation of Charities and Non-Profit Organisations*, (8th ed., 2011), para 2.17 (Scots law definition of charity).

priority would need to be devised as a judicial ad hoc solution. Neither is satisfactory. Admittedly, the same problem could in theory have arisen even before the 2006 Scots law, but in practice it probably never did.

The RDR manual para RDRM22120 assumes that the Scottish provision does have effect for tax purposes. It is possible to envisage circumstances where a taxpayer may wish to argue the opposite, but perhaps fortunately, that will not often arise.

## 2.14 Republic of Ireland/Northern Ireland

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

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

In *Re M*[57] the question arose concerning a person's domicile prior to the partition of Ireland in 1922. A person who lived all their life in what is now Northern Ireland was held to be domiciled in the part of the divided territory in which they had resided.

## 2.15 HMRC rulings and domicile investigations

There is no statutory rulings procedure.[58] HMRC formerly provided an informal rulings service but that was cut back in HMRC Brief 17/09 and abolished in HMRC Brief 34/10. The official reason for the change of practice was as follows:

> The publication of our new guidance on domicile, plus the fact that from 2008-09 onwards a claim to the remittance basis is no longer mandatory, and must be made on a year by year basis where an individual has unremitted foreign income or gains of £2,000 or more arising in the tax year, mean that HMRC will no longer accept initial non-domicile claims on form DOM 1 or form P86. Form DOM 1 is being withdrawn

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57 [1937] NI 159. This was followed in *Re P* [1945] Ir Jur Rep 17.

58 The ruling procedure for ordinary residence and domicile in ss.42 and 43 ITEPA and s.9(2) TCGA was repealed in 2008. It is a matter of speculation, but perhaps the decision to withdraw the informal residence and domicile rulings procedure had already been made at that stage (though not implemented until a year later).

> completely. It will be replaced by the new comprehensive domicile guidance mentioned above that will allow the vast majority of people to self assess their own domicile status.

The true reason was no doubt that the former rulings procedure was judged not to be efficient use of limited HMRC resources.

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

### 2.15.1 *Effect of old HMRC rulings*

HMRC Brief 17/09 provides:

> Where an individual has already submitted a form DOM 1 or P86 and obtained an initial view from HMRC about their domicile status it will be unusual for us to open an enquiry into domicile status in the few years after that, unless new information becomes available that indicates our initial view was incorrect or there has been a change in circumstances. However with the passage of time, circumstances and intentions change and so that initial view from HMRC can become less and less useful as an indicator of domicile status. For example if an individual had advised HMRC on their arrival in England a decade or so ago that they planned to leave the UK after five years but had since married, had a family and decided to make England their permanent home then they will have adopted a domicile of choice within the UK.
>
> **Domicile and Inheritance Tax**
>
> ... As is currently the case, where HMRC has expressed an opinion on the domicile status of a settlor for Inheritance Tax purposes we will not normally seek to reconsider that opinion unless new information becomes available that indicates our initial opinion was incorrect or there has been a material change in the circumstances of the settlor. However, when we make a decision it applies only to the date of the transaction concerned. So if circumstances change, the individual returns to the UK for example, that individual's domicile may need to be considered again at another point in time. Domicile is not a static thing, it can change as people's circumstances and intentions change.
>
> ... Where HMRC has expressed a view on an individual's domicile status for income tax or capital gains tax purposes, as a result of an enquiry, then that view will also apply for Inheritance Tax purposes at that time. Likewise a HMRC view expressed for Inheritance Tax purposes,

following a Part VIII IHTA enquiry, will also apply for income tax and capital gains purposes at that time. However, it is important to remember that each decision on domicile will be made at a certain point in time, if circumstances have changed since the time of the relevant decision, the domicile of the taxpayer may also have changed.

### 2.15.2 *When will HMRC make domicile enquiries*?

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

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

HMRC Brief 34/10 provides:

> In future HMRC will consider opening an enquiry where domicile could be an issue, or making a determination of Inheritance Tax in such cases, only where there is a significant risk of loss of UK tax.
> The significance of the risk will be assessed by HMRC using a wide range of factors. The factors will depend very much on the individual case but will include, for example:
> - a review of the information available to HMRC about the individual on HMRC databases
> - whether there is a significant amount of tax (all taxes and duties not just Inheritance Tax) at risk
>
> HMRC does not consider it appropriate to state an amount of tax that

would be considered significant, as the amount of tax at stake is only one factor.[59] It should be borne in mind that HMRC will take into account the potential costs involved in pursuing an enquiry, and also those of potential litigation should the enquiry not result in agreement between HMRC and the individual; clearly such costs can be substantial.
Where HMRC does open an Inheritance Tax enquiry in any of these cases, it will keep the factors in view and may stop the enquiry at any stage if it considers the continuation of the enquiry is not cost effective. The outcome of such an enquiry may be that HMRC does not consider it appropriate to make a determination of the Inheritance Tax.
Individuals should also bear in mind that enquiries into domicile involve a detailed inquiry into all of the relevant facts and HMRC is likely to require considerable personal information and extensive documentary evidence about the taxpayer and the taxpayer's close family.

### 2.15.3 *How HMRC investigates domicile*

HMRC Brief 17/09 provides:

> Enquiries aimed at establishing an individual's domicile are, by their very nature, examinations of an individual's background, lifestyle, habits and intentions, possibly over the course of a lifetime. Consequently, any such enquiries conducted by HMRC will, where necessary, extend to areas of individuals' and their families' affairs that may not normally be regarded as relevant to their UK tax position. As a result of some feedback from customers on such domicile enquiries our new domicile guidance includes a section starting at paragraph 49600 [now the RDR Manual 23070] which explains the nature of a domicile enquiry and the sorts of questions an individual will need to answer as part of that enquiry.

The RDR Manual provides:

> **RDRM23080 - Domicile: Enquiries into domicile status: Schedule of useful information and documents**
> The list below shows the types of information that might be requested during an enquiry. It should not be regarded as either prescriptive or comprehensive, and the individual may offer other relevant information or evidence for consideration too.

59 [Authors footnote] This is obviously less than frank; the true (and perfectly proper) reason to withhold this information must be to prevent fraud.

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

**Information**

Date of birth.

Full name at birth.

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

Place of birth, identifying the relevant law territory.

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

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

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

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

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

Information about any adoption proceedings.

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

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

Details of siblings

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

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

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

Summary of educational background, including places of education, periods of attendance and qualifications obtained.

Details of military service.

Details of governmental or diplomatic service.

Summary of employment and/or business history.

Explanation of employment and/or business plans, including anticipated retirement, and any arrangements that are in place in respect of these matters.

A detailed summary of properties that have been available for use other than as short-term holiday lettings. This should include the addresses of all the properties, a description of them, details of their ownership, the periods during which the properties have been available, and an explanation of how they have been used when not occupied by the individual.

Details of all marriages, civil partnerships, separations and divorces, including information relating to other relationships involving long-term cohabitation. These should cover the full names of any relevant parties, their dates, places of birth and nationalities, the periods during which the relationships existed, the dates of any formal acts or ceremonies, information relating to the domicile of the other parties, and explanations of any periods during which the parties to the relationship did not live together.

Information about transfers of property, including those between spouses or civil partners.

A summary of the names, dates of birth and nationalities of the children of the individual.

Details of where any children were educated.

The current locations of any children and the relevant background.

Information relating to the exercise of political rights in any territory, as either a voter or a representative.

Membership of any political parties, or participation in campaigns or lobbying groups, and the extent of any activities.

Details of professional qualifications, membership of professional bodies and active participation in these, including offices held.

Summary of membership of clubs, societies, associations, organisations and other bodies, and details of the level of participation in these.

Information about any representative activities undertaken on behalf of a country, territory, or any political, territorial or other sub-division thereof.

The location of personal papers and any items of financial, sentimental or other value. If such items are moveable, the place where they are usually kept and details of any insurance policies in respect of them.

Details of any wills, including an explanation of the law by which the will is intended to be construed and upon which it relies for its formal validity.

Summary of any deeds, declarations, covenants and similar documents created, including those relating to dependants.

Information relating to any legal proceedings or other matters in which domicile was relevant, either as a basis for any action or as an evidential point.

Locations of members of the extended family, including a description of the relationship between the individuals.

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

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

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

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

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

**49620**

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

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

Birth certificates
Adoption papers
Registrations of name changes
Marriage certificates
Civil Partnership certificates
Passports and identification documents
Social security documents
Applications for nationality (citizenship)
Documents renouncing nationality (citizenship)
Visas, residence permits, work permits and similar documents
Driving, firearms and other licences
Practising certificates and authorisations from professional or regulatory bodies
School records and reports
Examination certificates
Military service records
Employment contracts
Business accounts, reports and planning documents
Conveyances, leases, tenancy agreements and other documents relevant to the ownership, occupation or use of property
Mortgage and loan agreements
Health insurance policies
Property, motor and other insurance policies
Life assurance policies
Documents relating to savings, retirement and pension plans
Wills, expressions of wishes, deeds of covenant and other legal documents
Personal financial records, including bank account and credit card statements and documents relating to investments
Documents confirming membership of or participation in organisations and activities
Personal correspondence, photographs or electronic records relating to an individual's background, lifestyle and intentions

This is a daunting list, but forewarned is forearmed.

## 2.16 Domicile of company

The domicile of a company is where it is registered, which is the place of incorporation.[60] Domicile of a company is only rarely significant for tax or any other purpose.

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

CHAPTER THREE

# RESIDENCE OF INDIVIDUALS

## 3.1 Why do residence and ordinary residence matter?

Residence is fundamental to the territorial limitations of income tax and CGT. It is not possible to give a full list but the most important are:
(1) Income tax on foreign income is limited to UK residents.
(2) Income tax on certain UK source income is limited for non-residents.
(3) Capital gains tax is limited to UK residents.[1]
Ordinary residence does not matter as much as residence. The main differences (all advantages) for an individual who is resident but not ordinarily resident in the UK (compared to one who is resident *and* ordinarily resident) are as follows:
(1) The transfer of assets abroad provisions do not apply.[2]
(2) Different employment income rules apply.[3]
(3) The RFI remittance basis applies even if UK domiciled.[4]
(4) Different NIC rules apply.[5]
(5) FOTRA securities qualify for IT and IHT exemptions.[6]
Residence is also important for non-tax purposes, such as jurisdiction.

### 3.1.1 *Cross references*

This chapter considers residence of individuals: see too 4.1 (Residence of trustees); 5.1 (Treaty-residence); 36.8 (Residence of partnership); 67.3

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1 See 15.1 (Savings and Investment Income), 12.1 (Employment income), 37.1 (Limitation on liability for non-residents) and 43.1 (Capital gains tax on individuals).
2 See 25.1 (Transfer of assets abroad: introduction).
3 See 12.1 (Employment income).
4 See 9.5 (Who qualifies for the remittance basis?).
5 See 42.5 (ROW: employed in GB); 42.6 (ROW: residence requirements).
6 See 53.4 (Non-settled property: FOTRA Securities).

(Residence and domicile of PRs for CGT) and 68.2 (Residence of PRs for IT).

Residence of companies is a subject which deserves to be addressed in length and depth. I omit it here as it is well covered elsewhere.[7]

For MPs and members of the House of Lords, see App. 2.1 (Residence and domicile of MPs and members of the House of Lords). For visiting forces, see App. 3.1 (Residence of visiting forces).

## 3.2 The concepts of residence and ordinary residence

### 3.2.1 *Residence is a status*

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

### 3.2.2 *Residence during part of tax year*

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

(1) Sometimes it is used to describe a status which one has (or does not have) at a particular moment of time.[8]

(2) Sometimes it is used to describe a status which one has (or does not have) during a period of time. The period need not coincide with a

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7 For HMRC views see SP 1/90 and the International Tax Handbook chapters 3 and 4. For an important statement of judicial views, see Chadwick, "Control of Special Purpose Vehicles" [2007] Jersey & Guernsey Law Review 153 accessible *www.jerseylaw.je/Publications/jerseylawreview*. For general studies, see Couzin, *Corporate Residence and International Taxation* (2002); Brandon *Taxation of Non-UK Companies and their Shareholders* (2$^{nd}$ ed, 2002) and for historical perspective, see John Avery Jones "Jurisdiction to Tax Companies" in Tiley (ed.) *Studies in the History of Tax Law* (Vol 4, 2010) accessible *www.kessler.co.uk.*

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

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

For a tax example see 6.16.1 (Section 13).

tax year.[9]

I have considered whether the term is ever used to describe a status which one must have (or not have) specifically for the period of a tax year. Under this usage one could not cease to have the status of resident during a tax year: residence could only change at the beginning or end of a tax year. But I think this is not the case. There is of course a rule that someone who is resident in part of a tax year is strictly subject to income tax and GCT on income and gains arising in any part of the tax year, and the individual in this situation is sometimes said to be "resident *for* the tax year" (the language used in ESC A11).[10] But this does not mean that the individual has the status of resident throughout the year.[11] For instance, ESC A11 goes on to refer to "the period of residence here during the year" it is obviously using the word "residence" to describe a status which changes during a tax year.

If it matters (in practice the issue does not often raise difficulties) the context must determine which sense is meant. Sometimes the context makes it clear, eg s.13 TCGA applies if a person is resident at the time when the gain accrues to the company. Sometimes the context provides at least an inference, eg the CGT exit charge (which applies when the taxpayer ceases to be UK resident) applies at the time that the individual actually leaves, not at the end of the tax year.[12]

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

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

10 See 6.2.1 ("Residing in the UK in a tax year" and similar expressions).

11 See *Smallwood v HMRC* in the High Court [2009] STC 1222 at [31]:

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

The same applies for income tax, though the provisions are not so clearly drafted. The High Court decision was reversed on appeal but that does not affect this point.

12 See 7.2 (Clawback of holdover relief on emigration of individual), 7.4 (Exit charge for trusts), and 7.8 (Emigration of individual trader); presumably the usage of s.2 TCGA applies generally for CGT.

### 3.2.3 *Ordinary residence during part of tax year*

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

(1) to describe a status which one has (or does not have) at a particular moment of time, or during a period of time which need not coincide with a tax year.

(2) describe a status which one must have (or not have) specifically for a tax year. Under this usage one could not cease to be ordinarily resident during a tax year. Ordinary residence could only change at the beginning or end of a tax year.

But usage (1) is the normal meaning, and usage (2) would require a clear context to make it apply. It is considered that "ordinary residence", in an income tax or CGT context, is (in the absence of special context) a status which may change during a tax year. It is not a status which has to last an entire tax year.[13]

### 3.2.4 *The source of the concepts*

Given the centrality of the concept, it is surprising that there is nothing like a definition of "residence" in the legislation. Several statutory provisions impinge on the subject and residence has been discussed in a number of decisions by the courts. HMRC6 is also important, supplemented by other HMRC statements.

There is no statutory guidance on the meaning of "ordinary residence". Like simple residence, the meaning has been discussed in the case law and HMRC6 is important in practice.

This chapter first considers the statutory provisions, then the case law and then HMRC6.

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

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

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13 Thus in *Genovese v HMRC* [2009] STC (SCD) 373 the taxpayer was held to be resident throughout 2001/02 but became ordinarily resident on 1 October 2002.

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

## 3.3 Temporary UK purpose and 183-day rules

### 3.3.1 *Temporary UK purpose rule*

Section 831(1) ITA provides:

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

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

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

Two rules now follow:

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

Rule 1 goes on to specify an exotic set of provisions in inordinate detail.[16]

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

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

16 "(a) Chapter 4 of Part 9 of ITEPA 2003 (tax on foreign pensions),
(b) Chapter 5A of that Part (tax on pensions under registered pension schemes) but only if the income is an annuity under a registered pension scheme within para 1(1)(f) of Schedule 36 to FA 2004,
(c) Chapter 10 of that Part (tax on employment-related annuities),

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

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

The rule is vague because of the word "temporary". The words in s.831(1)(a)[ii] ("and with no view to establishing the individual's residence in the UK") should, I suggest, be regarded as a paraphrase or explanation of "for some temporary purpose only". The additional words do not clarify the matter at all. A definition or explanation of residence cannot be helpful if it uses the word "residence" without explanation, as happens here.

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

Section 832 ITA provides the identical rule (set out in full) for the

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(d) Chapter 15 of that Part (tax on voluntary annual payments),
(e) section 647 of ITEPA 2003 (meaning of 'foreign residence condition') but only in its application for the purposes of section 651 of that Act (which provides an exemption for tax under Chapter 14 of Part 9 of that Act), and
(f) Chapter 6 of Part 10 of ITEPA 2003 (taxable foreign benefits).

See sections 566 and 657 of ITEPA 2003 for the definitions of 'pension income' and 'social security income'."

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

"Para (e) of Rule 1 in subsection (2) applies only if—
(a) the individual makes a claim as mentioned in section 647(3)(a) of ITEPA 2003, and
(b) the Commissioners are satisfied that subsection (2) of this section applies in relation to the individual."

But all this is academic as the application of rule 1 never makes any difference in practice.

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

purposes of Chapters 4 and 5 Part 2 ITEPA (employment income). Note that the temporary UK purpose rule only applies for certain income tax purposes, and the question of residence may arise for other income tax purposes.[18]

### 3.3.2 *183-day rule*

Section 831(4) ITA provides:

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

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

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

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

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

18 For instance, residence may be relevant for the purpose of non-residents income tax relief; see 37.1 (Non-residents income tax relief).

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

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

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

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

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

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

| **Name of rule** | **Temporary UK purpose** | **183 UK days** | **Resident** |
|---|---|---|---|
| Temporary UK purpose rule | Yes | No | No |
| 182-day rule | Yes | Yes | Yes |

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

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

## 3.4 Occasional residence abroad rule

Section 829 ITA provides:

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

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

"Occasional residence abroad" is hopelessly vague in the modern world. But the rule, however vague, is consistent with the natural meaning of "residence" since someone leaving for occasional residence abroad (whatever that is) would not be said to be UK resident in the ordinary sense (whatever that is).

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

This rule applies "for the purpose of determining the individual's liability for income tax". If one can identify other purposes the rule would not apply to it. The collection of tax from a UK representative of a non-resident individual would be an example, but the point is academic.

## 3.5 Statutory residence rules and natural meaning of "residence"

If the temporary UK purpose rule applies, the individual is treated as non UK resident (for certain IT purposes). If the 183-day rule applies, the individual is treated as UK resident (for certain IT purposes). If the occasional residence abroad rule applies, the individual is treated as UK resident for the purposes of determining the individual's liability for IT (but not for other purposes, such as rules relating to collection of tax). The statutory residence rules are irrelevant for ordinary residence.

If this is taken literally, it creates an absurdly complicated situation. There are at least three classes of individual:

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

The only solution to this problem is to downplay the importance of the statutory residence rules. One could say that the sections should be regarded as laying down rules which apply for income tax generally. Then the enormously detailed list in s.831(2) specifying types of income which are affected is unnecessary and inappropriate. There is a hint of this approach in the former Inspectors Manual para 43 which provided:

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

But no distinction is drawn between residence for IT purposes and residence for NIC or jurisdiction purposes even though the latter have no equivalent statutory provisions. So the better view is that the statutory rules only state what would in any event be the normal meaning of residence. Then the statutory rules are entirely otiose.

If that is right, there is little point in considering separately "residence" in its ordinary meaning and then the statutory residence rules, as if they were separate and independent sets of rules.

In *Reed v Clark*, 58 TC 528, Nicholls J observes (at page 550 B):

> Despite the long history of the statutory provision now reproduced as s 49, [now s.829 ITA, the occasional residence abroad rule] the researches of very experienced Counsel have not revealed any reported decision in which a claim to tax has succeeded only by virtue of that provision. ...

The judge concluded that there was "little scope in practice" for the operation of the occasional residence abroad rule. There was no case where any of the statutory rules mattered from the inception of income tax until *Reed v Clark* in 1985; as far as I am aware there has been no case since then. It seems safe to say that such a case will never be.

## 3.6 Accommodation in the UK

### 3.6.1 *The supposed available accommodation rule*

It was formerly the official HMRC view that:

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

This is called "the available accommodation rule". John Avery Jones states tactfully that "it is difficult to see how the available accommodation rule ever arose".[20] More bluntly, the rule did not exist.[21] The supposed

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

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

20 [1993] BTR 286.

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

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

The rule was expressly rejected in *High Tech International v Deripaska* [2006] EWHC 3276 [2007] EMLR 15 at [25]; *Cherney v Deripaska* [2007] EWHC 965 (Com) [2007] ILR 49 at [45]; and *Yugraneft v Abramovich* [2008] EWHC 2613 (Comm) at [487]

> "Purchases of expensive property in England which, in the case of a man of ordinary wealth, would suggest settlement here, may have no such significance to someone for whom money is no object. Mr Abramovich's use of the Lowndes Square property ... does not indicate that ... it was his usual or settled place of abode. It was not then the place in which, even for limited periods, he habitually and normally resided for a settled purpose. It was a place to which he came when visiting London...".

How, then, did HMRC ever come to hold that the rule existed? I guess that the rule was abolished by statute, in two stages.

### 3.6.2 *Full-time workers abroad*

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

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

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

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

Section 830(2) requires a total disregard of available accommodation. It

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

22 This uses terminology discussed elsewhere: if s.830(2) mattered, see 12.13 (Where are duties performed: incidental duties); and 3.25.1 (Meaning of "work full-time abroad").

disapplies the available accommodation rule and disregards the accommodation for all purposes.

### 3.6.3 *Partial disregard of accommodation*

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

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

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

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

So one disregards available accommodation for the temporary UK purpose rule. But one does have regard to it for other purposes.[23] One purpose where one has regard to it is the occasional residence abroad rule.[24] Perhaps there are others. If this book is right that the temporary UK purpose rule is of nil or negligible importance, this was not the right way for Parliament to go about making the desired reform.

HMRC6 para 2.2 provides that one relevant factor in determining UK residence is:

> Property ties include a house or apartment that you own or lease, or property held primarily for investment but that also provides you with accommodation when you are in the UK. A house or apartment provided

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23 Except for full-time workers abroad.

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

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

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

> for your use for the duration of your time in the UK as part of an employment package is 'available accommodation' and is a tie to the UK.

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 abandoned: it is no longer suggested that one day's presence and accommodation is sufficient to amount to UK residence.[25]

## 3.7 CGT statutory residence rules

Section 9(1) TCGA provides:

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

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

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

25 See 3.37 (Longer-term visitors). This was HMRC's intention when enacting the legislation was similar but somewhat more precise. 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.

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

use.

There is no express CGT equivalent for the IT occasional residence abroad rule, but that arguably is incorporated into CGT by s.9(1) TCGA. However in *Hankinson* [2009] UKFTT 384 at [40] the argument was not raised, and the Tribunal considered that the occasional residence abroad rule did not apply for CGT:

> s 334 [ICTA now the occasional residence abroad rule] relates only to income tax. Section 9(1) TCGA 1992 does not in terms extend the application of s 334 to capital gains tax; s 9(1) simply adopts for capital gains tax purposes the meanings which the expressions "resident" and "ordinarily resident" have in the Income Tax Acts. [chargeability to CGT] therefore depends on the presence or absence of residence and/or ordinary residence examined under common law principles.

If this book is right that the occasional residence rule is of nil or negligible importance, it does not matter; if not, we would have the undesirable position that a person might be resident for IT purposes but not for CGT.

## 3.8 Case law on residence

A person who does not meet the 183-day rule may still be resident here, but in what circumstances? Since the statutory provisions do not give a clear answer we turn next to the case law. Tax residence case law is voluminous (the existence of voluminous case law is itself a sign that the law is in disarray). Case law on "residence" in non-tax statutes is also relevant, as it applies the "ordinary" meaning of residence and follows the principles of the leading tax cases.[27]

The leading cases are *Levene v IRC* and *Lysaght v IRC* 13 TC 486 and 511. They reflect conditions of life in the 1920s but are still the basis for modern decisions.

There have been two recent attempts to summarise the case law. The

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

first identifies eight points:

> [1] the concept of residence is not defined in the legislation; the word therefore should be given its natural and ordinary meaning (*Levene*).
> [2] 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*).
> [3] the question whether a person is or is not resident in the UK is a question of fact for the Special Commissioners (*Zorab*).
> [4] 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;
> [5] also, birth, family and business ties, the nature of visits and the connections with this country, may all be relevant (*Zorab*; *Brown*).
> [6] in general the availability of living accommodation in the UK is a factor to be borne in mind in deciding if a person is resident here (*Cooper*) (although that is now subject to [s.831(1)[B] ITA]).
> [7] the fact that an individual has a home elsewhere is not decisive, because a person may be dual resident (*Cooper* and *Levene*). However it may be a relevant factor (particularly if the home elsewhere is much more important).
> [8] 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*).

The second summary of case law identifies 13 points. Some relate to ordinary residence and some are covered by the above, but the following are worth noting separately:

> (iv) Residence in a place connotes some degree of permanence, some degree of continuity or some expectation of continuity: *Fox v Stirk* [1970] 2 QB 463; *Goodwin v Curtis* 70 TC 478;
> (v) However, short but regular periods of physical presence may amount to residence, especially if they stem from performance of a continuous obligation (such as business obligations) and the sequence of visits excludes the elements of chance and of occasion: *Lysaght v IRC* 13 TC 511...
> (xi) Although residence must be voluntarily adopted, a residence dictated by the exigencies of business will count as voluntary residence: *Lysaght v IRC* 13 TC 511;

(xii) The purpose, while settled, may be for a limited period; and the relevant purposes may include education, business or profession as well as a love of a place: *R v Barnet LBC ex p Shah* [1983] 2 AC 309;
(xiii) Where a person has had his sole residence in the UK he is unlikely to be held to have ceased to reside in the UK (or to have "left" the UK) unless there has been a definite break in his pattern of life: *Re Combe* 17 TC 405.

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

I deal with these points separately.

### 3.8.1 *Residence has its natural meaning*

[1] the concept of residence is not defined in the legislation; the word therefore should be given its natural and ordinary meaning (*Levene*).

It is an interesting question whether the UK courts have really succeeded in (what is said to be) the aim of identifying and applying the "natural and ordinary meaning" of the word residence. It is difficult (perhaps impossible) to assess the issue objectively, but I think the general public would be surprised how little was needed to constitute UK residence. This was also the view of the Canadian Supreme Court.[28]

### 3.8.2 *Settled or usual abode*

[2] 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

28 *Thomson v. Minister of National Revenue,* [1946] SCR. 209 at p.221, 224: ... *"Cooper v. Cadwaladar...* is the case of an American citizen living in the United States, who owned shooting rights in Scotland, where he spent a few months annually, and who was held liable in Scotland for income tax. I feel quite confident that no Canadian court, in similar circumstances, would hold that such a person... is a "resident" ... "it must, I think, be said that the language of "plain men" was stretched to the breaking point to encompass the facts that had been found by the Commissioners [in *Lysaght v IRC*] to be residence..."

or at a particular place" (*Levene*).

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[29] usual abode, to live in or at a particular place".

There follows a comment on (presumably short) absences:

> 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.[30]

Similarly:

> (iv) Residence in a place connotes some degree of permanence, some degree of continuity or some expectation of continuity: *Fox v Stirk* [1970] 2 QB 463; *Goodwin v Curtis* 70 TC 478;
> (v) However, short but regular periods of physical presence may amount to residence, especially if they stem from performance of a continuous obligation (such as business obligations) and the sequence of visits excludes the elements of chance and of occasion: *Lysaght v IRC* 13 TC 511...

### 3.8.3 *Purpose*

> (xii) The purpose, while settled, may be for a limited period; and the relevant purposes may include education, business or

29 *Yugraneft v Abramovich* [2008] EWHC 2613 (Comm) at [451] comments on the phrase "settled **or** usual place of abode": " I do not, however, read the decision of the court as using those adjectives antithetically, but rather as differently nuanced ways of saying much the same thing. This appears particularly so given that the court regarded the phrase as connoting some degree of permanence or continuity."

30 For a more recent restatement of the principle, see *Grace v HMRC* [2009] STC 213 at [6]: "Physical presence in a particular place does not necessarily amount to residence in that place where, for example, a person's physical presence there is no more than a stop gap measure: *Goodwin v Curtis* (1998) 70 TC 478, 510."

profession as well as a love of a place: *R v Barnet LBC ex p Shah* [1983] 2 AC 309;

### 3.8.4 *No home or establishment*

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

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

To live permanently in hotels was, I think, not unusual in the 1920s. It does not happen much now, but nowadays a house may be "not in the nature of home but a substitute for hotels".[31]

### *3.8.5 Question of fact*

> [3] the question whether a person is or is not resident in the UK is a

31 *Cherney v Deripaska* [2007] EWCH 965 at [45] "The 'quality' of the use of the house is, I think, equally important. In many ways its use by Mr Deripaska resembles that of a private hotel. It is infrequent, intermittent, and generally fleeting. The house has the character of continuity and permanence; its use does not. It cannot, I think, in any normal sense of those words, be described as a 'settled or usual place of abode' of Mr Deripaska."
Similarly, *Grace v HMRC* [2009] STC 213, Special Commissioners at [40]. This will need review when the decision is final.

question of fact for the Special Commissioners (*Zorab*).[32]

## 3.9 *Duration, regularity and frequency of visits*

[4] no duration is prescribed by statute[33] 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;

Similarly in *Lysaught:*

> My Lords, I think it is the shortness of the aggregate time during which Mr. Lysaght is here that constitutes the principal, though by no means the only point in his favour, but the question of a longer or a shorter time, like other questions of degree, is one peculiarly for the Commissioners. I do not say that time might not he so short, or again so long, as to make it right to hold, no matter what other evidence there was, that, as the case might be, there was either no evidence of residence or that the evidence was all one way in favour of it, but these questions are not before us.[34]

Similarly in *Reid*:

> In the *Wemyss* case, as here, 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

32 This point is made in many cases, eg *Lysaght v IRC* 13 TC 511 at p.534, 536.

33 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."

34 Viscount Sumner in Lysaught v IRC at p528.

consideration as the element of time, or the durability of the relation.[35]

### 3.10 *Birth, family and business ties*

[5] also, birth, family and business ties, the nature of visits and the connections with this country, may all be relevant (*Zorab*; *Brown*).

### 3.11 *Living accommodation*

[6] in general the availability of living accommodation in the UK is a factor to be borne in mind in deciding if a person is resident here (*Cooper*) (although that is now subject to [s.831(1)[B] ITA]).[36]

### 3.12 *Dual residence and foreign home*

[7] the fact that an individual has a home elsewhere is not decisive, because a person may be dual resident (*Cooper* and *Levene*).

However it may be a relevant factor (particularly if the home elsewhere is much more important).[37]

Viscount Cave considered dual residence in *Levine*:

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

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35 Reid v IRC 10 TC at p.679.

36 See 3.6 (Accommodation in the UK).

37 In *Gaines-Cooper* the Special Commissioners took a different view: “the fact that an individual has a home elsewhere is of no consequence.” But that view was tactfully (and correctly) rejected in *Grace v HMRC* in the Court of Appeal at [8]: “the proposition that a home elsewhere is of no consequence is not to be understood as meaning that the other home is entirely irrelevant to the necessary enquiry[!]. That would be inconsistent with the obligation to take into account all the facts of the case.”

effect is the case of *Loewenstein v de Salis* (10 TC 424).

### 3.13 *Difference between arrivers and leavers*

> [8] 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*).[38]

### 3.14 *Definite break*

> (xiii) Where a person has had his sole residence in the UK he is unlikely to be held to have ceased to reside in the UK (or to have "left" the UK) unless there has been a definite break in his pattern of life: *Re Combe* 17 TC 405.

### 3.14.1 *Presence must be voluntary*

> (xi) Although residence must be voluntarily adopted, a residence dictated by the exigencies of business will count as voluntary residence: *Lysaght v IRC* 13 TC 511.

The "voluntary" requirement does not have much practical role to play, as it only concerns imprisoned, kidnapped or shipwrecked taxpayers.[39]

## 3.15 Case law: ordinary residence

There are no statutory provisions on ordinary residence so case law is all we have. Since the statutory provisions on residence are entirely unhelpful, this is no bad thing.

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38 This passage (apart from [7]) is a quote from *Gaines-Cooper v HMRC* [2007] STC (SCD) 23 at [165]. That passage was an almost verbatim quote from *Shepherd v IRC* 78 TC 389 at [58] (Special Commissioner). The references are to *Levene v IRC* 13 TC 486; *IRC v Zorab* 11 TC 289; *Bayard Brown v Burt* 5 TC 667; *Cooper v Cadwalader* 5 TC 101.

39 "The residence must be voluntarily adopted. Enforced presence by reason of kidnapping or imprisonment, or a Robinson Crusoe existence on a desert island with no opportunity of escape, may be so overwhelming a factor as to negative the will to be where one is." *Shah* at p.344.

The leading case is *R v Barnet LBC ex p Shah.*[40] This is not a tax case but the expression "ordinary residence" has its natural and ordinary meaning which is the same in tax and non-tax contexts.[41]

In *Shah* the House of Lords noted that ordinary residence was distinct from domicile and rejected a "real home" test (which was similar to a domicile test).

What is the test? A number of dicta were approved, saying more or less the same thing in different words:

> I think that [ordinary residence] connotes residence in a place with some degree of continuity and apart from accidental or temporary absences.[42]

> "Ordinarily resident" refers to 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.[43]

The important requirement is the residence must have the degree of continuity, or in other words, it must be "for settled purposes." What does that mean?

> There must be a degree of settled purpose. The purpose may be one; or there may be several. It may be specific or general. All that the law requires is that there is a settled purpose. This is not to say that the "propositus" intends to stay where he is indefinitely; indeed his purpose, while settled, may be for a limited period. Education, business or profession, employment, health, family, or merely love of the place spring to mind as common reasons for a choice of regular abode. And there may well be many others. All that is necessary is that the purpose of living where one does has a sufficient degree of continuity to be properly described as settled.[44]

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40 [1983] 2 AC 309. The case is noteworthy for the fact that oral argument over the two words "ordinarily resident" lasted 9 days.

41 *Shah* at p.340.

42 *Shah* at p.341 citing Viscount Sumner in *Lysaght v IRC* 13 TC 511 at p.528

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

44 *Shah* at p.344.

### 3.15.1 *Accommodation*

*Turberville* at [9] notes that accommodation held long term is consistent with being non-ordinarily resident:

> We consider the retention of the house and flat in the UK as fairly neutral; he had retained these (or predecessor properties) throughout the time he was working abroad.

Accommodation is however a relevant factor in deciding whether a person is "settled".

### 3.15.2 *Minimum period before acquiring ordinary residence*

One would have thought that if a person settled in a country, they became ordinarily resident immediately. This is the view expressed in IR 20 and HMRC6.

In *Tuczka v HMRC* [2011] UKUT 113 (TCC) however the Upper Tribunal suggested that there was a minimum time (though the minimum is not very long):

> 12. ...After referring also to the dicta in the tax cases, Lord Slynn concluded that it was "plain that as a matter of ordinary language a person is not habitually resident in any country unless he has taken up residence and lived there for a period." Lord Slynn continued (at 1942G-1943B):
>
>> "It seems to me impossible to accept the argument at one time advanced that a person who has never been here before who says on landing, "I intend to settle in the United Kingdom" and who is fully believed is automatically a person who is habitually resident here. Nor is it enough to say I am going to live at X or with Y. He must show residence in fact for a period which shows that the residence has become "habitual" and, as I see it, will or is likely to continue to be habitual...
>>
>> The requisite period is not a fixed period. It may be longer where there are doubts. It may be short (as the House accepted in In *re S (A Minor) (Custody: Habitual Residence)* [1998] A.C. 750, my speech at p. 763A, and *In re F (A Minor) (Child Abduction)* [1992] 1 FLR 548, 555, where Butler-Sloss L.J. said: "A month can be ... an appreciable period of time")."
>
> 13. Even assuming for the purpose of argument that "habitually" and

> "ordinarily" mean the same thing, we do not regard *Nessa* as in any way departing from Lord Scarman's clear rejection of any requirement to establish an intention to reside permanently or for an indefinite period. All that *Nessa* established in that regard is that a person would not qualify as "habitually resident" immediately on arrival, save in a case where he resumed his previous habitual residence. Some period of time is therefore needed to establish "habitual residence". But the fact that this period need not be long can be seen not only from Lord Slynn's reference to the observation of Butler Sloss LJ quoted above but from the resolution of the Nessa case itself. The House of Lords upheld the decision of the Court of Appeal that the case be remitted for rehearing before a social security appeal tribunal to determine whether the claimant had established habitual residence by the date of the initial tribunal hearing (ie, 6 December 1994, and thus less than four months after her arrival in the United Kingdom) or "even earlier": see at 1943D.

This overlooks the fact that the question of ordinary residence is determined with an element of hindsight: see 3.16 (The relevant period of investigation). It is considered that there is no minimum period.

### 3.15.3 *Intention*

In *Shah,* Lord Scarman said:

> There are two, and no more than two, respects in which the mind of the "propositus" is important in determining ordinary residence. The residence must be voluntarily adopted. Enforced presence by reason of kidnapping or imprisonment, or a Robinson Crusoe existence on a desert island with no opportunity of escape, may be so overwhelming a factor as to negative the will to be where one is.

I have already discussed "voluntarily." The speech continues:

> And there must be a degree of settled purpose. The purpose may be one; or there may be several. It may be specific or general. All that the law requires is that there is a settled purpose. This is not to say that the "propositus" intends to stay where he is indefinitely; indeed his purpose, while settled, may be for a limited period. Education, business or profession, employment, health, family, or merely love of the place spring to mind as common reasons for a choice of regular abode. And there may well be many others. All that is necessary is that the purpose

> of living where one does has a sufficient degree of continuity to be properly described as settled. The legal advantage of adopting the natural and ordinary meaning, as accepted by the House of Lords in 1928 and recognised by Lord Denning M.R. in this case, is that it results in the proof of ordinary residence, which is ultimately a question of fact, depending more upon the evidence of matters susceptible of objective proof than upon evidence as to state of mind. Templeman L.J. emphasised in the Court of Appeal the need for a simple test for local education authorities to apply: and I agree with him. The ordinary and natural meaning of the words supplies one. For if there be proved a regular, habitual mode of life in a particular place, the continuity of which has persisted despite temporary absences, ordinary residence is established provided only it is adopted voluntarily and for a settled purpose.

In *Tuczka v HMRC* [2010] UKFTT 53 the tribunal said:

> The test requires objective examination of immediately past events, and not intention or expectation for the future ([1983] 2 AC 309 at 345).

It is considered that the concept of being "settled" necessarily requires an examination of intention or expectation for the future.

### 3.15.4 *Acquiring UK ordinary residence*

In *Tuczka v HMRC* [2011] UKUT 113 (TCC) the taxpayer came to the UK to work and intended to stay 33 months (2.5 years). There were other facts which suggested he was settled, in particular that his girlfriend came to join him.

It was argued that an intention to reside here for that period was too short to constitute a "settled purpose". The argument was rejected. Even a period of just over one year could be sufficient.[45]

### 3.15.5 *Losing UK ordinary residence*

In *Turberville v HMRC* [2010] UKFTT 69 the taxpayer left the UK in July 2001 to work abroad. The taxpayer remained ordinarily resident until July

45 At [17] citing relying on *Reed v Clark* quoted at [15]; but *Clark* was not considering ordinary residence of the taxpayer (which was not an issue).

2001 even though he had formed the intention to leave earlier, in February 2001:

> 8. In relation to 2001-02, while it was clear in February 2001 that he would go to Dallas in July 2001 we do not consider that this changes the quality of his residence between 6 April 2001 and 30 June 2001, which was a continuation of his residence during the previous four tax years. Although it was then known that such residence would cease about 1 July 2001 it was nevertheless part of his residence for settled purposes and the fact that the Appellant's state of mind was such that he would be leaving the UK at around that time does not, until his actual departure, alter the position.

In July 2001 the taxpayer ceased to be ordinarily resident, though since he was ordinarily resident during part of the tax year 2001/02, he was described as ordinarily resident "for" that year.

In October 2001 the taxpayer unexpectedly lost his job, but remained non-ordinarily resident. The judgment at [8] continues:

> From the date of actual departure, we consider that in deciding whether there was then a distinct break one should look at the position as it was in July 2001 without the benefit of hindsight. The three-year employment contract coupled with his expenditure on furnishing the apartment rented by his employer point to a distinct break.

In the absence of purchase of accommodation, three years has traditionally been regarded as the period of residence which is sufficient to amount to settled.

### 3.15.6 *Habitual residence and ordinary residence compared*

"Habitual residence" is a concept often used in non-tax legislation (the term is never found in tax legislation).

If the concept was the same as "ordinary residence" then cases which gave clear guidance on habitual residence might be valuable for tax. Unfortunately this line of enquiry leads nowhere.

It is considered that the terms habitual residence and ordinary residence should be regarded as synonymous and the House of Lords have so held.[46] The natural meaning of the two expressions is the same (or at least, equally vague in each case) and there is really no place or need for two separate concepts. However the point was not fully argued and the case law is not entirely consistent. Some cases suggest that habitual residence is "something more than" ordinary residence,[47] though that "something more" is elusive. It has also been said that the concepts merely share a "common core of meaning".[48]

In any case, the authorities on "habitual residence" do not provide a clear definition of the term.[49]

### 3.15.7 *Residence and ordinary residence compared*

*Tuczka* has significantly reduced the difference between residence and ordinary residence or (if one prefers) it shows that the difference is not as great as had generally been thought:

> [18] Nor is it correct to suggest that a finding that Dr Tuczka was ordinarily resident in the United Kingdom in the tax year 1998-99 erodes a fundamental distinction between the concepts of residence and ordinary residence. The distinction is not as wide or as basic as the present appellant seeks to suggest. Hence, in *Levene*, Viscount Cave LC stated at p507:
>
> > "The expression "ordinary residence" is found in the Income Tax Act of 1806 and occurs again and again in the later Income Tax Acts, where it is contrasted with the usual or occasional or temporary residence; and I think that it connotes residence in a place with some degree of continuity and apart from accidental or temporary absences. So understood, the expression differs little in meaning from the word "residence" as used in the Acts..."

Unless the courts step back from this, HMRC6 is more generous than the law on the subject, a state of affairs which may not survive the next edition of HMRC6 (but statutory reform is likely to address the issue.)

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

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

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

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

## 3.16 The relevant period of investigation

In *Levene* Viscount Sumner said:

> It is suggested that the Commissioners misdirected themselves in point of law, because they took into account, with regard to the earlier years, conduct which only occurred subsequently. I agree that the taxpayer's chargeability in each year of charge constitutes a separate issue, even though several years are included in one appeal, but I do not think any error of law is committed if the facts applicable to the whole of the time are found in one continuous story. Light may be thrown on the purpose with which the first departure from the UK took place, by looking at his proceedings in a series of subsequent years. They go to show method and system and so remove doubt which might be entertained if the years were examined in isolation from one another.[50]

This was followed in *Hankinson v HMRC*:

> We accept that the present case involves the consideration of liability in respect only of one year of assessment. However, we consider that the approach referred to by Viscount Sumner, of taking more than one year's circumstances into account, is of assistance in reviewing a case where the liability in question arises by reference to a single year of assessment. There is a degree of artificiality in confining the examination to that single year where (as will almost always be the position, and was the case here) departure from the UK is likely to have occurred during the latter part of the preceding year of assessment. Further, it is clear from such cases as the decision of the Special Commissioners in *Gaines-Cooper* [2007] STC (SCD) 23, in particular at paragraph 166, that cultural, family and social connections over a longer period are relevant to the question whether an individual is resident for tax purposes in the UK, and similarly to the question whether he is ordinarily resident in the UK.[51]

The consequence is that residence disputes become enormously lengthy and expensive. *Hankinson,* for instance, took 10 days before the tax tribunal. The reader is invited to speculate as to the costs of that appeal, or any appeal, and whether a system which requires such costs is

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50 13 TC 486 at p.501.
51 [2009] UKFTT 384 at [31]

defensible.

## 3.17 Tax reason for becoming non-resident

In *Reed v Clark* the taxpayer had carefully organised his year abroad 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[52] of tax. Likewise with ordinary residence.[53]

## 3.18 Commentary: Assessment of case law tests

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

> Residence is a question of fact. There are very few rules. Cases are decided as and when they arise, and without much reference to any other previous decision. The decisions might well conflict with each other but that's just tough luck and there is nothing anybody can do about it.[54]

Viscount Sumner made the point judicially in *Levine*:

> The words "resident in the UK", "ordinarily" or otherwise, and the words "leaving the UK for the purpose only of occasional residence abroad", simple as they look, guide the subject remarkably little as to the

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52 Nowadays one should use the term "mitigation" rather than "avoidance" here, see 29.7 ("Avoidance", "mitigation", "tax reduction", "evasion": introduction). Contrast the Special Commissioner in *Shepherd v IRC* 78 TC 389 at [62]: "Although the Appellant's intention in going to Cyprus was to *mitigate* tax, I do not regard that as a relevant factor in deciding whether he was resident in the UK."

53 58 TC 528 at p.556.

54 *Taxation*, 3 December 1992, Vol 130, p.234. Lord Clyde made the same point in *Reid v IRC* 10 TC 673: "The expression 'resident in the UK' and the qualification of that expression implied in the word 'ordinarily' so resident are just about as wide and general and difficult to define with positive precision as any that could have been used. The result is to make the question of law become (as it were) so attenuated, and the field occupied by the questions of fact become so enlarged as to make it difficult to say that a decision arrived at by the Commissioners with respect to a particular state of facts held proved by them, is wrong."

> limits within which he must pay and beyond which he is free. This is the more likely to be a subject of grievance and to provoke a sense of injustice when, as is now the case, the facility of communications, the fluid and restless character of social habits, and the pressure of taxation have made these intricate and doubtful questions of residence important and urgent in a manner undreamt of by Mr. Pitt, Mr. Addington or even Sir Robert Peel. The Legislature has, however, left the language of the Acts substantially as it was in their days, nor can I confidently say that the decided cases have always illuminated matters. In substance persons are chargeable or exempt, as the case may be, according as they are deemed by this body of Commissioners or that to be resident or the reverse, whatever resident may mean in the particular circumstances of each case. The tribunal thus provided is neither bound by the findings of other similar tribunals in other cases nor is it open to review, so long as it commits no palpable error of law, and the Legislature practically transfers to it the function of imposing taxes on individuals, since it empowers them in terms so general that no one can be certainly advised in advance whether he must pay or can escape payment.[55]

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

> The majority of the Court of Appeal have found themselves unable to give any more precise direction than that the appellant may leave Canada for a limited period and for a purely temporary purpose, without being able to define either the word "limited" or the word "temporary." … the questions [in short, when would the appellant be resident in Canada?] do not at present admit of categorical answers. … . But if the appellant's interest under the will is to be forfeited upon her "ceasing to reside in Canada," she has a right to have those questions categorically answered; and inasmuch as they cannot be so answered, the words... are void for uncertainty.[56]

## 3.19 Dual residence/dual ordinary residence

HMRC6 para 1 provides:

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55 *Levene v IRC* 13 TC 486 at p.502.

56 [1938] AC 656 at p.665.

> Even if you are resident (or ordinarily resident) in another country you may also be resident (or ordinarily resident) in the UK. This is sometimes referred to as dual residence.[57]

Similarly HMRC6 para 8 provides:

> You will **not** cease to be resident in the UK simply because you become resident elsewhere. You can become resident in another country and remain resident in the UK.

This is soundly based on case law: see 3.8 (Case law on residence). Similarly for ordinary residence. HMRC6 provides:

> 3.2 ... You can be ordinarily resident in the UK and, at the same time, be ordinarily resident in another country

This is soundly based on comments in *Shah*.[58]

## 3.20 Ordinary resident but not resident

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

> I find it difficult to imagine a case in which a man while not resident here is yet ordinarily resident here.[59]

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

> ... a person shall be chargeable to CGT in respect of chargeable gains

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57 Similarly, EIM para 42820 provides:
"An individual can be resident and ordinarily resident in more than one country at the same time. The fact that an individual might prove to be resident or ordinarily resident elsewhere does not mean that they will be neither resident nor ordinarily resident in the UK."

58 *R v Barnet LBC ex p. Shah* [1983] 2 AC at p.342; the point had already been made in *Reid v IRC* 10 TC 673 at p.680, 682.

59 13 TC 485 at p.507. Likewise Viscount Sumner in *Lysaght v IRC* 13 TC 511 at p.518 clearly assumes that one must be resident in order to be ordinarily resident.

> accruing to him in a year of assessment during any part of which he is resident in the UK, *or* during which he is ordinarily resident in the UK.

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

> 190. ...We are also of the view that the appellant would still be ordinarily resident in the UK even if there were an occasional year when he was not resident here.[60]

In *Grace v HMRC*[61] the Special Commissioner reached a compromise view. It is possible to be ordinarily resident and non-resident, but it does not happen much if at all in practice:

> If an individual is not resident in the UK, then it is difficult to find that he is ordinarily resident here.[62]

### 3.20.1 *HMRC view(s)*

HMRC6 provides at para 3.2:

> It is also possible (but unusual[63]) to be not resident in the UK but remain ordinarily resident here.[64]

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60 [2007] STC (SCD) 23 at [190].

61 [2009] STC 213 Special Commissioners at [48].

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

63 This is different from the 2009 version of HMRC6 which provided:
"In *exceptional* circumstances you may be not resident but still ordinarily resident in the UK. *This is very rare*."
Presumably HMRC now wish to be able to argue that some of their non-resident customers are ordinarily resident, and did not want HMRC6 to be cited against them.

64 HMRC6 makes the same point at 3.1: "Even if you are not resident in the UK, you may be ordinarily resident, ...".
SA109 Notes 2008 formerly provided:
"Were you resident in the UK in the year to 5 April 2008?
If 'NO', you are not ordinarily resident in the UK. Put 'X' in box 2. [Box 2 states that the individual is not ordinarily resident]."
In 2009 the form changed. SA109 Notes 2009 provides:
Were you resident in the UK in the year to 5 April 2009? Yes No

The only case which HMRC cite is that of a person who spends a year travelling abroad, as to which see 3.28 (Year travelling abroad).

Similarly, the Residence Consultation Paper refers to "the very few people who are ordinarily resident but not resident".[65]

If (which I doubt) it did arise in practice that a person was non-resident but ordinarily resident in the UK, it would play havoc with the system of foreign tax credit relief. The individual would not usually be subject to income tax as that usually requires residence. But CGT is charged on an individual who is ordinarily resident even though not resident. The INT Manual points out the difficulty and (perhaps) coyly suggests that the matter is dealt with by quiet concession:

> **169050. Not resident but ordinarily resident** [January 2011]
> A person who is not resident in the UK is chargeable to Capital Gains Tax on chargeable gains accruing to him in a year of assessment if he is ordinarily resident in the UK (Section 2 TCGA 1992). Strictly, no foreign tax credit relief is due (either under a treaty or unilaterally), because the person concerned is not resident in the UK. If a claim to tax credit relief is made in these circumstances, the case should be submitted to the Offshore Personal Tax Team (part of Charity, Assets & Residence).

## 3.21 HMRC practice before 2008/09: IR20

### 3.21.1 *Practice prior to 1936*

The topic of residence was considered by the Income Tax Codification Committee (1936), a committee including all the leading UK tax figures of the day. The Committee criticised the statute law. It was "remarkable" that the Income Tax Acts afforded no greater assistance in the solution of the problem than the statutory residence rules (now in ss 829–832 ITA 2007) which are "of limited application". Nothing has changed.

The Committee also criticised the case law: "Nor are the decisions of the

> If 'No', you are *likely* to be not ordinarily resident in the UK. Put 'X' in box 2. [Box 2 states that the individual is not ordinarily resident so the instruction which made sense before does not make altogether good sense.]

In SA109 notes 2010 the guidance was removed altogether; this can now be seen as an anticipation of the HMRC6 change of view.

65 HM Treasury, *Statutory Definition of Tax Residence: a Consultation* (June 2011) para 6.28.

Courts very helpful." Nothing has changed there either. The two House of Lords cases which governed the position back then (*Lysaght*, *Levine*) continue to do so now. Residence is now, as it was then, "a question of fact, on which the decision of the Commissioners before whom the matter comes on appeal is final unless the Courts decide that there was no evidence on which the Commissioners could properly have come to the conclusion at which they arrived". The Committee concluded:

> the present state of affairs, under which an enquirer can only be told that the question whether he is resident or not is a question of fact for the Commissioners but that by the study of the effect of a large body of case law he *may* [emphasis added] be able to make an intelligent forecast of their decision, is intolerable and should not be allowed to continue.[66]

### 3.21.2 *Practice from 1936 to 2008/09*

The situation did not continue, though the change was not the one that the Committee asked for. The Committee reported that in the 1930s "no one subject which arises in the application of the Income Tax Acts has been more prolific of dispute than the question of the meaning of residence in the UK". This was "in no way surprising" given the state of the law. However, immediately after (no doubt as a result of) the Codification Committee report, the position in this respect changed completely. For sixty years – from 1936 until *Shepherd v IRC* in 2006 – there were virtually no reported cases on residence, the only important exception being *Reed v Clark*. The topic of residence ceased to be "prolific of dispute". The reason was that the Revenue published guidance provided most of the bright line guidance which was needed, although the general tax law did not. From 1977 – 2009 the guidance was in IR20, though the basis of that guidance was already formulated in 1936 and is set out in the Codification Committee report.

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

> The first set of objections is constitutional ... The rules in IR20 – if they are worth the paper they are written on – are best regarded as tertiary legislation. Although IR20 purports to state the law on residence, it has

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

> only a tenuous connection with the law declared by Parliament and applied in the Courts. IR20 was issued without statutory authority. One consequence of this is that IR20 has been issued without the parliamentary scrutiny which tax legislation should receive. Nor have the rules ever been subject to public consultation. Another consequence is that appeals to the Courts are made very difficult. ... All in all, the current state of affairs (one cannot properly call it the current state of the law) is fit only for a banana republic.

The 1955 Royal Commission noted this was "unsatisfactory" and recommended reform.[67] The ill-fated 1988 Consultation Document (Residence in the UK) made proposals. More recently, STEP called for reform[68] and so did the CIOT ("the law determining whether an individual is resident in the UK is a mess").[69] The House of Lords Economic Affairs Committee agreed.[70]

HMRC argued that they are not bound by the terms of IR20 even for the years before its revocation in 2009/10 but wisely dropped the argument before the Court of Appeal and the binding nature of IR20 (so far as it contains unqualified statements) is now established. The Court of Appeal expressed itself strongly:

> [IR20] is the language of assurance, which the Revenue, in the interests

67 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*.

68 "Need for Statutory Residence Test" 23 November 2007, accessible to STEP members on *www.step.org/showarticle.pl?id=1971*.

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

70 Select Committee on Economic Affairs, 2nd Report of Session 2007–08, The Finance Bill 2008, accessible
*www.publications.parliament.uk/pa/ld200708/ldselect/ldeconaf/117/117i.pdf*:
"223. We were unable to glean from officials why legislation was not included in this year's package. They did not present the case for inclusion or against. It is disappointing that officials were less than forthcoming on this important issue.
224. We recognise that it will not be possible to include a comprehensive statutory definition of UK residence in this year's Bill.
225. However, we think this is something which should be taken forward as rapidly as possible so that Ministers are able to come to a view in good time before next year's Bill. We therefore recommend that HMT and HMRC should consult with the professional bodies over the coming months, building on the work which was done in 2003."

of fair dealing, has bound itself to honour.[71]

### 3.21.3 *The end of IR20 from 6 April 2009*

IR20 was summarily revoked on 31 March 2009, with effect from 6 April 2009, thus giving six days' notice of the new rules in HMRC6.

HMRC6 makes it clear that IR20 is dead and buried. Para 1 provides:

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

HMRC6 does not specify the practices which are withdrawn. HMRC Brief 17/09 mentions "for example HMRC Brief 1/07, TB52, SP A10, SP 3/81, SP 2/91, SP 17/91." However the latter four SPs are still included in the HMRC list of SPs at 15 Feb 2011[72] so it is unclear whether they are withdrawn or not.

There was no transitional relief for those who might have been relying on IR20 in arranging their affairs for 2009/10. In this manner, a fundamental change to the scope of UK taxation was carried out without consultation, without parliamentary sanction, and without public discussion of any kind.[73] This would not have been possible or even conceivable if the law had been on a proper statutory basis. One lesson to be learned is that constitutional fundamentals *do* matter.

The repeal of IR20 has led to an explosion of tax litigation.[74] We have

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71 *R on the Application of Davies and Gaines-Cooper v HMRC* [2010] STC 860 at [25]. The matter will need to be reviewed when the case is final but the position is not likely to change.

72 Statements of Practice Issued up to 15 February 2011, accessible *www.hmrc.gov.uk/practitioners/sop.pdf*.

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

74 Including since the publication of HMRC6: *Gaines-Cooper, Davies, Grace, Genovese, Turbeville, Tuczka, Karim*, *Farquhar*.

returned to the pre-1936 position where "no one subject which arises in the application of the Income Tax Acts is more prolific of dispute than the question of the meaning of residence in the UK". Of course anyone familiar with the Codification Committee report would find this "in no way surprising".

## 3.22 HMRC6

HMRC6 was published on 31 March 2009.[75] I refer to that as **"the 2009 version of HMRC6"**. In the 2009/10 edition of this work I predicted:

> HMRC6 shows some signs of being a document prepared in haste. I infer that a decision was made to bring it out on 31 March because it could not have been published after 6 April if it was to take effect from 2009/10. One foreseeable development is a revised version of HMRC6.

This proved to be correct and a revised version was published February 2010. I refer to that as **"the 2010 version of HMRC6"**. In this manner, significant changes to the scope of UK taxation were made for the second time, without consultation or public discussion (though these changes were not on the same scale as the year before).

References in this book are to the 2010 version unless otherwise stated.

HMRC6 provides:

> [1] HM Revenue & Customs does not consider that the latest revisions have altered the current position in most cases.
> [2] However you can continue to use the wording in the previous version of HMRC6 for any tax liability that arises before 5 April 2011.[76]

Point [1] correctly recognises that there are some significant changes in the new HMRC6. A track change version is available on *www.kessler.co.uk*.

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75 What was published was a draft and not a final version. Quite soon afterwards HMRC quietly replaced it with a revised version, more neatly laid out and with many stylistic improvements but no changes of substance as far as I could see. There was no public announcement but it seems that this was done by 17 April 2009. I infer that the unfinished draft had to be published as it needed to be in place before 6 April 2009.

76 Page 1 (there is no para no).

HMRC say:

> The guidance [HMRC6] is aimed at unrepresented individuals.[77]

There are in fact two aspects of HMRC6 (as there were for IR20). The first is a (relatively) brief guide to taxation generally. This is for unrepresented individuals, and professionals will not find it of interest. The second is a guide to residence and ordinary residence. This is vital to professionals (as was IR20) for at present it is the closest there is to an HMRC guide to the meaning of these terms. Further guidance was promised but that will probably be overtaken by statutory reform.

### 3.22.1 *HMRC6: who determines the issue of residence*

HMRC6 para 2 provides:

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

Constitutionally, the question is what *Parliament* means by "residence" and not what HMRC mean. The (unnamed) authors of HMRC6 may think the distinction pedantic. The rule of law requires a system where taxpayers or their advisors can work out for themselves whether they are resident. Is this so obvious that it goes without saying?

### 3.22.2 *Is HMRC6 binding?*

One of the issues in *Davies and Gaines-Cooper* was whether IR20 is binding, ie, whether HMRC are free to disregard its content. It appears that HMRC wished to put themselves completely free to argue against HMRC6. HMRC6 section 1 provides:

> This guidance outlines our (HM Revenue & Customs) application and interpretation of legislation and case law. The material is provided for your guidance. It sets out the main factors that are taken into account based on the rulings of the courts. Whether any section of this general

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

> guidance is applicable to you depends on your particular facts, as each set of circumstances will be different. It also seeks to give practical examples of what the relevant law means; these are only illustrative examples.
>
> Any practices described in this guidance are subject to periodic review and may subsequently be altered or withdrawn. If practices were to be changed or revoked this would not normally be done so retrospectively....
>
> This guidance will tell you the main factors to take into account when deciding your residence, ordinary residence and domicile status, and the potential consequences for your UK tax position. It is general guidance which is designed to help you reach a decision yourself. Depending on your circumstances this might not be straightforward and our guidance may not cover all of the issues which affect you.

I infer that the wording was drafted with one eye firmly on possible successor litigation to *Davies and Gaines-Cooper* even though HMRC6 contains far less clear guidance than IR20. However in the Court of Appeal HMRC lost so heavily on the issue that it is considered that where unqualified statements in HMRC6 do occur, they are binding on HMRC notwithstanding all the disclaimers:

> [IR20] sets out a limited number of specific situations in which a taxpayer will be treated as non-resident. If a taxpayer falls within the situation described by the Revenue, the Revenue has given an assurance that it will treat the taxpayer in accordance with the terms of the guidance. If a taxpayer comes, for example, within the terms of 2.2, the Revenue has given an assurance that it will treat that taxpayer as not resident and not ordinarily resident. It will not be permitted to resile from that assurance, unless and until it announces that it proposes, for the future, to alter the circumstances in which it will accept non-resident status.[78]

When HMRC argued in *Gaines-Cooper* that they were free to change their published practice retrospectively, the Court of Appeal were rightly outraged. The HMRC response is now to say that they would not "normally" do so. That should still be a matter of public concern; but

78 *R on the Application of Davies and Gaines-Cooper v HMRC* [2010] STC 860 at [17]. The matter will need to be reviewed when the case is final but the position is not likely to change.

there it is.

### 3.22.3 *HMRC6: types of residence*

HMRC6 divides residence into various categories. Leaving aside the 183 day rule, the primary distinction is between:
(1) those leaving the UK ("leavers"); and
(2) those coming to the UK ("arrivers").
These are subdivided as follows:
(1) *Leaving the UK* is divided into three understandable categories:
 (a) full-time workers abroad;
 (b) permanent or indefinite leavers;
 (c) the "year settled abroad" category.
(2) *Coming to the UK* is divided in a more confusing way:
 (a) the three years in the UK practice;
 (b) remaining two years in the UK practice;
 (c) visitors to the UK.

### 3.22.4 *HMRC6: connections to the UK*

HMRC6 para 2.2 provides:

> You can also be resident in the UK if you are present here for fewer than 183 days in a tax year. This will depend on how often and how long you are here, the purpose and pattern of your presence and your connections to the UK. These might include the location of your family, your property, your work life and your social connections.

The passage goes on to list relevant connections but starts with a disclaimer:

> The following are examples, but they are not a complete list. These and any other relevant factors must all be considered together to give a complete picture.

The list is as follows:

> • Family ties include having a spouse, civil partner, children or other family members you are close to, in the UK.
> • Social ties include membership of clubs and societies and events that

you regularly attend or host. It also includes any regular recreational engagement, such as returning each year for an annual sporting season.
• Business ties include owning or being a director of a business based in the UK, or having employment, including self-employment, in the UK. Regular employment duties in the UK are a tie and you need to consider the extent, frequency and nature of those duties. It does not matter if the duties themselves are not taxed, for example because of a DTA.
• Property ties include a house or apartment that you own or lease, or property held primarily for investment but that also provides you with accommodation when you are in the UK. A house or apartment provided for your use for the duration of your time in the UK as part of an employment package is 'available accommodation' and is a tie to the UK.
• If you think you may just be visiting the UK then part 7 will help you consider the pattern of your visits, but you must also consider the purpose of those visits. For instance, a short term one-off employment assignment to complete a project for a foreign employer might not in itself make you resident. But if you repeatedly come to the UK for regular business meetings then your visits have a non-temporary purpose. You need to look at the frequency of those visits alongside your other ties to the UK.

If the nature and degree of your ties to the UK show that it is usual for you to live in the UK, you are resident in the UK. It does not matter whether you live here for employment, leisure, or just because you like being in the UK.

## 3.23 The 183-day rule

HMRC6 adopts the 183 day rule:

> 2.2 ... The only occasion when the number of days that you are physically present in the UK will determine your residence status is when you are here for 183 days or more during a tax year. If you are here for 183 days or more in a tax year, you are resident in the UK. **There are no exceptions to this.**

This has a sound basis in the statutory 183-day rule.[79]

79 See 3.3 (Temporary UK purpose and 183-day rules).

## 3.24 Short absences

HMRC6 para 8.1 formerly provided:

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

This was obviously correct. It had a sound basis either in the ordinary meaning of "residence"[80] or perhaps in the occasional residence abroad rule. The 2010 version of HMRC6 extends the point beyond short absences:

> **8.2 Leaving the UK for shorter periods of time**
> You will still be treated as resident in the UK if any periods of time you spend outside the UK are for occasional residence abroad only. Occasional residence means you have no settled purpose for a continuing absence from the UK. 'Occasional' does not mean that your absence must be isolated or of short duration. A series of business trips abroad is an example of periods of occasional residence abroad.
> If you normally live in the UK and go abroad regularly, for example on extended holidays, you will continue to be resident here. This type of absence does not stop you being resident and ordinarily resident in the UK, because you have not made a definite break from the UK.

## 3.25 Full-time work abroad

HMRC6 para 8.5 provides:

> **8.5 Leaving the UK to work abroad as an employee**
> If you are leaving the UK to work abroad full-time, you will only become not resident and not ordinarily resident from the day after the day of your departure, as long as:
> • you are leaving to work abroad under a contract of employment for at least a whole tax year
> • you have actually physically left the UK to begin your employment abroad and not, for example, to have a holiday until you begin your

80 See the passage from *Levene* set out at 3.8 (Case law on residence).

> employment
> • you will be absent from the UK for at least a whole tax year
> • your visits to the UK after you have left to begin your overseas employment will
> - total less than 183 days in any tax year, and
> - average less than 91 days a tax year...

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

One change concerns holidays. According to HMRC6, if the employee goes on holiday before work starts, they are still UK resident until work starts. I find that bizarre.

In *Davies and Gaines-Cooper*, the taxpayer left the UK in March 2001 but did not start full-time employment abroad until after 6 April. The Court of Appeal said:

> In my view, properly construed, [IR20] 2.2 does not entitle a person to non-resident status, for capital gains tax purposes, unless he leaves to work full-time either before or by the start of a tax year, in the instant case by 6 April 2001. To come within 2.2, a taxpayer must leave for and remain in full-time employment throughout the relevant tax year. Full-time employment throughout any subsequent tax years does not affect the date when a taxpayer first attained non-resident status; that date is determined by reference to the date the taxpayer left to work full-time abroad.[81]

This interpretation is surprising (it is worth noting that it never occurred to the inspector of taxes who dealt with the case) but there it is. The same will apply to the HMRC6 para 8.5 which is similarly worded. The Court did more helpfully state:

> In [IR20] 2.2, it is not enough that the taxpayer has left the UK, he must have left to work full-time. Absence is not sufficient, it must be absence whilst engaged on full-time employment for at least a whole tax year. No more is, however, required. The absence need be neither permanent nor indefinite. Accordingly, ... there is no requirement, under 2.2, for a

81 *R on the Application of Davies and Gaines-Cooper v HMRC* [2010] STC 860 at [33]. The matter will need to be reviewed when the case is final.

> taxpayer to demonstrate that he has severed family and social ties within the UK. The Revenue accepts that the taxpayer need do no more than establish that he has left the UK for full-time employment abroad, and that the employment has continued throughout the relevant tax year. There is no need to be concerned with any persisting social or family ties in the UK, unless those ties themselves cast doubt on whether the employment is genuinely full-time.[82]

The same will apply to HMRC6.

### 3.25.1 *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 HMRC6 para 8.5:

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

The former IR20 added:

> If you have several part-time jobs overseas at the same time, we may be able to treat this as full-time employment. That might be so if, for example, you have several appointments with the same employer or group of companies, and perhaps also where you have simultaneous employment and self-employment overseas. But if you have a main

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82 *R on the Application of Davies and Gaines-Cooper v HMRC* [2010] STC 860 at [33]. The matter will need to be reviewed when the case is final but this is not likely to change.

> 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.[83]

This is not in HMRC6. I wonder if the omission is deliberate. There is no indication either way.

In the 2010/11 edition of this work I said:

> 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.[84]

The minutes of the Joint Expatriate Forum record:

> 6.5 HMRC were asked whether, if their position on FTWA changed, such changes would apply retrospectively. HMRC explained that generally changes were made prospectively, but in this case it is not entirely clear what the practice had been in the past, so they were unable to make a definitive statement before settling their legal advice.[85]

HMRC have issued the following guidance:

> HMRC accept that it has a practice whereby non residence can be demonstrated by working abroad full time even though some of the duties carried on in the UK are substantive. Although this is not in accordance with the definition of full time work at section 830 Income Tax Act 2007, HMRC's guidance on ceasing to be UK resident covers a wider range of issues than that section.
> How much work can be carried on in the UK depends upon the facts and circumstances relevant to each individual. However HMRC will generally accept that working in the UK for fewer than 10 days in a year will not by itself prevent an individual claiming they have made a break with the UK because they are working full time abroad. If more days than this are worked in the UK, whether an individual is working full

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83 RI 40 comments further on the meaning of "full-time".

84 See 12.13 (Where are duties performed: incidental duties).

85 Joint Expatriate Forum on Tax and Nics: 10 February 2011 *www.hmrc.gov.uk/consultations/expat-mins-feb2011.pdf*

> time abroad will depend upon their particular circumstances.
> Given that
> (a) Residence is a long term issue affecting the entirety of a tax year and individuals and companies will have planned actions on the basis of HMRC guidance, and
> (b) The government has announced that it will consult on a statutory residence test to codify the rules on residence
> HMRC can confirm that for 2011/12 this practice will continue. It will however, be reviewed for future years having regard to the outcome of the consultation on a statutory residence test.[86]

### 3.25.2 *Working abroad and home for weekends*

In *Davies and Gaines-Cooper* the Court of Appeal say:

> long distance commuters, who work full-time abroad, but return at week-ends, providing their presence remains less than the number of days specified, are treated as not resident and not ordinarily resident.... advisers received explicit assurances that the Revenue's approach to mobile workers would not be applied to such commuters; they would continue to be regarded as coming within 2.2.[87]

In the HMRC view these commuters are different from mobile workers, though the distinction is far from clear.

### 3.25.3 *Return to the UK after working abroad*

HMRC6 para 8.6 provides:

> **8.6 Returning to the UK after working abroad**
> If you were not resident and not ordinarily resident when you were working abroad and you return to the UK when your employment ends, you will be not resident and not ordinarily resident in the UK until the day **before** you return to the UK. You will become resident and ordinarily resident on the day you return to the UK unless you can show

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86 *www.ion.icaew.com/TaxFaculty/22023* [2011] STI 1498.

87 *R on the Application of Davies and Gaines-Cooper v HMRC* [2010] STC 860 at [54] and [71]. The correspondence should of course have been made public but no doubt it could be obtained on a FOI application. The matter will need to be reviewed when the case is final.

> that your return was simply a short visit to the UK between two periods of full-time employment abroad. ...

What if the employee has a holiday before return to the UK? Clearly the individual is not UK resident if the contract of employment continues (ie contractual holiday entitlement). Otherwise the statement does not cover the situation expressly, but it is suggested that UK residence does not arise until actual return to the UK.

### 3.25.4 *Changes to employment while abroad*

HMRC6 para 8.7 provides:

> **8.7 Changes to your employment when abroad**
> If your circumstances change while you are abroad, for example there is a break in full-time employment, you might no longer meet the requirements of paragraph 8.5 and so remain resident and ordinarily resident in the UK. You must tell us about such changes by contacting your tax office.
> You must also tell us when you return to the UK at the end of an overseas employment, even if you are planning to go abroad again to work under a new contract of employment. You must do this even though you see your return to the UK as temporary and for a very short period. You should tell us this information by contacting your tax office.

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

### 3.25.5 *Self-employment abroad*

HMRC6 para 8.8 provides:

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

### 3.25.6 *Partly employed and partly self-employed*

A published HMRC letter of 10 July 1979 provided:

> ... where an employee left the UK on 4 April 1979 and did not return until 6 April 1980 and was on a full-time service contract during that period, he would be regarded as not resident and not ordinarily resident in the UK throughout the year 1979–80.
> However this practice would not be extended to a taxpayer who was only partly in employment and partly self-employed during a similar period. In such circumstances the normal rules for determining an individual's residence status would apply and on the basis that no visits were made during the intervening period, the taxpayer would be regarded as not resident but ordinarily resident for the year 1979–80 in these circumstances.

I find this bizarre, and consider that a court is not likely to draw a distinction between those working full-time in either employment or self-employment, and those partly employed and partly self-employed. The former IR20 para 2.5[88] watered this down to a "perhaps". Now there is no guidance at all.

### 3.25.7 *Accompanying spouse concession: ESC A78*

ESC A78 provides:

> 1 The residence and ordinary residence status of a husband and wife is determined independently but the circumstances of one spouse may, in certain situations, be taken into account when determining the residence status of the other. This can apply when one spouse goes abroad for full-time employment, or to work full-time in a trade, profession or vocation, and is regarded as not resident and not ordinarily resident from the day following departure to the day before return. The following concession applies where an individual in this position is accompanied, or later joined, by his or her spouse who is not in full-time employment (or working full-time in a trade, profession or vocation) abroad.

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88 Set out in 3.25.1 (Meaning of "work full-time abroad").

> 2 Where the accompanying spouse is abroad for a complete tax year and interim visits to this country do not amount to—
> – 183 days or more in any tax year; or
> – an average of 91 days or more in a tax year (the average is taken over the period of absence up to a maximum of four years);
>
> then the accompanying spouse's liability to UK tax which is affected by residence, for the years of departure and return at the beginning and end of the period spent abroad, will be determined by reference to the period of his or her residence here during the year.

The concession (like all concessions) applies to civil partners.[89] HMRC6 para 8.9 provides:

> **8.9 Leaving the UK with your spouse or partner**
> When your husband, wife or civil partner leaves the UK to work abroad within the terms of paragraphs 8.5 or 8.8, you are able to receive the same tax treatment if you accompany or later join them abroad. This treatment is by concession (extra-statutory concession A78) and means that even when you yourself are not in full-time employment abroad, you will also be not resident and not ordinarily resident in the UK from the day after your
> departure. This treatment will apply as long as:
> • you will be absent from the UK for at least a whole tax year, and
> • your visits to the UK after you have left
> – total less than 183 days in any tax year, and
> – average less than 91 days a tax year. This average is taken over the period of absence up to a maximum of four years – see 8.5 which will show you how to work out this average....[90]
> You will remain not resident and not ordinarily resident in the UK until the day **before** you return to the UK. You become resident and ordinarily resident on the day you return to the UK.

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89 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 or Statements of Practice should be taken as extended to apply equally to civil partners and married couples."

90 The omitted passage is discussed elsewhere; see 3.32 (Calculating annual average visits: illness & exceptional circumstances).

## 3.26 Seafarers

*Rogers v Inland Revenue*[91] concerned a master mariner. Captain Rogers had a house in Fife where his wife and children resided. He had no home in any other country, but in the year 1878/79 he was entirely absent from the UK while in command of his ship. In fact he was away for much more than one calendar year as he left in July 1877. Captain Rogers was held to be resident here:

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

(The ship was not regarded as a residence.)

The view that one can spend all year outside the UK and still be UK resident is supported by s.829(2) ITA.[92]

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

> **70230 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.

91 1 TC 225, referred to with approval in *Levene* and *Lysaght* 13 TC at pp.223, 244.

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

## 3.27 Year settled abroad

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

During the year settled abroad 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 settled abroad.[93]

HMRC relied on *Rogers v Inland Revenue*.[94] 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.

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93 *Reed v Clark* 58 TC 528.

94 See 3.26 (Seafarers). A court may be less sympathetic to HMRC in a similar case now that HMRC are known to ignore *Rogers* in practice.

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

may acquire non-residence by a "year settled abroad". I refer to this as "**year settled abroad**" non-residence, though "non-full-time worker's year settled abroad" would be more accurate. The individual should ideally spend no time whatsoever in the UK in the relevant tax year.[95] He should 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 "bases" or "headquarters".

## 3.28 Year travelling abroad

### 3.28.1 *Position before 2011/12*

The 2009 version of HMRC6 provided at 1.5.15:

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

This concerns individuals who:

(1) do not work full-time abroad (so do not fall within the full-time work abroad practice); and

(2) do not have a base abroad (so do not fall within the "year settled abroad" rule in *Reed v Clark*).

That is, individuals who leave the UK to wander the world for a year without coming back to the UK at any time in that year. Backpacking gap-yearers may fall into this category, or those on a leisurely world cruise. In practice, as HMRC say, this does not arise often, but it is not unknown.

There are two points in the HMRC6 statement, that a traveller who is not

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

present at any time in a tax year:
(1) is not UK resident but
(2) is UK ordinarily resident.
I first consider point (1), residence. HMRC form SA109 Notes 2010 (Residence, remittance basis etc notes for 2009/10) makes the same point:

> Put an 'X' in box 1 [claiming non-residence] if you were not present in the UK at any time during the year ended 5 April 2010.

As far as residence is concerned, this is I think an informal concession, as it is reasonably clear from *Reed v Clark* that an individual who is absent for a year is only non-resident if they have a *base* in their new place of residence. The statements are perfectly clear.[96] Nevertheless there is a risk that HMRC may refuse to follow their published guidance, especially if there is an element of tax planning or tax avoidance. It is an interesting question to what extent the Courts might require HMRC to follow their guidance.

As far as ordinary residence is concerned, there are some doubts whether a person can be non-resident but ordinarily resident,[97] but since the strict analysis here is that the traveller remains UK resident they are no doubt also ordinarily resident.

### 3.28.2 *Position from 2011/12*

This passages set out above are not found in the 2010 version of HMRC6 or in HMRC form SA109 Notes for 2010/11.

HMRC6 provides:

> **8.3 Complete absence from the UK**
> Residence is connected to physical presence. If you live outside the UK for a complete tax year and do not set foot in the UK you will not be resident in the UK for that tax year, unless your absence from the UK is for the purpose of occasional residence abroad only. For example, if your absence was for a one-off year long holiday after which your residence in the UK resumed its previous pattern, you would remain UK resident during your absence.

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96 Indeed the practice goes back to at least 1979; see 3.25.6 (Partly employed and partly self-employed).

97 See 3.20 (Ordinary resident but not resident).

> If you became not resident simply because of a complete absence from the UK, it is unlikely that your presence in the UK on your return is for a temporary purpose only if any of your UK ties remained throughout your period of absence. You would most likely become resident again on your return.

HMRC have changed their practice as regards residence and now wish to take the point that if "you have gone abroad for a long holiday and you do not set foot in the UK in the tax year" then you remain UK resident.

3.28.3 *Ordinary residence*

HMRC6 para 3.2 provides:

> It is also possible (but unusual) to be not resident in the UK but remain ordinarily resident here. If you normally live in the UK you might become not resident solely for one tax year. As you would usually be resident in the UK and this is where you have your normal home, family ties and other social connections, you might still be ordinarily resident here.

Similarly HMRC6 para 8.3:

> Even when you are absent for a whole tax year and so become not resident, you might remain ordinarily resident in the UK. You will need to consider the pattern of your residence over a number of years and the purpose and pattern of any ordinary residence abroad.

Thus regardless of residence, HMRC still argue for ordinary residence in this case.

## 3.29 Leaving the UK permanently or indefinitely

For at least six decades HMRC operated a 91-day test. In short – I omit refinements which do not affect the position in general – what a UK resident formerly had to do to lose UK resident status under IR20 was to average under 91 days in the UK over the four-year period. HMRC withdrew this practice in Business Brief 1/2007.[98] HMRC seek to change

98 This was later set out as an appendix in the May 2008 version of IR20.

their practice retrospectively. In *Davies and Gaines-Cooper* HMRC succeeded on the grounds that the relevant passage in IR20 as a matter of construction only applied if the taxpayer "has severed his ties to the extent that his previous social and family ties in the UK are no longer retained."[99] That construction is bizarre and it remains to be seen what will happen on appeal.

Whatever the position as to the past, from 2009/10 the 91-day test is no longer decisive. HMRC6 provides:

> 1.2 .. Your status is determined by the facts of your particular case. It is **not** simply a question of the number of days you spend in the country.
> 2.2 There are many different factors which will determine whether you are resident in the UK. With one exception [the 183-day rule], it is not simply a question of the number of days you are physically present in the UK during a tax year, although this is an important consideration.

So we need to consider when a UK resident person loses UK resident status other than under the full-time work abroad rule (or the year settled abroad rule). HMRC6 para 8.1 provides some terminology. Firstly, there is a commonsense definition of "permanently":

> Leaving the UK 'permanently' means that you are leaving the country to live abroad and will not return here to live.

Next there is a definition of "indefinitely":

> Leaving 'indefinitely' means that you are leaving to live abroad for a long time (at least three years) but you think that you might eventually return to live here, although you do not currently have plans to do so.

This is a change from the 2009 version of HMRC6, which provided:

> *By leaving "indefinitely" we mean that you are leaving to live abroad for a long time (at least three years) but you acknowledge that you might eventually return to live here.*

In the 2009/10 edition I criticised this wording as a slightly odd use of

99 *R on the Application of Davies and Gaines-Cooper v HMRC* [2010] STC 860 at [40] - [48].

"indefinitely" ("long-term" would be nearer the mark) though not too confusing. The new definition changes the definition to accord with the natural meaning of the word indefinitely. But HMRC should have kept the definition and changed the label to long-term. For instance, an individual who goes for a 5 year posting has "plans" to return to the UK so taken literally they do not leave "indefinitely" in the 2011 sense of the word.

3.29.1 *Definite break*

HMRC6 places considerable emphasis on requirement of a "definite break". This is a new feature: the expression which occurs 8 times in the text of the 2010 version is not found at all in the 2009 version. The 2010 version provides:

> 8.1 ... The act of leaving the UK does not necessarily make you not resident and not ordinarily resident. You must also make a definite break from the UK and any remaining ties you have with the UK must be consistent with not being resident here. If you say that you are no longer resident and ordinarily resident in the UK, we might ask you to give some evidence to show that you have left the UK permanently or indefinitely and that there has been a clear change in the pattern of your life. For example, we would expect you to show that when you left the UK you had acquired accommodation abroad to live in as a permanent home. If you still have property in the UK which you can use after you leave, we might want you to explain how retaining that property is consistent with leaving the UK....
>
> **8.2 Leaving the UK for shorter periods of time**
>
> [This passage is considered at 3.24 (Short absences).]
>
> **8.2.1 Evidence of a definite break**
>
> If you do not make a definite break and cut your UK ties then you remain resident in the UK. You could also be dual resident – that is resident in the UK and another country.
>
> You might not have evidence of a definite break from the UK for some time after you leave the UK. In this situation you will need to review your residence status later to confirm whether you have become not resident, and when this happened.
>
> For example, if you have travelled in and out of the UK fairly frequently, the exact timing of the end of your residence here could be difficult to establish. You should therefore keep evidence relating to your lifestyle before and after the date on which you think you ceased to be resident.

> If the circumstances of your life change gradually, then you will become not resident only when you have sufficiently reduced your ties to the UK and are more than occasionally resident abroad.
> The evidence that you will be able to show that you have made a definite break will depend on the extent of your UK ties initially. If you had few initial connections with the UK you will have less evidence to show you have made a definite break.
> In those circumstances strong ties to another country, including a home and settled purpose for your presence there throughout a complete tax year, would be more of a factor in deciding if you have left the UK permanently or indefinitely.

## 3.30 Days of arrival and departure

It is important to know whether days or arrival or departure count as UK residence days for the purposes of the 183 day test (which is statutory) and it may be important to know for the purposes of the 91 day test.

Section 831 ITA provides:

> (1A) In determining whether an individual is within subsection (1)(b) treat a day as a day spent by the individual in the UK if (and only if) the individual is present in the UK at the end of the day.
> (1B) But in determining that issue do not treat as a day spent by the individual in the UK any day on which the individual arrives in the UK as a passenger if–
> (a) the individual departs from the UK on the next day, and
> (b) during the time between arrival and departure the individual does not engage in activities that are to a substantial extent unrelated to the individual's passage through the UK.[100]

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

When is a person "present in the UK"? I would have said a person is "present" once a boat reaches UK territorial sea[101] or once a plane flies over the territorial sea. But HMRC take a different view:

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100 For completeness, the 8th edition of this work para 3.20 contains a critique of misleading comments in EN FB 2008 on this provision, but this material is now omitted as it is not now of practical importance.

101 See App. 1.1.4 (Territorial sea).

> The published answer [from HMRC] confirmed that "the point of arrival in the UK will be when, an aircraft lands, a train arrives at the first station in the UK, a boat docks at the quayside or drops anchor in territorial waters". HMRC were asked to confirm that similar rules applied to determine the time of departure. HMRC confirmed that the departure rules were consistent with those described for arrival ie "the point of departure from the UK will be when, an aircraft takes off, a train leaves the last station in the UK, a boat leaves the quayside or its anchorage point in territorial waters".[102]

That time is certainly easier to ascertain.

3.30.1 *Transit passenger*

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

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

This is vague, but it will not often need to be considered. HMRC6 para 2.3 provides a gloss:

> So if you attend a business meeting, visit a property you own, arrange to meet people socially or attend social activities, you must count that day as a day of presence if you are in the UK at the end of the day.
> *Example*
> You are resident of the Isle of Man and travel to the UK as part of a journey to the USA. You have to stay overnight in the UK before catching a flight to the USA the following day. Your being in the UK for that one night would not count as a day of presence in the UK. But, if you were to carry out an activity such as attending a business meeting, visiting the theatre or visiting family before catching the flight to the USA, the exception would not apply and the night spent in the UK would be counted as a day of presence.

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

EN FB 2008 provides some unexceptionable examples:

> *Example 1* – Peter works for the Jersey arm of HSBC and is travelling from Jersey to Frankfurt. He flies from Jersey to Gatwick and will catch his onward flight the next day to Frankfurt from London City airport. He travels from Gatwick to Canary Wharf for a meeting with several other HSBC colleagues before staying overnight in a nearby hotel.
> The meeting with colleagues is not an activity substantially related to completing travel to a foreign destination. The transit passenger provisions will not apply.
> *Example 2* – John works for the Jersey arm of HSBC and is travelling from Jersey to Frankfurt via Gatwick and London City airport. In lobby of his hotel near London City Airport, he unexpectedly spots another colleague who has just arrived from Paris. They have a couple of pints together and their conversation covers a number of business-related issues. [John][103] then travels to London City airport to catch his onward connection.
> This meeting was not planned and therefore it can be considered that John's activities in the UK substantially related to completing travel to a foreign destination. The transit passenger provisions will apply.
> *Example 3* – Shirley lives in Guernsey and is travelling to New Zealand by way of Gatwick and Heathrow. She has planned to spend most of the day with her daughter and grandchildren, who live in Crawley and will also spend the night there before travelling to Heathrow for her onward flight.
> Her visit is not an activity substantially related to completing travel to a foreign destination. The transit passenger provisions will not apply.
> *Example 4* – Phil lives in Guernsey and is travelling to New Zealand by way of Gatwick and Heathrow. His flight from Guernsey is delayed by fog and he arrives too late to make his onward connection to New Zealand that day. His son had already arranged to meet him at Gatwick and drive him to Heathrow, now he drives him to a hotel near Heathrow instead where Phil will stay overnight before catching his rearranged flight. At the hotel they have a snack together.
> These activities are substantially related to completing travel to a foreign destination – Phil would have eaten in the hotel even if he had been unaccompanied. The transit passenger provisions will apply.
> *Example 5* – George lives in the Isle of Man and is flying to New York on business via Manchester. He has made an appointment with a consultant orthopaedic surgeon based in Manchester to carry out a number of tests. He will stay in the clinic overnight before travelling on to New York the following afternoon.
> The appointment is not an activity substantially related to completing travel to a foreign destination. The transit passenger provisions will not apply.
> *Example 6* – George lives in Jersey and is travelling to Stavanger. He does not fly and travels to the UK by ferry before continuing to London by train. He stays overnight at a West End hotel, having prearranged dinner and a trip to the theatre

103 The original erroneously reads: Peter.

with friends. The next day he travels to Newcastle by train, where he boards a ferry to Stavanger. His activities in the UK are not substantially related to completing travel to a foreign destination. The transit passenger provisions will not apply.

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

3.30.2 *Transitional aspects*

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

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

From 2009/10 this is only relevant for the limited areas where the 91 day test remains important.

## 3.31 Method of calculating 91 day average

HMRC6 provides:

> **8.5 Leaving the UK to work abroad as an employee**
> ... To calculate your annual average visits to the UK:
> $$\frac{\text{Total days visiting UK}}{\text{Tax years you have visited (in days)}} \times 365 = \text{annual average visits}$$

After a disclaimer which does not seem to rate the intelligence of the reader very highly[104] the text continues with a straightforward example:

> If you were to leave the UK on 20 May 2008 to work full-time abroad and you visit the UK for:
> 79 days in the tax year 2008–09 (320 days in the remainder of the tax year)
> 91 days in the tax year 2009–10 (365 days in the tax year)
> 98 days in the tax year 2010–11 (365 days in the tax year)
> 79 days in the tax year 2011–12 (366 days in the tax year)
>
> The average of your visits would be:
> 2008–09 — 79÷320×365 = 90.1 therefore treated as not resident from 21 May 2008
> (subject to split year treatment applying)
> 2009–10 — (79+91)÷(320+365)×365 = 90.6 therefore not resident
> 2010–11 — (79+91+98)÷(320+365+365)×365 = 93.2 therefore resident
> 2011–12 — (79+91+98+79)÷(320+365+365+366)×365 = 89.4 therefore not resident
>
> The calculation of average visits for the year 2012–13 will not include the visits or relevant days for the year of departure. The rolling period of four years is maintained by excluding the oldest year at each annual review.
> ...[105]
> **If you do not meet all of these conditions, you will remain resident and ordinarily resident in the UK unless paragraph 8.1 applies to you.**
> **If your employment comes to an end and you do not return to the UK it will be necessary to consider if you continue to be not resident and not ordinarily resident in the UK.**

### 3.31.1 *Day counting in the case law*

In *Gaines-Cooper v HMRC* [2007] STC (SCD) 23 the Special Commissioners adopted figures which:

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104 **"This is for illustrative purposes and any calculation you make would be based upon your own circumstances – the date that you actually left the UK and the days that you have visited the UK in the period."** Bold font is original.

105 The omitted passage is discussed elsewhere; see 3.32 (Calculating annual average visits: illness & exceptional circumstances).

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

It is considered that (apart from the 183 day test) the correct approach in law would be to take into account all days of arrival and departure, but with less weight than full days. But the *Gaines-Cooper* approach amounts to more or less the same.

## 3.32 Calculating annual average visits: illness & exceptional circumstances

HMRC6 provides much guidance on calculating 91 day average visits, but from 2009/10 the average is not nearly as important as formerly. It is no longer decisive as to residence, it is merely one factor. Nevertheless I will set out the passages here. HMRC6 provides:

> 8.5 ... Any days you spend in the UK because of exceptional circumstances beyond your control, for example an illness which prevents you from travelling, are not normally counted for this purpose.[106]

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.

Notwithstanding the use of the word "normally", the only situation I can envisage where the practice would not apply is in cases of abuse, eg if a UK resident individual "left" the UK knowing they 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.

The former IR20 provided:

> *Any days spent in the UK because of exceptional circumstances beyond your control, for example the illness of yourself or a member of your*

106 The same passage is found in HMRC6 para 8.9. For completeness: a similar practice is recorded in SP 2/91 but it appears from Business Brief 17/09 that this SP has now been withdrawn.

*immediate family, are not normally counted for this purpose.*

The practice recognised 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" was obviously be taken realistically rather than literally.)

It is considered that illness of immediate family can still qualify as exceptional circumstances. Any other view is offensive to humanity, and, certainly, if HMRC wished to change their view it should have been stated expressly rather than left to be inferred.

This practice is applied to the non-statutory 91-day rule (if one can call it a rule) but it is not applied for the 183-day rule. There is perhaps a reason for this distinction: the 183-day rule is statutory, so to disregard days of illness or exceptional circumstances would have to be classified as a concession, not simply as an HMRC practice. But the 183-day rule can therefore operate rather harshly.

3.32.1 *Volcanic Ash: disruption to air travel 2010/11*

HMRC say:

> HMRC confirmed that, where individuals had planned to leave the UK but were genuinely prevented from doing so because of the recent travel disruption caused by the Eyjafjallajoekull volcano eruption, they would treat the situation as an exceptional circumstance and therefore covered by existing guidance in paragraph 2.2 of [the 2009 version of] HMRC6. This meant that any additional days spent in the UK purely as a consequence of this disruption may be disregarded when considering whether an individual is resident in the UK.
>
> However, where an individual is present in the UK for 183 days or more in the year, including any days spent here because of exceptional circumstances, including this travel disruption, then they will be resident in the UK for that year.
>
> HMRC also confirmed that individuals who wished to claim that any days spent in the UK were due to exceptional circumstances should keep sufficient evidence to support their claim as they would for similar

claims.[107]

### 3.32.2 *Unrest in Middle East*

HMRC say:

> For those individuals who are evacuated from Egypt, Libya and Tunisia due to the current political situation, this situation would be treated as an exceptional circumstance and therefore covered by existing guidance in HMRC6. This will remain the case for the period that the FCO advice for the country they are leaving is in place.... Exceptional circumstances will only apply for the period individuals were advised by the Foreign and Commonwealth Office to leave Egypt, Libya and Tunisia and the week thereafter.
> The relevant periods and areas where an FCO advisory to leave has been, or is currently, in force are:
> Egypt – For the period 29 January to 15 February 2011 those in Cairo, Alexandria and Suez were advised to leave.
> Libya – Since 20 February 2011 the FCO have advised those who could to leave, this advisory remains in place.
> Tunisia – For the period 15 January to 20 January 2011 the advisory was in place.
> At the present time there are no restrictions on travel to Egypt or Tunisia.[108]

## 3.33 Coming to the UK

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

(1) the three years in the UK practice;
(2) visitors to the UK, not within (1), a category divided into:
    (a) short-term visitors:
        (i) indecisive visitors;
        (ii) intentional visitors;
    (b) longer-term visitors.

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107 Minutes of Joint Expatriate Forum on Tax and NICS, 26 May 2010 *www.hmrc.gov.uk/consultations/260510-epf-minutes.pdf*.

108 *www.ion.icaew.com/TaxFaculty/21604*.

HMRC6 para 7 begins with the following general comments:

> If you come to live here permanently or to work here for an extended period, or with no particular end date, you will become resident in the UK. But not everyone who comes to the UK becomes resident here. For example, those who are in the UK on holiday or for a short period of work will generally (!) not become resident in the UK.
> In most cases it will be clear whether you become resident or not, but sometimes it needs careful consideration of a number of factors. These include:
> • whether you have been resident in the UK before
> • how many days you spend here
> • the pattern of your presence in the UK or absence from it over a period of years
> • whether your purpose for being in the UK is settled or temporary
> • your family, social and work ties to the UK
> • your accommodation arrangements.

## 3.34 The three years in the UK practice

HMRC6 provides:

> **7.2 When you come to the UK permanently, indefinitely, or to live or work for three years or more**
> [1] If your home has been abroad and you have come to the UK to live here permanently or indefinitely, you will be resident and ordinarily resident from the date you arrive.[109]
> [2] You will also be resident and ordinarily resident from the date you arrive if you have come to the UK to remain here for three years or more. This is because you are not simply visiting but have settled in the UK for the time being.

Para [1] refers to those who "come to live here". Para [2] refers to those who "come to remain here". Perhaps this means the same thing, so para

109 A sidenote adds: 'From the date you arrive' means from the beginning of the tax year, but you will not normally be charged tax for the period up to your arrival in the UK.

[2] covers just about everyone in para [1].[110] Perhaps there is a difference in nuance, ie someone who comes to live in the UK permanently is resident even if they do not "remain" in the UK. In practice this is not likely to matter.

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

> If you have previously been resident in the UK and are returning after a period abroad, you will need to consider whether or not your absence from the UK was a period of non-residence. You may not have been entitled to the split-year treatment. If you were not resident you may have been 'temporarily not resident' and this might affect your liability to UK tax when you become resident in the UK again.
> Whether or not you have lived here before, if you have come to the UK to live or work permanently, indefinitely, or for three years or more, you should tell us immediately so that you can make sure that you are paying the correct amount of tax as soon as possible.

Notwithstanding the peremptory terms of this paragraph, there is no obligation to disclose anything to HMRC unless the individual becomes UK resident and even then no obligation to do so "immediately". The paragraph continues.

> • If you work for an employer in the UK, they will give you the forms you need to complete for us and will deduct tax from your earnings on our behalf under PAYE – see part 6. The forms might include form P46.
> • If you have been seconded to work in the UK while employed by a foreign employer, they should give you the form P46 (Expat) to complete. We will send you any other forms you need.
> • If you are going to work for yourself – that is, as a self-employed person –
> you can find out what you need to do if you go to www.hmrc.gov.uk or you can phone our Self-employed Helpline. The helpline will be able to give you the advice you need to make sure that you pay the right amount of UK tax at the right time.
> • If you have come to the UK to live (permanently or indefinitely or for three years or more) but do not intend to work here, you must tell us if

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

you have any taxable income and/or gains.

### 3.34.1 *Meaning of "remain"*

HMRC6 para 7.2 formerly provided:

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

This was an odd use of the word "remain". "Stay full-time in the UK" would be a more accurate expression.

The current version of HMRC6 has deleted this passage but does not provide any explanation of the meaning of "remain".

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

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

## 3.35 Remaining in the UK for two years

The 2010 version of HMRC6 is quite different from the 2009 version. Para 7.4 provides:

> **7.4 When you come to the UK temporarily**
> If you are simply visiting the UK, then you might not be resident. But you are not simply visiting the UK if you have a purpose for being here which is not temporary. The nature and extent of your connections to the UK may indicate that your purpose in the UK is not temporary.

The term "visit" is vague. Whether someone was a "visitor" mattered under the 2009 version of HMRC6 and the former IR20, since a visitor was (subject to specific exceptions) classified as non-resident. Since now it is only the case that a visitor "might not" be UK resident the question of whether someone is a visitor is no longer so crucial. The 2009 version of

HMRC6 used the term "visit" in a slightly defined and somewhat technical or artificial sense, which is not in the 2010 version, but that does not matter any more.

Para 7.4 continues:

> ...If you remain in the UK for a period that spans two tax years and are resident in the second year then you will need to consider whether you were also resident in the first tax year. This will depend on all the facts. It is possible that after you first come to the UK your circumstances change and you are going to live here permanently or indefinitely, or you are going to remain here for three years or more from the date of your arrival. In such a situation, you will become resident and ordinarily resident in the UK and you should read paragraph 7.7. If your circumstances change and you become resident in the UK, you should tell us as soon as possible to make sure that you are paying the correct amount of tax.

HMRC6 para 7.7.1 provides:

> **7.7.1 Residence**
> [1] ...If you remain in the UK for a period that spans two tax years and are resident in the second year then you will need to consider whether you were also resident in the first tax year. This will depend on all the facts.

It is difficult to see how the guidance could be more vague or unhelpful if it tried. The passage continues:

> [2] If you have come to the UK and will be remaining here for at least two years but for not more than three years, you will be resident from the date of your arrival (even if you are here for fewer than 183 days in the first tax year). This does not necessarily mean that you will also be ordinarily resident.

The category within point [2] ("remaining 2 years") overlaps unhappily with the three years in the UK practice. A person who intends to remain three years is in the "three years in the UK category". A person who only intends to remain two years is in category [2].

A person who "remains" in the UK for two whole years will be present in the UK during three tax years.[111] During the middle tax year the person will satisfy the 183-day rule. The relevance of the remaining-2-years category is to establish residence in the tax years of arrival and departure if the 183-day rule is not satisfied in those years.

The 2009 version of HMRC6 made it clear that the purpose of the distinction between the two practices is that a person who falls within the remaining-2-years category is resident but not ordinarily resident. A person within the three years in the UK practice is resident and ordinarily resident. The 2010 version removes the clarity by saying that the person who remains 2 years is not "necessarily" ordinarily resident. It gives no further guidance. Perhaps the authors contemplated a further extension of the concept of ordinarily residence, but in practice this should be overtaken by statutory reform.

## 3.36 Visitors

### 3.36.1 *One-off visit*

HMRC6 para 7.5 provides:

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

The word "usually" was added in the 2010 version of HMRC 6, which adds to the vagueness and detracts from the usefulness of the passage. There is no guidance as to what takes the matter out of the "usual". The point is to ensure that the taxpayer cannot rely on the passage if HMRC do not wish to follow it, but in practice no doubt that will happen rarely if at all.

### 3.36.2 *Repeated visits*

HRMC 6 para 7.5 continues:

> But, if you are going to make a number of separate visits to the UK you need to consider whether this will make you resident and/or ordinarily

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

> resident here. It does not matter whether the visits are for the same purpose or different purposes, or varying lengths of time.
> If you are making a number of separate visits, part 2 explains that you need to look at the pattern and regularity of your visits. The length of time required to establish a pattern will depend on your circumstances but after three[112] years it will usually be possible to judge the pattern that has emerged.
> [1] You may not know how long you will continue to visit when you first arrive in the UK. If, after three[113] complete tax years, a pattern has emerged that these visits total more than 91 days on average and your visits continue, then you will become resident and ordinarily resident in the UK from the start of the next tax year.

I refer to those within [1] as "**indecisive visitors**". "Indecisive visitors" is not an entirely accurate label for this category of UK residence, but "those who come regularly for more than 90 days average over a four-year period without knowing that they will do so at the outset" is something of a mouthful. According to HMRC6 a 91 day test operates in this context. This is not reconcilable with their emphatic statement that residence is not just a matter of counting days, and it is clearly wrong in law,[114] but it is a workable rule of thumb which has survived from IR20. HMRC have no objection to a workable rule of thumb which favours the Revenue.

HMRC6 continues:

> But there are situations where you might become resident and ordinarily resident in the UK before you have been visiting for four years, for example:
> • where you know, when you start visiting the UK that your visits here will be for an average of 91 days or more per tax year. In these cases, you will be resident and ordinarily resident from 6 April of the tax year in which you first start making your visits.
> • when you realise after starting to visit the UK regularly that your visits are going to be for an average of 91 days or more. In these cases you will be resident and ordinarily resident from 6 April of that tax year.
> • when your circumstances change so that your purpose for being in the UK is no longer temporary.

112 There is a significant change in the 2010 version of HMRC6 which has changed the figure from four years to three.

113 See above fn.

114 See 3.8 (case law on residence).

> It is possible that after you first come to the UK to visit, or after you have made a number of visits here, your circumstances change so that you are going to live here permanently or indefinitely, or are going to remain here for three years or more from the date of your first arrival. If this is the case, you will become resident and ordinarily resident in the UK and should read paragraph 7.7.
> If your circumstances change and you become resident in the UK you should tell us as soon as possible so that you can make sure that you are paying the correct amount of tax.

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

A change from the former IR20 is that the text now reads "might" whereas IR20 formerly stated that intentional visitors "would" become UK resident. I wonder if this is really what HMRC meant to say. If one takes "might" literally, there is no guidance of when a visitor would or would not be UK resident. Another change is that "intend" is replaced by the word "know" but in the present context I think that comes to the same thing.

Perhaps the changes are due to a problem of the former IR20 identified in the 7th edition of this work:

> This category (intentional visitors) seems again to have the status of provisional and uncertain residence. Suppose T intends to average more than 90 days here over five years, and in year 1 he spends 99 days here; T may think he is UK resident in year 1 but he cannot be sure. If in year 4 T unexpectedly changes his intention and leaves the UK, he retrospectively finds that he is not resident in years 1, 2 and 3 after all![115]

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

Perhaps the reason for this change is the emphatic statements elsewhere in HMRC6 on the non-decisive nature of a day count test.[116]

### 3.36.3 *Does a year with no day in UK restart the clock?*

The former Inspectors Manual provided at para 45:

> An individual should be regarded as becoming resident if he visits the UK year after year so that his visits become in effect part of his habit of life and are annual visits for a substantial period or periods of time. Normally, an average annual period or periods amounting to 91 days or more should be regarded as substantial and the visits as becoming habitual after four years, *provided that there has been a visit in each of the four years*; such an individual should be regarded as resident for and from the fifth year.
> (Emphasis added)

There has been no announcement of a change of practice on this point but one might infer that HMRC practice has changed.

Suppose:

(1) Year 1: T spends a relatively short period in the UK (say 30 days).
(2) Years 2–3: T spends much longer in the UK (say 160 days).

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

### 3.36.4 *Knowing that visits will average more than 91 days*

The 2010 version of HMRC6 replaces "intend" with "know".

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?

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116 HMRC6 para 2.2 provides:
"There are many different factors which will determine whether you are resident in the UK during a tax year. **With one exception [the 183-day test], it is not simply a question of the number of days you are physically present in the UK during a tax year although this is an important consideration.**"

Such a person ,might "intend" to remain in the UK[117] but they do not "know" that they will remain in the UK.

## 3.37 Calculating annual average visits for visitors rules

The method of computation for the visitors rules is slightly different from the method used for those leaving the UK.
HMRC6 provides:

> **7.6 How to calculate your average days in the UK**
> Calculating your annual average days in the UK is a useful indication of the extent of your connection to the UK. It may also indicate if – when you have visited the UK frequently – you have become resident here.
> If you need to calculate your annual average days in the UK, you do so like this:
>
> $$\frac{\text{Total days in the UK}}{\text{Relevant tax years (in days)}} \times 365 = \text{annual average visits}$$
>
> The annual average is calculated over the number of years you have been visiting the UK, up to four years after which only the last four years are included in the average. (But if the pattern of your visits varies substantially year by year, it might be appropriate to look at the periods with different patterns separately and to calculate average days in the UK for each distinct period).

The text continues with a straightforward example though with a specific disclaimer before it[118] and a general disclaimer after it:

> **Example**
> If you arrived in the UK on 20 May 2008 and were in the UK for:
> 79 days in the tax year 2008–09 (320 days in the remainder of the tax year)

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117 This is consistent with the rule that an illegal immigrant may be UK domiciled: see 2.11 (Refugees, illegal immigrants and temporary visas). See Michael Bratman, "Intention, Plans, and Practical Reason", CSLI Publications, (1999), pp.37, 38, accessible *www.kessler.co.uk*.

118 "This is for illustrative purposes only and any calculation you make would be based upon your own circumstances – the day that you actually started to visit the UK and the days that you have been here in the period."

91 days in the tax year 2009–10 (365 days in the tax year)
98 days in the tax year 2010–11 (365 days in the tax year)
79 days in the tax year 2011–12 (366 days in the tax year)
The average of your visits would be:
2008–09 — 79÷320 × 365 = 90.1
2009–10 — (79+91)÷(320+365) × 365 = 90.6
2010–11 — (79+91+98)÷(320+365+365) × 365 = 93.2
2011–12 — (79+91+98+79)÷(320+365+365+366) × 365 = 89.4

This is the general practice, but it will not necessarily be appropriate in all cases. If you spend very significant amounts of the year travelling internationally, you should keep a record both of the days you were present in the UK and of those days where you are here at midnight. Both will be factors when looking at the pattern and purpose of your visits.

## 3.38 Ordinary residence

HMRC6 provides:

**3.2 What does ordinary residence mean?**
Ordinary residence is different from 'residence'. The word 'ordinary' indicates that your residence in the UK is typical for you and not casual. It is important not to confuse ordinary residence with domicile (see part 4).
If you have always lived in the UK then you are ordinarily resident here. When you come to the UK you do not have to intend to remain in the UK permanently or indefinitely in order to be ordinarily resident here. It is enough that your residence has all the following attributes.
• Your presence here has a settled purpose. This might be for only a limited period, but has enough continuity to be properly described as settled.
Business, employment and family can all provide a settled purpose, but this list is not exhaustive.
• Your presence in the UK forms part of the regular and habitual mode of your life **for the time being**. This can include temporary absences from the UK. For example if you come to live in the UK for three years or more then you will have established a regular and habitual mode of life here from the start.
• You have come to the UK voluntarily. The fact that you chose to come to the UK at the request of your employer rather than seek another job does not make your presence here involuntary.

> The pattern of your presence, both in the UK and overseas, is an important factor when you are deciding if you are ordinarily resident in the UK. You will also need to take into account your reasons for being in, coming to, or leaving the UK and your lifestyle and habits. Parts 7 and 8 will help you with this, as they explain the considerations for those coming to and departing from the UK.
> ....

HMRC6 para 3.3 gives two examples. After the usual four disclaimers[119] they are:

> ***Example 1 (Sarah)***
> S is a British citizen who has lived in the UK most of her life. She has homes in London, California and France and has spent substantial amounts of time at her other homes or travelling on business.
> The opportunity arises for S to travel more on business, especially in North America and she therefore spends less time in the UK and more time in her California home. S's partner and their children are based in the UK and the family spends the summer together in France. During the year ended 5 April 2010 S is present in the UK at the end of 43 days, although she typically arrives in the UK in the morning and leaves in the evening so many of the days she is in the UK do not get counted for the 183 day test.
> S's 'end of day' counts for the years ended 5 April 2011, 5 April 2012 and 5 April 2013 are 85, 110 and 90 respectively. The average for the four years to 5 April 2013 is just under 82 days.
> Although S has been present in the UK at the end of the day for an average of less than three months during the four years under review, she has remained resident and ordinarily resident here. This is because her presence in the UK in all years shows a pattern indicating residence here and that such residence is 'ordinary' for her. There is nothing casual about her residence – S has a home and family in the UK to which she returns whenever she wishes and her business allows. S's residence in the UK continues. Her presence in the UK is an integral part of the regular pattern of her life. The precise amount of time that S spends in

119 "These examples are only illustrative. You will need to consider all the facts in your own case, including the purpose of any previous visits, any emerging patterns and your total and average day counts. It is not possible to cover every eventuality in this guidance and you may like to contact us or take professional advice if your circumstances are not obviously covered in this part of the guidance. If any of the facts in the examples are changed then the status of the individuals might change."

the UK does not affect this fundamental point.

S has been and remains resident and ordinarily resident in the UK. It is possible that S is resident in France or the USA for the purposes of French or US federal and state income taxes. This does not affect her residence in the UK. If she is dual resident for any period it might be necessary to decide where S is treaty resident for the purposes of the relevant Double Taxation Agreement.

The next example is a straightforward case of non-ordinarily residence.

***Example 2 (Juan)***

J is a Spanish citizen and is seconded by his Spanish employer to work on a project in the UK for approximately nine months from early June 2009. J's wife and family remain in Spain and he returns there to visit them every two weeks. He takes two weeks holiday in August 2009 which he spends outside the UK and another two weeks at Christmas which he spends in Spain with his family.

When he first arrives in the UK, J stays in hotels but he then takes a six-month lease on an apartment here that he extends for two months in early 2010. The project is completed and J returns to Spain in mid-March 2010.

J has spent more than 183 days in the UK. He is resident for the year ended 5 April 2010 but he is not ordinarily resident.

J takes up a new employment in Spain in July 2010. His new employer seconds him to their UK business to resolve a crisis in the business. His wife and family again remain in Spain, but he is not able to visit them very often and they visit him in the UK once a month. Between early September 2010 and 5 April 2011 J spends over 183 nights in the UK, either in a company flat or in various hotels. His secondment ends and he returns to Spain at the end of May 2011.

J is resident in the UK for the year ended 5 April 2011 but he is not ordinarily resident here.

His residence in the UK does not yet have a sufficiently settled purpose; it is still not 'ordinary' for him.

### 3.38.1 *Ordinary residence: arrivers*

HMRC6 provides:

**7.7.2 Ordinary residence**

Your ordinary residence status may affect what UK tax you have to pay and this status may change while you remain in the UK.

... Generally, you become ordinarily resident in the UK when it becomes normal ('ordinary') for you to be resident in the UK. Sometimes it is clear that you become ordinarily resident as soon as you arrive in the UK, but sometimes ordinary residence is established only after you have been here for a while. If you come to the UK for less than three years, you might not be ordinarily resident here but there are many factors to consider. You should read part 3 of this guidance which explains what is meant by 'ordinarily resident in the UK'.

If your circumstances change after you first arrive in the UK, it is possible that your ordinary residence status might change as a result.

**7.7.3 Ordinary residence when you arrive**

If you have come to the UK for a settled purpose, for example to live or work in the UK for three years or more, you will be ordinarily resident from when you first arrive.

If you own or acquire accommodation on a long-term lease of three years or more in the year you arrive this is an indication that your presence in the UK forms part of the regular and habitual mode of your life for the time being. Such a mode of life means you are ordinarily resident from when you arrive. But the ownership of accommodation by itself will not make you ordinarily resident provided you dispose of it and leave the UK within three years of your arrival.

You can still be ordinarily resident in the UK even if you leave within three years, for example if your purpose for being here was settled when you first came here.

**7.7.4 Ordinary residence after arrival**

If you do not have a settled purpose on arrival you can still become ordinarily resident. You will become ordinarily resident with effect from the start of the tax year in which:

• you first have a settled purpose

• you decide to stay here for three years or more from the date of your arrival

• you remained for more than three years from the date of your arrival.

Factors that indicate you have made a decision to stay in the UK for more than three years include acquiring a lease on accommodation or accepting an employment contract lasting more than three years from the date of your arrival.

As explained above, if you have remained for more than three years from the date of your arrival you will be ordinarily resident here from the start of the tax year in which the third anniversary falls. While this applies to the vast majority of cases, there could be exceptions, where particular facts – that you would need to support with evidence – might indicate the contrary. For example, if you marginally overstayed a three-year period

> and then left the UK, perhaps because a project you were working on over-ran or a house purchase fell through, you might still be not ordinarily resident for the duration of your stay. (If you later return to the UK and become resident again, within two years of having left, you are very likely to become ordinarily resident on your return.)
> In very unusual circumstances you may be resident in the UK for three years or more but remain not ordinarily resident. If this is the case, you will need to demonstrate that your residence in the UK is not 'ordinary' for you and that you have no settled purpose here. The circumstances in which this would apply and when you will become ordinarily resident will be taken on the facts of each case. You may wish to take professional advice if you think this applies to you.
> If you are ordinarily resident in the UK, leave and return within two years, you will usually be ordinarily resident from the date of your return.

Para 7.8 HMRC6 gives three examples. After the standard disclaimers,[120] it provides:

> **7.8.1 Example 1 – Ordinary residence when you have remained in the UK for three years or more**
> When you arrived in the UK on 6 June 2009, in the tax year 2009–10, you did not think that you would be staying here for three years or more. Since then you have not bought any accommodation here or leased any accommodation for three years or more. The accommodation you have used has been on short-term leases.
> On 7 June 2012 (tax year 2012–13) you are still in the UK. This is three years and a day since you first arrived here.
> You will be ordinarily resident in the UK from 6 April 2012. This is because you have now been in the UK for a long enough period of time for your being here to be considered 'ordinary' for you. 6 April 2012 is the start of the tax year 2012–13 in which the third anniversary of your arrival in the UK occurred.
>
> **7.8.2 Example 2 – Ordinary residence when your circumstances change and you remain in the UK for longer than originally planned**

120 "These are illustrative examples to support the guidance outlined in 7.7.4. The examples are not exhaustive or definitive but will help you understand your ordinary residence status when you have come to the UK. Your ordinary residence in the UK will be based on your individual circumstances."

When you arrived in the UK on 6 June 2009 you came on a fixed term appointment for a period of 18 months and did not think that you would be staying here for more than three years. In October 2010 you accepted a two year extension to your employment contract. You are contracted to remain in the UK until the end of 2012 which will be more than three years from the date you arrived here.

You will be ordinarily resident in the UK from 6 April 2010. This is because you are now going to be in the UK for a longer period than you first thought and the period is now long enough for your being here to be considered 'ordinary' for you. 6 April 2010 is the start of the tax year in which you made the decision to remain in the UK for longer than you originally planned.

If you had decided in December 2009 – in the same tax year as you arrived here, that you would be remaining in the UK until 2015 you would be ordinarily resident from 6 June 2009 which is the date you arrived in the UK. This is because – although you did not think you would be staying when you first arrived – you have decided to stay within the same tax year. The period for which you are now going to be here is long enough for your presence in the UK to be considered 'ordinary' for you.

**7.8.3 Example 3 – Ordinary residence when you buy or lease accommodation for three years or more**

When you arrived in the UK on 6 June 2009 you did not think that you would be staying here for three years or more. In May 2010 you buy a house in the UK to live in.

You will be ordinarily resident in the UK from 6 April 2010. This is because buying the house here shows that your being in the UK is now 'ordinary' for you. 6 April 2010 is the start of the tax year in which you bought the house.

*but*

If buying the house was the only reason you were ordinarily resident, and you sold the house and left the UK before 6 June 2012, you would be able to say that you were not ordinarily resident for the period you were here. The period of ownership was sufficiently short not to be classed as for a settled purpose of living in the UK.

HMRC say:

HMRC said that the recent First Tier Tribunal decision in the *Tuczka* case confirmed their interpretation of guidance on ordinary residence, building on the decision last year in *Genovese* which confirmed their interpretation of IR20 and SP 17/91 on the same matter. This meant that individuals originally intending to leave the UK within three years would be ordinarily resident from the beginning of the year in which that intention changed. At what point the decision was made to remain in the UK would always be a question of fact. The Tribunal decision in Turberville also confirmed HMRC's published position. HMRC were asked whether a work permit constituted an indicator of an intention to work permanently in the UK. HMRC replied that it would be one of a series of facts about an individual's circumstances which needed to be considered in their entirety. HMRC stressed that guidance could not be read as if it were legislation: it cannot provide a definitive answer to every situation which might arise in practice, but instead seeks to deal with the most common cases. Whether a taxpayer's circumstances fit within these common cases will be determined by the facts. ... HMRC were asked for clarification of paragraph 7.7.3 of HMRC6 (ordinary residence in the year of arrival in the UK). They explained that it sought to make clear that an individual's circumstances could change twice within three years and that there could be no guarantee that residence in the UK for less than three years will in all cases result in a not ordinarily resident status. For instance, a trainee could be offered a permanent job in the UK which they hadn't anticipated after completing a one year placement in the UK, only to be made redundant 20 months later at which point they depart from the UK. The final paragraph of 7.7.3 makes clear that such situations might be unusual, and residence status will always depend on the actual facts of each case.[121]

## 3.39 Students

HMRC6 provides one special rule for ordinary residence of students. Para 7.3 provides:

> [1] If your home has been abroad and you have come to the UK for less than two years for a period of study or education, you might not be resident in the UK (see paragraphs 7.4 and 7.5).

We then come to the point:

121 Joint expatriate Forum on tax and NICS: 26 May 2010 *www.hmrc.gov.uk/consultations/260510-epf-minutes.pdf.*

> [2] If you have come to the UK for more than two years but less than four years for study or education, you will be resident in the UK while you are here. But you will **not** usually be ordinarily resident if:
> • you do not own or buy accommodation here
> • you do not acquire accommodation here on a lease of three years or more
> • when you leave the UK you do not plan to return here regularly for visits which average 91 days or more in a tax year (to calculate your average visits to the UK – see paragraph 7.6).

The word "usually" was added in the 2010 version of HMRC 6, which once again adds to the vagueness and detracts from the usefulness of the passage. There is no guidance as to what takes the matter out of the "usual". The point is to ensure that the taxpayer cannot rely on the passage if HMRC do not wish to follow it, but in practice no doubt that will happen rarely if at all.

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. Why do HMRC say this? I suspect that the practice may have a long history. The Education Act 1962 conferred student grants on those who were ordinarily resident in the UK. The Department of Education took the view that those who came to the UK to study did not become ordinarily resident (in order to deprive them of the right to a grant.) This was held to be wrong in *Shah*[122] which held that a student who comes to the UK to study comes for a settled purpose and so is ordinarily resident. The statement in HMRC6 (which presumably derives from the earlier practice, not reviewed since *Shah*) cannot possibly be defended. But it probably does not matter very often and taxpayers are not likely to complain.

DTAs often make special provision for students and will need individual consideration.[123]

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122 See 3.15 (Case law: ordinary residence).

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

## 3.40 Diplomats, UN/EU officials

HMRC TDSI Guidance Notes provide:

> **4.44 Diplomats**
> ... The rules for determining whether someone is resident or ordinarily resident in the UK apply to members of a Diplomatic Mission in the same way as they apply to everyone else. ...
> **4.45 United Nations**
> The salaries of United Nations workers are usually exempt from income tax but whether or not they are resident or ordinarily resident in the UK is decided in the usual way. ...
> **4.46 European Community (EC) Officials**
> ... A brief outline of the residence status of officials of the European Community is
>
> - an individual who was NOR in the UK, but was ordinarily resident in another member state before taking up such employment and who is working in a member state will remain NOR in the UK,
> - an individual who was not ordinarily resident in any member state before taking up such employment will have his/her residence status determined according to the normal rules, or
> - an individual who takes up employment as an official of the EC and who works outside the EC, will have his/her residence status determined according to the normal rules
>
> An individual who was ordinarily resident in the UK before taking up employment as an official of the EC, and who works in a member state will remain ordinarily resident in the UK....

## 3.41 HMRC forms, rulings and certificates

### 3.41.1 *P85 (leaving the UK)*

The introduction to form P85 provides:

> Use this form to claim tax relief or a repayment of tax if:
>
> - you have lived or worked in the UK
> - you are leaving the UK, and
> - you may not be coming back or you don't know when you're coming back or,
> - you are leaving the UK to work full-time abroad for at least a complete tax year.

> Do not fill this form in if:
> • you normally live in the UK and are going abroad for short periods, for example on holiday or a business trip
> • you have completed, or are required to complete a Self Assessment tax return for the tax year that you leave the UK (unless you are leaving the UK to work full-time abroad for at least a complete tax year for a UK based employer).

The RDR Manual provides:

> **10115. Form P85** [March 2011]
> When you know that an individual is leaving, or has left the UK
> • issue form P85
> 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.
> If the individual is within self assessment
> The form P85 should be rejected if there is a continuing source of UK income. You should advise the customer that as he has a continuing UK source of income the SA Return issued at the end of the tax year should be completed in the normal way.
> Providing the taxpayer has left the UK and all sources of UK income have ceased, the completed form P85 can be accepted as a request for an early settlement and an in-year return should be issued. (Refer to PAYE90020).
> However, if the taxpayer is leaving to work full time abroad for a UK employer for a period of at least a complete tax year, the form P85 can be completed to enable the taxpayer to receive a code NT. If a form P85 has not been received before the Return for the tax year of departure is issued, the following action may need to be taken
> • issue the form P85 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 advice on residence where the case needs to be sent to CAR, PTI Advisory, Residence & Domicile Technical Team, Bootle.

There was formerly a form P85(S) for non UK citizens. HMRC say:

> From 30 November 2010 the form P85(S) should no longer be used.

Individuals claiming a tax refund on leaving the UK to work or live abroad, following the completion of a work assignment, should complete the form P85 (Leaving the UK – getting your tax right).

### 3.41.2 *Form P86 (arrival in the UK)*

HMRC form P86 (arrival in the UK) is now withdrawn. The RDR manual provides:

> **RDRM10215 - Residence: Coming to the UK: Form P86**
> Since 1 June 2010 the form P86 has been withdrawn and new arrivals to the UK will be integrated into HMRC processes by existing means
> • Form P46 or P46(Expat) for new employees
> • CWF1 for newly self employed, or
> • SA1 registration process for customers who are not self employed but who need to complete a tax return
> Please refer to BGN 044/10 for further information (also refer to EIM42890 and PAYE81750).

### 3.41.3 *Form P46(expat)*

Form P46 is for new employees. Form P46(expat) is the version for employees seconded to the UK. The 04/10 version provides:

> Only fill in this form if you have been seconded to work in the UK.
> For the purposes of this form only, a seconded employee includes:
> • individuals working wholly or partly in the UK for a UK resident employer on assignment whilst remaining employed by an overseas employer
> • individuals assigned to work wholly or partly in the UK at a recognised branch of their overseas employer's business
> • all individuals included by an employer within a dedicated expatriate scheme
> • all individuals included by an employer within an expatriate modified PAYE scheme.

HMRC say:

> The form P46 (Expat) has been designed specifically for use with inward assignee employees. HMRC procedures meant that without this special form, notification of commencement would be mis-directed within HMRC which could

> then lead to further difficulties for both customers and HMRC alike. It was essential that employers bringing inward assignees to the UK use form P46 (Expat) to notify commencement and indeed HMRC would no longer be able to accept forms P86 in lieu of a P46 (Expat).To do so would override fixed HMRC procedures and may generate penalties for employers. Accordingly, HMRC would no longer accept forms P86 or 64-8 as notification of a new employee where no P46 (Expat) was received and CAR Expats would return such forms where the P46 (Expat) was absent.
>
> HMRC accepted that there may be cases where no PAYE obligation existed. In these circumstances, advisers can write to CAR Expats setting out the relevant circumstances and an SA record will be set up for the individual taxpayers.
>
> Attention was drawn to recent publicity surrounding the SA1 process and in particular the need for National Insurance numbers to be quoted in this connection. HMRC is looking at the procedures in so far as they relate to inward expatriates and is seeking to identify some individuals for whom an annual SA Return may not be required. This work is on-going but feedback will be provided to the Forum as soon as any is available. In the meantime, the SA1 process need not be followed for inward expatriates; CAR Expats will continue to issue an SA Return from receipt of the P46 (Expat).
>
> HMRC confirmed that the national process related to the setting up of UTRs does not involve automatic notification to agents of the UTR created. However, in CAR Expats there will be automatic notification to agents of the UTRs where forms 64-8 have been submitted. Agents can also gain access to UTR information through the Gateway but HMRC can no longer handle requests for UTRs to be entered on to lists. It was recognised that there was some confusion around agents' codes which could lead to difficulties but HMRC felt that this was a simple thing for agents to resolve. CAR Expats was no longer resourced to handle requests for the entry of UTR details on lists provided by agents and, accordingly, would no longer be prepared to do so. Agents should therefore ensure that timely and accurate information was provided to HMRC in the first place to ensure that they were advised of the UTR on its creation and that they use the Gateway to gain access to UTRs belonging to their clients.[124]

Where s.828A ITEPA applies, an appropriate letter should be submitted with form 46(expat) to prevent issue of an SA return: see 12.30.9 (Administration: avoiding issue of SA return).

### 3.41.4 *Rulings*

HMRC will not give residence rulings. The International Manual provides:

124 Notes of the Joint Expatriate Forum 15 October 2009 *www.hmrc.gov.uk/consultations/expat-mins-151009.htm*.

**162040. Determination of UK residence - individuals** [January 2011]
An individual's residence status is determined in accordance with the principles set out at IM25 onwards, and for years up to and including 1995-96, rulings were provided routinely by the Centre for Non-Residents, Bootle.
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. Officers 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 Officers, 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.

## 3.42 Scotland Act 2011

HMRC say:

10.1 ... the Scotland Bill ... devolved a number of powers to the Scottish Parliament, including the power to set a Scottish rate of income tax. This would mean that Scottish taxpayers would pay an element of tax on their non-savings income direct to the Scottish Parliament at a rate to be determined. The tax would be first implemented in the tax year following the 2015 election.
10.2 This would entail significant changes to PAYE and SA systems and processes but HMRC stressed that the long lead-in times would enable them to be resolved before implementation. They also stressed that only the power to set the rate of tax was being devolved and that all other aspects of the tax system were reserved matters. This meant that there would be no impact on issues such as double taxation agreements and the remittance basis.
10.3 An individual will always be a Scottish taxpayer for a full tax year in which his sole or main residence is in Scotland. HMRC stressed, however, that split year treatment under ESC A11 would continue to be available to Scottish taxpayers entering or leaving the UK in the same way as it would for any other UK-resident taxpayer.[125]

125 Joint Expatriate Forum on Tax and NICs: 10 Feb 2011 Meeting Note.

The Scotland Act 2011 introduces a definition of "Scottish taxpayer" in a new s.80D Scotland Act 1998. This definition is different from common law residence and distinct from the proposed statutory residence test. I hope to consider it in a future edition of this work.

## 3.43 Commentary: the future of residence

In the 2010/11 edition of this work I said that "The urgent need for a statutory definition of residence will be obvious to anyone who has read this chapter"[126] and "the pressure for a proper statutory definition of residence is likely to prove irresistible." The Residence Consultation Paper proposing a statutory residence test is discussed in the next chapter.

126 See in particular 3.18 (Commentary: Assessment of case law tests).

CHAPTER 3A

# RESIDENCE OF INDIVIDUALS FROM 2012/13

## 3A.1 Residence from 2012/13 - Introduction

In June 2011 HMRC published a consultation paper entitled Statutory Definition of Tax Residence (**“the Residence Consultation Paper”**).[1] This proposes a new statutory residence test.

Subject no doubt to minor changes, this is likely to become law from 2011/12. Most of the problems raised by the current (non)definition of residence will be swept away, thus carrying out the reform recommended by the Consolidation Committee in 1936.

This chapter discusses the consultation paper.

## 3A.2 Scope of new statutory residence test

The Residence Consultation Paper provides at 3.10:

- [The SRT] will define tax residence for individuals and it will not cover the residence of companies;
- it will apply for the purposes of income tax, capital gains tax and inheritance tax;
- it will not apply for non-tax purposes or other Government services where residence is separately defined, such as National Insurance Contributions[2]; and
- the new statutory definition will supersede all existing legislation, case law and guidance for tax years following its introduction.

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1 Accessible *www.hm-treasury.gov.uk/d/consult_condoc_statutory_residence.pdf*

2 In fact there is no definition of residence for NIC purposes.

## 3A.3 Outline of statutory residence test

The Residence Consultation Paper provides:

> 3.11 To enable the SRT to provide both for those with straightforward affairs and those whose tax residence position is more complicated, the Government proposes that the test will have three parts:
> - Part A contains conclusive non-residence factors that would be sufficient in themselves to make an individual not resident.
> - Part B contains conclusive residence factors that would be sufficient in themselves to make an individual resident.
> - Part C contains other connection factors and day counting rules which will only need to be considered by those whose residence status is not determined by Part A or Part B.
>
> 3.12 In using the test, an individual will need to consider which part of the test is applicable to their personal circumstances:
> - If an individual satisfies any of the conditions at Part A for a tax year they will definitely be not resident in that tax year.
> - If Part A does not apply but the individual satisfies any of the conditions in Part B, they will definitely be resident in that tax year.
> - If none of the conditions at Part A or Part B are satisfied, the individual should consider Part C.
>
> 3.13 In the rare situations where an individual satisfies one of the conditions in both Part A and Part B, for example someone whose only home is in the UK but who spends very few days in the UK in a particular tax year, Part A will take precedence and the individual will definitely be not resident in that year.

## 3A.4 Conclusive non-residence (part A)

The Residence Consultation Paper provides:

> **Part A: conclusive non-residence**
> 3.15 In some circumstances an individual should have certainty that they are not tax resident in the UK without having to take account of the connections they have with the UK. This is particularly the case when they are present in the UK for only a small number of days in a tax year.
> 3.16 In addition, as under the current rules, the Government believes a UK resident individual who leaves the UK to work abroad full-time should be non-resident for the duration of this work irrespective of the connections with the UK they leave behind, subject to certain conditions. This provision is important to employers and business as it significantly

reduces administration relating to employees being sent abroad.

3.17 Therefore, Part A of the test will conclusively determine that an individual is not resident in the UK for a tax year if they fall under any of the following conditions, namely they:

[1] were not resident in the UK in all of the previous three tax years and they are present in the UK for fewer than 45 days in the current tax year; or

[2] were resident in the UK in one or more of the previous three tax years and they are present in the UK for fewer than 10 days in the current tax year; or

[3] leave the UK to carry out full-time work abroad, provided they are present in the UK for fewer than 90 days in the tax year and no more than 20 days are spent working in the UK in the tax year...

3.19 An individual who does not fall within Part A would not necessarily be UK resident. They would instead need to consider Part B or Part C of the test...

## 3A.5 Conclusive residence (part B)

The Residence Consultation Paper provides:

**Part B: conclusive residence**

3.20 There are a large number of people who are clearly tax resident in the UK because they:

- spend almost all their time in the UK;
- work exclusively or predominantly in the UK; or
- have their home in the UK and base their life and family here.

3.21 The SRT should provide a clear answer for such individuals, including those who come to the UK part way through the tax year. The purpose of Part B is to provide certainty for this group, including the many expatriate employees who come from abroad to work on posts in the UK.

3.22 Provided Part A of the test does not apply, an individual will be conclusively resident for the tax year under Part B if they meet any of the following conditions, namely they:

[1] are present in the UK for 183 days or more in a tax year; or

[2] have only one home and that home is in the UK (or have two or more homes and all of these are in the UK); or

[3] carry out full-time work in the UK. ...

3.24 The Government considers that these factors are simple to apply and would provide certainty for many individuals as well as for employers who bring employees to the UK on secondment.

3.25 An individual who does not meet any of the conditions in Part B would not necessarily be non-resident; instead they would need to consider Part C of the test.
3.26 As outlined in paragraph 3.13 in cases where an individual satisfies a condition in both Part A and Part B, the individual would be non-resident.

## 3A.6 Non-conclusive cases: Part C

The Residence Consultation Paper provides:

3.27 Part C would apply only to those individuals whose residence status is not determined by Part A or Part B and, therefore, whose circumstances are less straightforward.
3.28 Part C reflects the principle that the more time someone spends in the UK, the fewer connections they can have with the UK if they want to be non-resident. It also incorporates the principle that residence status should adhere more to those who are already resident than to those who are not currently resident.
3.29 Under Part C an individual would simply need to compare the number of days they spend in the UK against a small number of clearly defined connection factors. Individuals who know how many days they spend in the UK and how many relevant connection factors they have would find it straightforward to assess whether they are resident.
3.30 The Government proposes that the following connection factors should be relevant to an individual's residence status, but only when linked to the amount of time the person spends in the UK. These factors are defined in detail in Chapter 4:

- **Family** – the individual's spouse or civil partner or common law equivalent (provided the individual is not separated from them) or minor children are resident in the UK;
- **Accommodation** – the individual has accessible accommodation in the UK and makes use of it during the tax year (subject to exclusions for some types of accommodation);
- **Substantive work in the UK** – the individual does substantive work in the UK (but does not work in the UK full-time);
- **UK presence in previous year** – the individual spent 90 days or more in the UK in either of the previous two tax years;
- **More time in the UK than in other countries** – the individual spends more days in the UK in the tax year than in any other single country.

3.31 All of these factors are a strong indication of where the centre of a person's life is and all are relevant under current case law. Including these factors provides clarity on the residence status of individuals who 'leave' the UK but keep their family and home here; these situations account for much of the uncertainty in the current rules.

3.32 These connection factors would be combined with days spent in the UK into a "scale" to determine whether the individual is resident or not.

3.33 It is proposed to have separate "scales" for arrivers and leavers, reflecting the principle that it should be harder for leavers to relinquish residence than for new arrivers to acquire it. These are described in detail below.

## 3A.7 Non-conclusive cases: arrivers

### 3A.7.1 *Connecting factors for arrivers*

The Residence Consultation Paper provides:

**(i) Individuals not resident in all of the previous three tax years (arrivers)**

3.34 If the individual was not resident in all of the three tax years preceding the year under consideration, the following connection factors may be relevant to their residence status, if they occur at any point in the tax year, namely the individual:

[1]has a UK resident **family**;
[2]has substantive UK **employment** (including **self-employment**);
[3]as accessible **accommodation** in the UK;
[4]spent **90 days or more** in the UK in either of the previous two tax years.

3.35 The way these connection factors are combined with days spent in the UK to determine residence status is as follows:

### 3A.7.2 *Interaction of day test with arrivers connecting factors*

The Residence Consultation Paper provides:

| **Days spent in UK** | **Impact of connection factors on residence status** |
|---|---|
| Fewer than 45 days | Always non-resident |
| 45 – 89 days | Resident if individual has **4 factors** (otherwise not resident) |
| 90 – 119 days | Resident if individual has **3 factors or more** (otherwise not resident) |
| 120 – 182 days | Resident if individual has **2 factors or more** (otherwise not resident) |
| 183 days or more | Always resident |

## 3A.8 Continuing significance of old residence law

The Residence Consultation Paper provides:

> 3.56 The current rules will continue to apply for the assessment of tax liability in tax years prior to the introduction of the statutory test, including 2011-12. It is not proposed to allow individuals to apply the new definition retrospectively to calculate tax for prior years.
> 3.57 As set out in the proposed framework, the application of some elements of the test for years after the introduction of the new definition would depend on whether or not an individual was resident in previous tax years. In particular, an individual would need to know whether they had been resident in any of the previous three years to decide which element of Part C to use. The Government has considered whether there is a case for introducing a transitional rule enabling individuals to elect to apply the new statutory definition of residence to prior years in these specific situations. However, despite the uncertainty of the current rules, the individual will have needed to know what their residence status was in prior years to determine their tax status in the UK and many will have filed a Self Assessment (SA) tax return for those years declaring either that they were resident or not resident. It therefore does not propose to offer such a transitional rule but would welcome views on this point.

Because of the distinction between leavers and arrivers, the existing law will continue be directly relevant to determine whether a person is a leaver or an arriver:
**2012/13:** position depends on residence in 2008/09, 2009/10, 2010/11 (applying old residence definition)
**2013/14:** position depends on residence in 2009/10, 2010/11 (applying old residence definition)
**2014/15:** position depends on residence in 2010/11 (old law directly applicable)
By **2015/16** the position will depends on residence in 2012/13 - 2014/5, applying the new law; but the residence position in those years will apply the old law. Thus it will take decades before the old law is completely obsolete, but the number of cases in which it matters will become small by 2015 and will diminish each year thereafter.

## 3A.9 Non-conclusive cases: leavers

### 3A.9.1 *Connecting factors for leavers*

The Residence Consultation Paper provides:

> **(ii) Individuals resident in one or more of the previous three tax years (leavers)**
> 3.36 If the individual was resident in one or more of the three tax years immediately preceding the tax year under consideration, the following connection factors may be relevant to their residence status, if they occur at any point in the tax year, namely the individual:
> [1] has a UK resident **family**;
> [2] has substantive UK **employment** (including **self-employment**);
> [3] has accessible **accommodation** in the UK;
> [4] spent **90 days** or more in the UK in either of the previous two tax years;
> [5] spends **more days in the UK** in the tax year than in any other single country.

Factor 5 (more time in UK than another country) applies to leavers but not to arrivers. Presumably the object is that HMRC can notify tax authorities of the country where the individual spends most time, to see if tax should be paid there.

The definition of "country" is crucial, and the question will sometimes arise as to what constitutes a single country. If an individual spends time in different states of a federal country, such as the USA, then the time counts as spent in one country. But some constitutional research will occasionally be necessary. Are Spain and Majorca one country? Or Guernsey, Alderney and Sark? Or are they separate countries?

### 3A.9.2 *Interaction of day test with leavers connecting factors*

The Residence Consultation Paper provides:

> 3.37 The way these connection factors are combined with days spent in the UK to determine residence status is as follows:

| Days spent in UK | Impact of connection factors on residence status |
|---|---|
| Fewer than 10 days | Always non-resident |
| 10 - 44 days | Resident if individual has **4 factors or more** (otherwise not resident) |
| 45 – 89 days | Resident if individual has **3 factors or more** (otherwise not resident) |
| 90 – 119 days | Resident if individual has **2 factors or more** (otherwise not resident) |
| 120 – 182 days | Resident if individual has **1 factor or more** (otherwise not resident) |
| 183 days or more | Always resident |

## 3A.10 "Full-time work abroad"

The Residence Consultation Paper provides:

> 4.1 ... These definitions are not final and there will be scope to refine them, if appropriate, when legislation is drafted.
> **Full-time work abroad**
> 4.2 A person has full-time work abroad (FTWA) if they leave the UK to perform work abroad and are:
> - employed abroad under one or more contracts of employment (including consecutive employments) or hold offices which have combined total hours of 35 hours per week or more; or
> - carrying on one or more trades or professions wholly abroad where 35 hours of work per week or more is undertaken on average.
>
> 4.3 In either of these cases the work must be carried out for at least one full tax year if it is to be classed as full-time work abroad.
> 4.4 When a person is working full-time abroad, no more than 20 working days can be performed in the UK in any one tax year. This limit will be reduced pro rata if the individual is treated as being not resident for part of a year under the split year rules.
> 4.5 The person must be present in the UK for fewer than 90 days. This limit will be reduced pro rata if the individual is treated as being not resident for part of a year under the split year rules.
> 4.6 Individuals who do not meet all the criteria for full-time work abroad, for example if they have more than 20 working days in the UK, will not necessarily be resident; they may still be non-resident under Part C.

## 3A.11 "Working day"

The Residence Consultation Paper provides:

> 4.7 A working day is any day on which three hours or more of work is carried out.
> 4.8 If an individual carries out fewer than three hours of work, the day will not count towards the threshold of 20 working days for the purposes of FTWA.
> 4.9 Even if an individual is not present in the UK at the end of the day, they will still be treated as working in the UK on that day if they have worked in the UK for three hours or more.
> 4.10 Where individuals work in the UK for less than three hours on a particular day, they would be expected to have sufficient records to demonstrate this fact.

## 3A.12 "Day present in the UK"

The Residence Consultation Paper provides:

> 4.16 There will be no change to the definition of what is meant by a 'day' or 'presence in the UK'. A person will be treated as being in the UK on any day where they are in the UK at midnight at the end of that day.
> 4.17 The current rules for individuals travelling through the UK as a passenger where they are in the UK at the end of any day will also be retained. This will mean that a day will not count as a day of UK presence if they arrive in the UK as a passenger, they depart from the UK on the next day and during their time in the UK they do not engage in any activity substantially unrelated to their passage through the UK.

## 3A.13 "Home"

The Residence Consultation Paper provides:

> 4.12 If a person has only one home and that is in the UK or they have more than one home and all of these are in the UK, this will constitute an 'only home'.
> 4.13 Residential accommodation is not treated as an individual's home if that accommodation is being advertised for sale or let and the individual lives in another residence.
> 4.14 A person is working full-time in the UK if they are:
>
> - employed in the UK under one or more contracts of employment (including consecutive employments) or hold offices with total combined contracted hours of 35 hours per week or more; or

> - carrying on one or more trades or professions in the UK where 35 hours of work per week or more is undertaken on average.
>
> 4.15 The work must be carried out in the UK over a continuous period of more than 9 months (excluding short breaks such as illness or holidays) and not more than 25% of the duties can be undertaken outside of the UK within that period.

## 3A.14 "Family in the UK"

The Residence Consultation Paper provides:

> 4.19 An individual has family in the UK in a tax year if either of the following applies:
>
> - the individual's spouse, civil partner or common law equivalent is resident in the UK in that tax year or any part of that tax year. This does not include a spouse, civil partner or common law equivalent if they are separated from the individual under a court order or a separation agreement or where the separation is likely to be permanent; or
> - the individual has children under the age of 18 who are resident in the UK and the individual spends time with those children (one to one or with others present), or lives with them, for all or part of 60 days or more during the tax year. It would not matter whether these days were spent with the child in the UK or elsewhere.
>
> 4.20 A child will not be treated as being resident in the UK for these purposes if their residence is mainly caused by time spent at a UK educational establishment. This will be when the child spends fewer than 60 days in the UK not present at the educational establishment and the child's main home is not in the UK.

## 3A.15 "Accommodation"

The Residence Consultation Paper provides:

> 4.21 An individual has UK accommodation if residential property:
>
> - is accessible to be used by them as a place of residence; and
> - is used by them or their family in the year as a place of residence. Family has the same meaning as in paragraphs 4.19 and 4.20.
>
> 4.22 The following categories of accommodation are not included as UK accommodation:
>
> - accommodation provided by an individual's employer where the accommodation is also accessible to, and used by, other employees

of that employer who are not connected to the individual. For example, premises owned or rented by the company that is used by all employees visiting the country while on company business;
- any accommodation held on a lease of six months or less, except where there are consecutive leases taking place. For example, if an individual moves from house A, with a six month lease to house B with a six month lease, and there are fewer than six weeks between leaving one house and living in the other, they will be considered to have UK accommodation;
- accommodation accessible to a child of the individual under the age of 18 where that accommodation is provided in relation to the child being a student at a UK educational establishment;
- short-term accommodation in hotels; and
- lodging with relatives, where staying in the home of a relative is for a temporary short-term visit only.

## 3A.16 "Substantive employment/self employment"

The Residence Consultation Paper provides:

> 4.23 An individual has substantive employment or self-employment in the UK if they work in the UK for 40 or more days in the tax year.
> 4.24 The definition of a working day is any day on which more than three hours of work is undertaken. This includes any day where the person is not in the UK at the end of that day.

## 3A.17 Transitional rules

The Residence Consultation Paper provides:

> 3.55 The SRT will provide a complete set of rules for determining whether a person is tax resident in the UK or not. It is intended that these will broadly recreate the outcome of the current residence rules and, therefore, it is not envisaged that there will be any need to provide transitional rules to cover any change in residence status for individuals between the old rules and the new ones.

## 3A.18 Ordinary residence

The Residence Consultation Paper provides:

6.16 The Government's proposed definition is that individuals who are resident in the UK should also be treated as ordinarily resident unless they have been non-resident in the UK in all of the previous five tax years. If they meet this condition, they may be not ordinarily resident. The status of being not ordinarily resident should be available in the tax year in which the individual arrives in the UK and for a maximum of two full tax years following the tax year of arrival.

6.17 The Government does not propose that everyone who comes to the UK for the first time or after a long period of absence should be entitled to be not ordinarily resident. In particular, it should not be possible for those who are coming to the UK permanently to be not ordinarily resident. This is the case under the current rules and the Government would like to preserve this feature as far as possible. Therefore, notwithstanding the individual's residence status in the previous five years, there will be exclusions from being not ordinarily resident if the individual:

- is resident in the UK on the basis that their only home is in the UK; or
- has more than one home and all of their homes are in the UK.

6.18 The Government is also considering whether any statutory definition of ordinary residence should be limited to non-domiciled taxpayers ("non-domiciles") only. Currently it is possible to be UK domiciled but also to be not ordinarily resident. However, very few individuals receive beneficial tax treatment purely as a result of being not ordinarily resident: fewer than 300 in 2008-09.

6.19 It would not be viable to recreate the current subjective definition of ordinary residence in statute. As a result, it is likely that some individuals who are currently ordinarily resident on the basis that they are coming to the UK permanently, would be not ordinarily resident under a statutory definition. This would pose a risk to the Exchequer in the case of domiciled individuals because they could gain access to the general remittance basis and overseas workday relief where they currently do not.

6.20 Therefore, the Government's preference is that it should only be possible for non-domiciled individuals to be not ordinarily resident.

## 3A.19 Reform of ordinary residence

The concept of ordinary residence is relatively unimportant for tax purposes and there have been calls for its abolition.[3] Abolition would be a gain in simplicity and few would be affected by the change. That is not enough to justify the abolition of ordinary residence: one would need to go through every occasion where ordinary residence mattered and ask whether the change was justified.

In the 2010/11 edition of this work I concluded:

> It is suggested that a useful distinction can be drawn between those resident for a year or two and those resident for three or more years, and ordinary residence (if clearly defined) does have a useful role to play in a fair tax system.

This is only correct if one adopts the understanding of what is ordinarily residence which was in the former IR20 and the 2009 version of HMRC6, and which broadly survives (with less clarity) in the 2010 version. If one adopts the view in *Tuczka*[4] that "the expression differs little in meaning from the word residence" then there is indeed no point in having two concepts and ordinary residence should be abolished where possible.

In some cases, ordinary residence is enshrined in international agreements or in existing Government undertakings (eg the promise not to tax non-ordinary residents on FOTRA securities) and that could not easily be abolished.

The Residence Consultation Paper provides:

> **Option for reforming ordinary residence**
> 6.21 The Government is considering two main options for the reform of ordinary residence and seeks views on the merits of these options.
> **Option 1: abolish ordinary residence for all tax purposes except overseas workday relief**
> 6.22 This option would abolish the concept of ordinary residence as a general concept for determining tax liability and access to the remittance basis.
> 6.23 The concept of overseas workday relief would be retained and the definition of 'not ordinarily resident' for this purpose would be put on

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3 David Jeffrey, *Taxation*, (2001, p.254); STEP response to 2003 Background Paper on Residence & Domicile accessible *www.kessler.co.uk*. Ordinary residence is also unsatisfactorily vague but (like residence) that could quite easily be put right by a statutory definition.

4 See 3.15.7 (Residence and ordinary residence compared).

a statutory footing using the definition proposed in paragraphs 6.16 to 6.17.

6.24 This would mean that, for most purposes, individuals would simply have to determine whether they were resident and/or domiciled in the UK.

6.25 This would be a significant simplification. Individuals would no longer have to consider whether they were also not ordinarily resident and could concentrate on one simplified **26** definition of residence. It would also allow the many other references to ordinary residence in tax legislation, most of which are consequential, to be removed or replaced by a reference to residence.

6.26 It should be stressed that this option would not affect other legislative instances of ordinary residence outside tax legislation. For instance, ordinary residence is separately defined for the purposes of liability to National Insurance Contributions and it is not proposed to amend this.

6.27 Under this option the 300 individuals who are currently domiciled but not ordinarily resident and claim the remittance basis would lose access to the remittance basis for foreign investment income. There would be no impact on the ability of non-domiciled taxpayers to claim the remittance basis.

6.28 There would also be an impact on some individuals in other circumstances:

- individuals who are currently resident and not ordinarily resident would become liable to any charges that will apply under the transfer of assets legislation, provided the other provisions of that legislation applied; and
- the very few people who are not resident but ordinarily resident would no longer be liable to some tax charges such as CGT.

CHAPTER FOUR

# RESIDENCE OF TRUSTEES

## 4.1 Trustee residence – Introduction

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

There is one main definition of trustee residence, which is the same for IT and CGT.[2] The IT and CGT provisions are differently worded, but the effect of the rules is the same. In this chapter I set out both sets of provisions.[3]

The current rules adopt proposals originally made in the Trusts Consultative Document (1991) Chapter 10.[4] This is worth reading as it explains the background to the current rules.

The law before 2007/08 provided that a UK professional trustee of a trust with a non-resident, non-domiciled settlor was regarded as non-resident. This 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 Department of Trade and Industry had advised the rule breached EU

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

2 For IHT see 4.14 (Trustee residence for IHT).

3 Under the FA 2006, the wording was exactly the same (though the provisions were set out twice, once in ICTA and again in TCGA). But ITA repealed the ICTA provisions and recast them in its own plain English style. 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.

4 Accessible *www.kessler.co.uk*.

restrictions on State Aid.[5]

Different rules apply to PRs.[6]

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

## 4.2 Who are the trustees?

One needs first of all to identify the trustees.

Trustee is not usually defined for IT and CGT purposes and the identity of trustees of a classic settlement is a matter of trust law.

What if there has been an invalid appointment of new trustees, and the trust property has been transferred to the invalidly-appointed trustees? Trust 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 transfer 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).[7] But it is considered that such a person is not a "trustee" for tax purposes.[8]

For the question whether a protector may be a trustee, see 4.13 (UK protector and trustee residence). For the identity of trustees of a

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5 There are strong arguments against that view of EU law, and indeed the former UK rule still applies in Ireland. However HMRC refused to disclose the DTI advice which makes it impossible to assess the validity of the advice which HMRC said they received. One might speculate as to whether this was a true reason or an excuse. Following an application under the Freedom of Information Act, the Information Tribunal "urged" HMRC to disclose their reasons (which were "bald and substantially unexplained.") Unfortunately the Tribunal did not order HMRC to do so and HMRC disregarded the urging of the Information Tribunal as non-binding. So it remains a matter of speculation. For the freedom of information aspects, see *www.kessler.co.uk/FoI.*

6 See 67.3 (Residence and domicile of PRs for CGT) and 68.2 (Residence of PRs for IT)

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

8 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.

settlement-arrangement which is not a classic trust, see 45.2 ("Settlement" and "trustee").

## 4.3 Trustees treated as single and distinct person

Section 474(1) ITA provides:[9]

> 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).

EN CTA 2010 Annex 1 change 3 explains this deeming provision:

> Section 474(1) of ITA (which applies also for corporation tax purposes - see section 1169 of this Act) substitutes a notional person for the trustees. That notional person is not a company and so cannot be an associated company [for the purposes of s.25 CTA 2010]. It follows that [the former] ESC C9 is not needed to prevent a trustee company and a company which it controls from being treated as associated. Similarly, if section 474(1) of ITA treats the trustees of two settlements as separate notional person, the concession is not needed to prevent two companies controlled by different settlements from being treated as associated [even if the trustees are actually the same person].

Section 69(1) TCGA provides the equivalent rule for CGT:

> 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).

## 4.4 Trustee residence for income tax and CGT

Section 475 ITA provides:

> (1) This section applies for income tax purposes and explains how to work out, in relation to the trustees of a settlement—

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

> (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.

Similarly, s.69(2) TCGA provides:

> 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.

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

Since the same rules govern trustee-residence and trustee-ordinary residence, I generally refer just to "trustee-residence" and leave trustee-ordinary residence to be understood.

## 4.5 Trustee residence condition A: all trustees UK resident

Section 475(4) ITA provides:

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

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

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

One must identify the trustees' actual place of residence in their personal capacities, applying the tests of individual/corporate residence to each individual or corporate trustee. If all the trustees are UK resident, the trust is UK resident; conversely if all the trustees are not resident in the UK, then the trust is non-resident.

## 4.6 Trustee residence condition B: mixed resident trustees

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

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

I refer to condition C as "**trustee residence condition C**".

Similarly for CGT, s.69 TCGA provides:

> (2B) Condition 2 is that:
> (a) at least one trustee is resident in the UK,
> (b) at least one is not resident in the UK, and
> (c) a settlor in relation to the settlement was resident, ordinarily resident or domiciled in the UK at a time which is a relevant time in relation to him.
> (2C) In subsection (2B)(c) 'relevant time' in relation to a settlor—
> (a) means where the settlement arose on the settlor's death (whether by will, intestacy or otherwise), the time immediately before his death, and
> (b) in any other case, a time when the settlor made the settlement (or was treated for the purposes of this Act as making the settlement).

## 4.7 Trustee residence condition C

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

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

Section 476(2) ITA deals with testamentary trusts:

> If—
> (a) the settlement arose on S's death (whether by S's will, on S's intestacy or in any other way), and

> (b) immediately before S's death, S was UK resident, ordinarily UK resident or domiciled in the UK,
>
> then S meets condition C from the time of S's death until S ceases to be a settlor in relation to the settlement.

Section 476(3) ITA deals with lifetime trusts:

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

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

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

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

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

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

### 4.7.1 *Identifying settlor and date of provision: tainting*

In trusts with mixed resident trustees, it is necessary to identify the settlor(s)[10] and to ascertain when the settlor(s) provide trust property.

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

10 See 69.1 (Who is the settlor?).

This is known as "tainting" the trust.[11]

Suppose:

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

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

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

For the position where a settlor leaves a loan outstanding after coming to the UK, see 69.16 (Interest-free or back-to-back loan).

### 4.7.2 *Split years*

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

## 4.8 Accidental residence: a trap

A trust may become UK resident if:

(1) its sole trustee becomes UK resident; or

(2) any trustee becomes UK resident and it is a UK-linked trust.

The consequences of a trust becoming UK resident will be disastrous for CGT and (except for IP trusts) for IT. Before 6 April 2007 this rule was mitigated for CGT, because a trust would not become UK resident for CGT if a trustee became resident for one year only.[12] That has been withdrawn. So it is essential for an individual to resign trusteeship before becoming UK resident if (1) a sole trustee or (2) trustee of a UK-linked trust. This includes trusteeships of foreign law charitable trusts.

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

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11 See 69.3.9 (Tainting).

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

## 4.9 Sub-funds

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

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

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

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

> The cases covered by subsection (2) include cases where settled land (within the meaning of the Settled Land Act 1925) is vested in the tenant for life and investments representing capital money are vested in the trustees of the settlement.[14]

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.

## 4.10 Transfer between settlements

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

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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.

15 Private correspondence.

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

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

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

## 4.11 Permanent establishment residence rule

Section 475(6) ITA provides:[16]

> 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 reasoning:

> 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

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

> company's UK branch. It would not be appropriate if such a trust were treated as non-resident, because it would then be taxed more favourably than a similar trust dealt with by a branch of a UK corporate trustee, or by some other UK professional. That could both lead to a loss of tax and put UK professionals at a competitive disadvantage. It is therefore suggested that the UK branch of a foreign trustee should be treated as a trustee resident in the UK for the purpose of the common residence test.[17]

The PE residence rule has four requirements:

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

HMRC has published 17 pages of guidance on the PE residence rule (**"HMRC Trustee Residence Guidance"**).[18] This is supplemented by another 25 pages of guidance issued in 2010 which is not discussed here, but which I hope to consider in the next edition.[19]

### 4.11.1 *"A business"*

The PE residence rule only applies if the trustee carries on a business. A trustee which does not charge, or only charges to recoup expenses (such as a family trustee company) does not carry on a business. This may offer a solution to the problem of the PE residence rule.

HMRC agree. HMRC Trustee Residence Guidance provides:

> By business we mean the business of providing professional trustee services for a fee.

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17 accessible *www.kessler.co.uk*.

18 Accessible *www.hmrc.gov.uk/cnr/trustee-res-guidance.pdf.*. This was published 31 July 2009 (though the published version is dated 1 July 2009). HMRC say that the guidance will eventually be incorporated into the TSE Manual.

19 Taxguide 3/10 Trustee Residence: Guidance note agreed by HMRC issued August 2010 by ICEAW, CIOT and STEP accessible *www.icaew.com/en/technical/tax/tax-faculty/~/media/Files/Technical/Tax/Tax%20 news/TaxGuides/taxguide-3-10-trustee-residence.ashx*.

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

The business must be (or include) the business of acting as trustee. For instance, a trustee may run a property business in the UK, but is not acting as trustee in the course of running that business.

HMRC agree. HMRC Trustee Residence Guidance provides:

> 8. When considering the applicability of the [PE residence rule] the following three questions are relevant:
> **A. Is the trustee carrying on a business in the UK?**
> ... This question does not relate to the business of a particular trust that might be conducted by the trustee. It enquires whether the person who is a trustee carries out business activities (as a professional or businessman, not as trustee of a particular trust) in the UK.

HMRC Trustee Residence Guidance provides:

> 8. When considering the applicability of the [PE residence rule] the following three questions are relevant ...
> **B. If the trustee is carrying on a business in the UK is it carrying on that business through a branch, agent, or permanent establishment in the UK?**
> Again this means that the trustee is carrying on through the branch, agency or permanent establishment the sort of activities from which it substantially derives its worldwide profits - providing professional services for a fee - and not what it is doing in relation to an individual trust.
> In the case of a corporate trustee it might be the case that activities are carried out in the UK on its behalf by a dependent agent with the result that the trustee is treated as having a PE in the UK (see paragraph 3 of Part 2 of this guidance).

### 4.11.3 *"Business carried on in the UK"*

What if T carries on business partly in the UK and partly elsewhere? It is suggested that T carries on business in the UK, so if the UK part is carried on through a PE, T is deemed UK resident. If this is right, the rule lacks all proportionality. There is no *de minimis* rule. If a tiny part of T's trust business is carried on through a UK PE, the entire trust may become UK resident. As to whether a business is partly carried on in the UK, see 13.5 (Trading income of a non-resident), but if the business is carried on through a PE in the UK, there must be a business carried on in the UK.

### 4.11.4 *"Through a branch/agency and PE"*

In tax, the concept PE is used for companies[20] and "branch or agency" is used for individuals.[21] It is considered that one asks whether an individual trustee is carrying on a trustee business through a branch/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. HMRC Trustee Residence Guidance provides:

> 5. HMRC accept that for trustees the '*branch*' and '*agency*' tests apply to non-corporate trustees and the '*permanent establishment*' test to corporate trustees. Non-UK resident companies that are trustees therefore need only be concerned about being treated as UK resident if they carry on a business through a permanent establishment in the UK. This is in line with section 10B Taxation of Chargeable Gains Act 1992 which has the effect that an overseas company is not taxed on the gains made by a UK branch or agency, but only on those made by a permanent establishment here. ...

In practice offshore trusts often do not 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 just as well. If, exceptionally, the issue did arise, the concept of branch/agency is more or less the same as PE and for most practical purposes is identical.

If, as advocated in this book, the concept of branch/agency was replaced altogether by PE, this problem would cease to arise.

### 4.11.5 *One trustee of several trusts*

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

20 The statutory definition only applies to companies. See 74.2.1 (Scope of UK law definition).

21 For discussion of these concepts, see 74.2 (Meaning(s) of "permanent establishment"); 74.11 (Meaning of "branch or agency").

trustee through a UK PE 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. HMRC agree. HMRC Trustee Residence Guidance provides:

> 8. When considering the applicability of the [PE residence rule] the following three questions are relevant ...
> **C. If so is the trustee carrying on the activity of being a trustee of that particular trust in the course of its business through the branch, agent or permanent establishment?**
> For example, a corporate trustee could have a permanent establishment in the UK but it is only when it is acting as a trustee through that place that the deemed residence rules apply in relation to the particular trust for which the company acts as trustee. The test is on a trust by trust basis. So while a corporate trustee might be acting as a trustee in relation to one trust through a fixed place of business in the UK, other trusts must be considered separately according to their facts and circumstances.
> The same principle applies in the case of a non-corporate trustee: the test is on a trust by trust basis.

### 4.11.6 *Several trustees of one trust*

Suppose:
(1) a trust has two trustees, T1 and T2.
(2) T1 is deemed UK resident (because it has a UK PE) but T2 is not (e.g. T2 is an individual who does not carry on business).

This is treated as a trust with mixed resident trustees; see 4.6 (Trustee residence condition B: mixed resident trustees). So where a trust does not have a UK-linked settlor, the appointment of a co-trustee who does not carry on trustee business would solve the difficulty posed by the PE residence rule. HMRC agree. Trustee Residence Guidance example 4b provides:

> **Example 4b**
> As in example 4a but the significance of the meetings Mr. Monday has in the UK with the beneficiaries of the Tuesday Trust is sufficient for December Ltd to have a permanent establishment in the UK in respect of that trust. However December Ltd has a co-trustee Mr. Wednesday who is a non-UK resident trustee.
> **HMRC view**: As there is a co-trustee who is non-UK resident and as the

settlor of the Tuesday Trust was not resident or domiciled in the UK when he introduced property into the trust that means that the trustees of the Tuesday Trust as a body will not be UK resident.

## 4.12 When is there a UK PE?

The HMRC Trustee Residence Guidance on this, the central point of the PE residence rule, is vague and heavily qualified. It also contains errors in law for the author nowhere cites the applicable statutory provisions, of which they appear to have been unaware.

### 4.12.1 *Acts of the trustee in the UK*

HMRC Trustee Residence Guidance provides:

> **Core activities**
> 9. In connection with Question C[22] and in line with the Commentary to the OECD Tax Model Convention, "carrying on the function of being a trustee" means in this context activities which are the core activities of a trustee and not those activities which are auxiliary or preparatory. This applies equally to non-corporate trustees.

It is correct that activities which are of a preparatory or auxiliary character cannot constitute a PE.[23] The use of the label "*core* activities" to describe those which are not merely preparatory or auxiliary is not entirely apt, but it is difficult to think of a better term. The Trustee Residence Guidance explains "core activities":

> 10. A trustee is the person who has a legal duty to manage the assets of that trust in the best interests of the beneficiary or beneficiaries. The trustee manages, employs and disposes of the trust assets in accordance with both the terms of the trust and the duties and responsibilities which the law places upon trustees. The core activities of a trustee would therefore be regarded as including:
> 10.1 the general administration of the trusts
> 10.2 the over-arching investment strategy.
> 10.3 monitoring the performance of those investments.

22 See 4.11.5 (One trustee of several trusts).
23 See 74.7 (PE: preparatory and auxiliary activities).

> 10.4 decisions on how trust income will be dealt with and whether distributions should be made.[24]

The Trustee Residence Guidance then explains "ancillary activities":

> 11. There are other activities which trustees carry out which are not core activities central to their conduct and management of the trust, but are instead preparatory or auxiliary activities. These *generally* can include information gathering meetings, including meetings with independent agents or with beneficiaries but, as mentioned below, each case will have to be considered individually.

In fact, the rule that information gathering is auxiliary is a statutory rule.[25] But in practice meetings tend to move seamlessly from information gathering to decision making.

> 12. In deciding whether the conduct and management of a particular trust is being carried on in the course of the corporate trustee's business through a permanent establishment, HMRC's approach will be to look at where the core activities are physically being carried out. If these core activities are being carried on in the UK through the corporate trustee's permanent establishment, the trustee would be treated as UK resident for the purposes of the particular trust. However as well as the nature or significance of the individual activities and meetings and whether they are core activities, we would also consider the issue of frequency. So where there is, in relation to a particular trust, evidence of considerable administrative work – such as meetings with investment managers or beneficiaries - being carried on in the UK through a permanent establishment, so that such meetings have become a major element of the trustee's activities in relation to that trust, and no longer preparatory or auxiliary, we would need to consider carefully whether as a matter of fact the non-UK resident corporate trustee was acting as a trustee through that permanent establishment.

Before turning to the examples, the Guidance sets out the usual disclaimer:

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24 The draft guidance included a further paragraph 10.5: "accounting, making tax returns and record keeping." Significantly, the final guidance has deleted this.

25 See 74.7 (PE: preparatory and auxiliary activities).

13. The guidance that follows sets out examples of when a corporate trustee may or may not be regarded as UK resident. This guidance is based on the law as it stood on the day of publication. HMRC will publish amended or supplementary guidance if there is a change in the law or in the Department's interpretation of it. Whilst the guidance is intended to be as extensive and helpful as possible, it should not be assumed that it will provide a definitive answer in every case. That will depend upon the facts of each individual case. You can of course take your own advice on this issue and where HMRC's view is that there is a liability to UK tax on the basis that it regards a trust as UK resident because of how these rules apply to the trustees then the trustees can appeal to an independent tribunal.

Marketing to prospective settlors is not carrying on trust business in the UK because no trust at that time exists. HMRC agree:

**1. Preparatory work prior to the creation of any trust**
1.1 A non-UK resident trust company that is to be a trustee of a settlement may carry out a number of activities in the UK before the trust is created. This might, for example, include discussions with clients such as potential settlors or beneficiaries over the appropriate terms of any trust. It could also include research with specialist professionals about possible trust investments and assets. These discussions may take place even before the beneficiaries are chosen.
**Example 1**
Before the January Trust is established, February Ltd, a non-UK resident trust company holds several meetings in the UK at its Manchester office with the potential settlor Mr January. The meetings are to discuss the possible terms of the trust and suitable investments.
**HMRC view:** The January trust does not yet exist, so there is no need to consider the tests in section 69(2D) TCGA 1992 and section 475(6) ITA. In any case, introductory meetings and discussions of this type would generally be regarded as preparatory or auxiliary activities and not core activities.

Occasional visits to meet the settlor/beneficiaries or others cannot constitute a PE, which requires regularity.[26] HMRC agree:

**2. Trustee carrying out duties for the administration of any trust**
As mentioned in paragraphs 9 to 11 of the Background section of this guidance, a range of activities may be carried out by a trustee once a trust has been set up including meetings. When considering whether the corporate trustee is carrying on the administration of a particular trust in the course of their business through the permanent establishment, the frequency of the meetings will be looked at as

26 See 74.3.2 (Degree of permanency).

well as their significance and quality.

**Example 2**

March Ltd, a non-UK resident trust company that is trustee of the April Trust, holds quarterly meetings in the UK at its London offices with investment advisers. The purpose of these meetings is for March Ltd to collect purely factual information about potential assets to inform future investment strategy for the April trust. The actual decisions about the investment strategy are taken by March Ltd at their home office outside the UK. No other activities or meetings relating to the April Trust are carried on in the UK.

**HMRC view:** March Ltd has a permanent establishment in the UK. However, the significance of the meetings with the investment advisers is not sufficient for March Ltd to be regarded as acting as a trustee in respect of April Trust through that permanent establishment. They will not, therefore, be regarded as UK resident for the purposes of the April Trust.

The correct analysis is that the trustee does not have a PE in the UK, for two independent reasons: information collecting is an auxiliary matter, and the office is not used with sufficient regularity to constitute a PE. (One is of course looking on the matter on a trust by trust basis).

The author assumes that the trustee does have a PE but does not carry on business through it. Strictly a PE means a place of business through which a business is carried on, so there is no PE. However the end result is the same.

By contrast:

**Example 2a**

May Ltd, a non-UK resident trust company, is sole trustee of the June Trust. May Ltd carries out all the work for the trust through its UK offices, including preparatory work, general administration, meetings with investment managers, accountants, beneficiaries etc.. The investment and distribution policies are also all determined in the UK office. Formal ratification of those strategies, including signature of documents, is made by May Ltd at very brief meetings outside the UK, with little or no further discussion of the proposals before approval is given.

**HMRC view:** Although the strategic decisions are core activities, all the administration of the June Trust has been carried out in May Ltd's UK office. The formal meetings outside the UK although prima facie core activities are in reality merely "rubber stamping" all the UK work. May Ltd has acted as a trustee in respect of the June Trust through its UK permanent establishment and so will be treated as UK resident for the purposes of the June Trust.

That seems correct.

**Example 2b**

July Ltd, a non-UK resident trust company is trustee of the August Trust. It always carries out the core activities of the August Trust at its office overseas.

> The beneficiary of the trust has a single one-off meeting with July Ltd at July's Manchester office to discuss the potential release of capital from the August trust. The discussion involves the imposition of certain conditions on the beneficiary before such a release. [The author here seems unfamiliar with trust terminology and practice, though nothing turns on that.]
> **HMRC view:** On the face of it July Ltd by discussing the release of capital and the imposition of conditions with the beneficiary has engaged in a core activity and this has taken place at what is July's permanent establishment in the UK. So prima facie July Ltd is acting as trustee of the August Trust through a permanent establishment. However the whole context has to be looked at - i.e. where the decision making on the trust is being carried on and if the meeting in the UK was a one-off. If the trustee took the information from the meetings out of the UK with them and then discussed and made the decisions outside the UK, they would not be UK resident. If there was any doubt as to where the decision making is taking place we would as part of our considerations consider the frequency of any meetings both within and outside the UK.

More analytically, the issues (which are not clearly identified or addressed) are:
(1) Are the acts of the trustee in the UK merely preparatory (such as information gathering)? If so, there is no PE.
(2) Is the office used with sufficient regularity to constitute a PE? On the given facts, a one-off meeting is clearly not sufficient and the office is not a PE, so (although the HMRC example does not reach any conclusion) the answer is that the trustees are not UK resident.

### 4.12.2 *Services provided by UK companies or other agents: the law*

UK companies (which may in the same group as the trustee company or may be unconnected) may provide accounting, tax or investment services to the trustees. Does this constitute a PE?

If the agent is an investment manager or broker, the question for a corporate trustee is whether the investment manager or broker exemption applies: if so there is no PE. In practice these exceptions will be met.

If the agent is any other agent, the question is whether there is an agency PE, which arises if (in short)
(1) it has and habitually exercises authority to do business on behalf of the company and
(2) it is not "an agent of independent status acting in the ordinary course

of their business."[27]

### 4.12.3 *Services provided by UK companies: the guidance*

The HMRC guidance in this area bears only a tenuous connection to the law. The original HMRC guidance did however have the merit of clarity:

> I can confirm that our interpretation of the rules is that the provision of services on an arms length basis would not cause non-UK trustees to have a permanent establishment and therefore would not make the non-resident trustee UK resident.
> More specifically, this would include where services are carried out by a subsidiary on a fully arms length basis, such as:
> - maintaining the financial or accounting records
> - preparation of accounts
> - preparation and submission of tax returns for any settlement by a separate entity within the organisation contracting at arms length terms.
>
> Provided the services are contracted (at arms length terms) HMRC would not consider this constitutes a permanent establishment as the UK company will be rendering a service to the trust. Therefore, these activities would not cause the non-UK trustees to have a permanent establishment in the UK and the non-UK trustee is not made resident by [the PE residence rule].[28]

The correct questions are whether the IM exemption applies, and whether the agent is of independent status and acting in the ordinary course of their business, not whether the agent is receiving an arm's length fee. However the HMRC arm's length fee test reflects the policy aims of the provision, would be a simpler and workable rule, and would not normally give a different result from the correct approach.

In the HMRC Trustee Residence Guidance, this approach is maintained but is unfortunately watered down with qualifications such as "likely" or "ordinarily":

27 See 74.4 (Agency PE) and 74.5 (Independent agent).
28 Extract from letter dated 18 July 2007 accessible *www.step.org/pdf/TrusteeResidenceALS*.pdf

> **3. Activities carried on for the trust other than by the non-UK resident trust company**
> 3.1 Whilst a non-UK resident trust company acting as a trustee may not carry out trust business at a fixed place of business permanent establishment in the UK, it is also necessary to consider whether activities are carried out in the UK on that non-UK resident trust company's behalf by a dependent agent. If this is the case the trustee may be treated as having a permanent establishment in the UK. Annex A provides further information on dependent agents.
> 3.2 The activity of providing services to a non-UK resident trustee, whether by a connected person or not, does not of itself create a dependent agency permanent establishment (see paragraph 5 in the Annex). It is necessary to consider the capacity in which the person provides the services to the trust on behalf of the non-UK resident trustee. Where
> [1] the services that are provided to the trust are only those that the person is contractually obliged to provide under their agreement with the non-UK resident trustee and
> [2] are remunerated at arm's length,
> then this is *unlikely* to create a dependent agency permanent establishment.

At first point [1] is hard to understand. Who would provide services without a contract? Perhaps the author has in mind a beneficiary providing services to the trust informally?

> 3.3 Whether there is a dependent agency permanent establishment will depend on the facts of the case; the position is the same whether it is an unconnected third party or a UK subsidiary or other connected person that carries out the work for the trust. Where, say, a UK subsidiary of a non-UK resident trust company is providing services to a trust, then unless the powers granted to it by the non-UK resident trust company are such that it becomes a '*dependent agent with authority to do business on behalf of the non-resident trustee*' (see paragraph 5 of Annex A) we will not contend that the UK subsidiary's actions cause the non-UK resident trustee company to have a permanent establishment.

This is correct.

> **Example 3**
> September Ltd, a non-UK resident trust company contracts with October

Ltd which is a UK company within the same group. The services to be provided by October Ltd are for investment advice for the November Trust. The contract between September Ltd and October Ltd is on an arm's length basis and October Ltd has no powers granted to it by September Ltd.

**HMRC view:** October Ltd is providing a service for September Ltd and has contracted to do so on arm's length terms. They have no authority to do business on behalf of September Ltd so are not their dependent agent. Therefore, September Ltd will not be treated as having a permanent establishment through the work carried out by October Ltd in the UK. So September Ltd will not be treated as UK resident for the purposes of the November Trust.

This is straightforward. If the investment advisor had no authority to do business on behalf of its principal, then it is not an agent at all. It cannot be a dependent agent.

If the investment advisor did have power to do business on behalf of the trust, it is still not PE as long as it qualified for the IM exemption (which in practice will be the case).

Other examples which would be treated in the same way where there was an arm's length relationship are:

- Preparing trust accounts for the trustees' review and approval
- Preparing trust tax returns for the trustees' review and approval and filing the return on their behalf with HMRC
- Obtaining quotes for necessary repair work on trust property
- Having contact with workmen to ensure that those repairs are carried out
- Day to day management of let property (such as dealing with tenants etc)
- Signing small cheques such as paying for minor repairs

**Example 3a**

As above but October Ltd also has authority to buy and sell commodities with a view to realising profits for the trust subject to trading limits set by September Ltd. It receives an arm's length fee for this activity.

**HMRC view:** The investment manager is appointed by the trustee, and so is its agent. If it receives an arm's length fee for the investment management services, it will not *ordinarily* constitute a dependent agent of the non-UK resident trustee. If, however October Ltd was providing investment management services to the trustees other than on arm's length terms i.e. was acting as their dependent agent, rather than simply providing a service to them, in that case the trustees would be *likely* to

> have a dependent agent permanent establishment. (This is in line with the Investment Manager Exemption provisions – in particular that the provision of services at less than a customary rate can indicate that the investment manager is not an independent agent of the non-UK resident trustee.)

This is muddled because if the IM exemption applies, there is no PE.

### 4.12.4 *UK resident director or employee of trustee*

HMRC Trustee Residence Guidance provides:

> **4. UK resident directors or other employees of a non-UK resident trust company.**
> 4.1 First, it is necessary to consider the role of the UK resident director or employee of the non-UK resident trustee.
> 4.2 If the UK resident employee is not carrying out activities that would be regarded as core trustee activities in relation to a particular trust then the presence in the UK of an employee of a non-UK resident trust company could not by itself cause a non-UK resident trustee to have a permanent establishment in the UK.

This is consistent with the point made at 4.12.1 (Acts of the trustee in the UK).

> 4.3 Where in relation to a particular trust the UK resident employee does carry out [core] trustee activities in the UK then it is likely that the non-UK resident trustee will have a permanent establishment in the UK. This will be the case if the employee operates from a fixed base, or does not have a fixed base but habitually acts on behalf of the non-UK resident trustee for the particular trust, i.e. is a dependent agent permanent establishment of the non-UK resident trustee. The crucial point in relation to a dependent agent permanent establishment is whether the non-UK resident trustee company has in the UK-resident employee a dependent agent with authority to conduct business on behalf of the non-UK resident trustee. If this UK resident employee of a non-UK resident trustee does have the authority to make decisions then s/he is likely to constitute a dependent agent permanent establishment of the non-UK resident trust company.

The first example is a simple variant of example 1 (marketing):

**Example 4**
December Ltd, a non-UK resident trustee has a director or other employee Mr. Monday 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 Mr. Monday. His role is to market the business of the non-UK resident trust company in the UK which includes meeting with prospective settlors and other business contacts for this purpose.
**HMRC view:** In this case, Mr Monday's role is only meeting with prospective settlors and other business contacts for the purpose of marketing the business of December Ltd. Although these activities are carried out at the same place, they are not activities as a trustee that are carried out at a fixed place of business. They would generally be preparatory or auxiliary activities. This would not cause December Ltd to be treated as carrying on trustee business through a permanent establishment in the UK.

In the next example, the director does more than marketing:

**Example 4a**
As in example 4, but Mr. Monday's role also extends to meeting beneficiaries of existing trusts.
**HMRC view**: In this case, the importance of the subject matters discussed and the decisions taken at those meetings, and the frequency of the meetings held, will need to be analysed in relation to each trust in order to reach a conclusion as to whether December Ltd is carrying on a business through a permanent establishment in the UK for that trust through Mr Monday
If no office accommodation is at his disposal Mr Monday could still constitute a dependent agent permanent establishment of the non-UK resident trustee if he has authority to enter into contracts or otherwise do business on behalf of the trustee of the trusts i.e. more than simply meeting the beneficiaries and he habitually exercises that authority on behalf of his employer for the trust.

HMRC do not answer the question in the example, but the general approach to the answer is correct.

### 4.12.5 *Conclusion: Some guidelines on the PE residence rule*

It is considered that the following guidelines will avoid difficulties under the UK PE rule. It is assumed that the trust has only a corporate trustee, or if it has individual trustees, they are not carrying on a business (so it is necessary to consider PE issues but not branch/agency issues).

Use of professional UK investment managers and brokers is safe provided that the terms of the IM/broker exemptions are met, which in practice will be the case.

Use of professional UK advisors to prepare tax returns is safe, provided that they are acting in the ordinary course of their business, which in practice they will be.

Use of UK agents to manage UK property investments is safe, providing they are acting in the ordinary course of their business, which in practice they should be.

The trustees may if they wish to meet beneficiaries (or others) in the UK in the following circumstances:

(1) If the meeting is at the offices of the beneficiaries (or others) and not in the trustees own offices, or in offices provided by a company in the same group as the trustees.

(2) If the meeting is occasional. Less than once a year would be "occasional" for this purpose.

(3) If the meeting is purely for information gathering purposes. (The minutes of the meeting should make that clear.) However it may be difficult to restrict meetings to information gathering topics.

The trustees should not appoint a beneficiary to act for the trustee (unless, exceptionally, the beneficiary is carrying on a business and acting in the course of that business.)

Where the trustees own a house which is occupied by the beneficiary, I see no difficulty in the trustees authorising the beneficiary to maintain the house, as that does not constitute carrying on business in the UK.

There are no restrictions on marketing or meetings with prospective settlors.

The trustees would not normally have an employee or director who was UK resident, but if that did happen, the employee or director should not be involved in the management of the trust in the UK, except as above.

## 4.13 UK protector and trustee residence

It is normal practice to appoint a "protector"[29] who has power:

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29 On trust law and drafting aspects of protectors, see Kessler & Sartin, *Drafting Trusts and Will Trusts* (10th ed., 2010), para 7.29.

(1) to consent to certain key matters of trust administration; and
(2) to appoint and dismiss trustees.

The protector may be a UK resident. A protector could not be regarded as a trustee[30] and so their actual residence is irrelevant in ascertaining the

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30 The position is clear but since the question has been asked I set out the authorities in some detail.

*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* 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 for the purposes of the Charities Act 1993:

> "His power to direct investments is not an obligation to do so. 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."

[2002] EWHC 1304 (Ch); [2002] WTLR 989; 5 ITELR 125 at [41].

In *Bridge Trustees v Noel Penny (Turbines)* [2008] EWHC 2054 (Ch) an employer had power to distribute the surplus assets of a pension scheme. The employer was not "a trustee properly so called, that is to say, a person in whom property is vested as trustee"; see at [23].

Underhill and Hayton, *Law Relating to Trusts and Trustees*, 18th ed, 2010, p.1.78, takes the same view: "Because the protector merely has powers vested in him and not trust property he is not a trustee".

It might be a different matter if the protector's powers extend beyond those traditionally given to a protector. One could imagine a trust deed under which:

(1) persons named "trustees" held legal title to property; and
(2) a person named (or mis-named) "protector" held all the administrative and dispositive powers normally given to trustees.

This case (depending on the drafting) might be equivalent to the common situation 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 actual residence of the trustees in their personal capacities.

One must take care that the protector is not a permanent establishment of the trustees. This will not normally be the case, but it might be if the protector is given unusually wide powers.

## 4.14 Trustee residence for IHT

Trustee residence is not very important for IHT but the concept is used on a few occasions. IHT definitions of trustee residence are different from the IT/CGT definition.

For the (somewhat academic) relief for foreign currency bank accounts,[31] s. 157(4) IHTA provides:

> For the purposes of this section—
> (a) the question whether a person is resident or ordinarily resident in the UK shall, subject to paragraph (b) below, be determined as for the purposes of income tax; but
> (b) the trustees of a settlement shall be regarded as not resident or ordinarily resident in the UK unless the general administration of the settlement is ordinarily carried on in the UK and the trustees or a majority of them (and, where there is more than one class of trustees, a majority of each class) are resident and ordinarily resident there.

For the duty to disclose the creation of non-resident trusts,[32] s.218(3) IHTA provides:

> For the purposes of this section trustees of a settlement shall be regarded as not resident in the UK unless the general administration of the settlement is ordinarily carried on in the UK and the trustees or a majority of them (and, where there is more than one class of trustees, a majority of each class) are for the time being resident in the UK.

For the purposes of s.201(1)(d) IHTA (collection of non-resident trust's tax from settlor), s.201(5) IHTA makes an identical provision.[33]

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determinative of the meaning of "trustee" in a UK statute.

31 See 53.17 (Non-residents foreign currency bank accounts).

32 See 75.9 (IHT reporting requirement on creation of settlement).

33 For completeness, the same definition is set out yet again in the IHT (Delivery of Accounts) (Excepted Settlements) Regulations 2008.

For the question of where the administration of a settlement is carried on, see the 5th edition of this work, para 5.6. There are various interesting points that could in theory arise under these definitions, but I doubt if any of them will ever arise in practice.

### 4.14.1 *Commentary*

IHT trustee residence is a mess: essentially the same definition is repeated four times.

There is no need to have a separate definition of trustee residence for IHT at all, and if we need to keep the concept of trustee residence, it would be best to switch to the IT/CGT definition. Failing that, a single standard definition applying for all IHT purposes would be a small improvement.

## 4.15 Commentary: Let's abolish the relevance of trustee residence

Residence of individuals is a sensible connecting factor for UK taxation: everyone will accept that an individual who is UK resident should to some extent at least be subject to UK tax. Residence of trustees is a matter which is chosen by the 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: the connecting factor should be that property is 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 (or wholly 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.[34] But the mad anti-avoidance structure of ss.86 to 98 TCGA, bolstered (supposedly) by Schs 4A to 5, can be replaced with one based on s.731 ITA. The reform, like any, would bring winners and losers but

34 See 69.33 (Planning to create trust with foreign domiciled settlor).

the overall result could — if properly drafted — be a system which was fairer, simpler and much more effective.

CHAPTER FIVE

# TREATY-RESIDENCE

## 5.1 Treaty-residence - Introduction

The word "residence" (in isolation) is ambiguous. It may mean:

(1) **"treaty-residence"** ie residence as defined for the purposes of a double taxation arrangement ("DTA"); or

(2) "**domestic-law residence"** ie residence as defined for UK tax purposes. (I use the expression "domestic-law" to refer to UK domestic law, unless otherwise stated, though of course every state has its own domestic law.)

These concepts are distinct and to avoid confusion it is essential to use distinct terminology. ("Dual residence" is even more ambiguous and should also not be used without considering what sort of dual residence is involved.)

This chapter discusses the meaning of treaty-residence. The discussion is mainly on the OECD model treaty, though I refer at points to the US and other treaties. In any particular case it will be necessary to review the terms of the actual treaty concerned.

DTAs refer to "contracting states" but I abbreviate this to **"treaty state"** or just **"state"** and where that state is not the UK, I refer to it as **"the other state"**.

For an introduction to DTAs, see 50.1(DT reliefs - Introduction). For further reading, see Maisto (ed.) *Residence of Individuals under Tax Treaties and EC Law* (2010); Venables "The interpretation of double taxation conventions: Residence of dual resident and temporarily non-UK resident individuals" (1999) 8 OTR 189.

### 5.1.1 *Relationship between treaty- and domestic-law residence; dual residence*

A person can of course be domestic-law resident in two (or more) states.

A person cannot be treaty-resident in two treaty states: the tie-breaker test requires treaty-residence to be in one state alone. So a person who is treaty-resident in another treaty state is necessarily not treaty-resident in the UK.

However a person may be domestic-law resident in the UK while treaty-resident in the other state (and not treaty-resident in the UK). Treaty non-residence does not preclude domestic-law residence (except for companies).

The INT Manual provides:

> **154020. Dual residents** [November 2010]
> ... Although the agreement overrides some of the normal consequences of being a UK resident, it does not, in the case of an individual, override the fact of UK residence itself for purely domestic law purposes. Even though an individual may be resident for agreement purposes elsewhere, he (as a resident of the UK for UK tax purposes) still has to complete returns and fulfil any similar obligations imposed by the Taxes Management Act. He will also remain entitled to any personal allowances which may be due on account of his UK residence status.

Sometimes this rule works in favour of the taxpayer; for instance, it preserves the right to personal allowances (which are conferred on domestic-law UK residents but not generally available to non-residents).[1] Often however the rule works in favour of HMRC. For instance, a year in which an individual is domestic-law UK resident counts for the purposes of:

(1) the long-term residence test for the £30k remittance basis claim charge;[2]

(2) deemed domicile for IHT;

even though the individual is treaty non-resident during the year.

## 5.2 Starting point: residence under art. 4.1

Article 4 OECD Model Convention provides:

1 See 41.7.3 (Personal allowances under DTAs: non-residents).

2 See 9.11.10 (Individual treaty non-resident).

> 1. For the purposes of this Convention, the term "resident of[3] a Contracting State" means any person who, under the laws of that State, is liable to tax[4] therein by reason of his domicile, residence, place of management or any other criterion of a similar nature, and also includes that State and any political subdivision or local authority thereof.

I describe a person who is within this paragraph as **"resident of a state under article 4.1"**.

For the purposes of discussion it is convenient to abbreviate the phrase "domicile, residence, place of management or any other criterion of a similar nature" to "domestic-law residence"; in a UK context this is a permissible shorthand since it is UK domestic-law residence (not the other criteria mentioned) which decides whether a person is liable to UK tax.

There are then four requirements to be a resident of a treaty state under article 4.1:

(1) There must be a "person".
(2) The person must be liable to tax in the state.
(3) The person must be domestic-law resident in that state.
(4) Domestic-law residence must be the reason for liability to tax.

A person may be resident under article 4.1 in one treaty state alone, in which case they are treaty-resident in that state. A person may be resident under article 4.1 in both treaty states, in which case the tie-breaker tests discussed below are applied to identify the state in which they are treaty-resident.

So far as the UK is concerned, a person who is domestic-law UK resident is in general a resident of the UK under article 4.1. The expression would also include the (probably theoretical) case of a person who is domestic-law ordinarily resident in the UK but not domestic-law resident.

### 5.2.1 *Certificate of foreign residence*

HMRC helpsheet 302 (Dual Residents - 2010/11) provides:

> If you:

3 UK domestic law always refers to a person as resident *in* the UK; whereas the OECD model always refers to a person as a resident *of* a state; but nothing turns on the choice of preposition.

4 "Tax" is usually defined to mean IT or CGT.

> • are resident in the UK under domestic law, and
> • are also resident in another country under that country's rules, and
> • want to claim that you are a resident of the other country for the purposes of the DTA between the UK and that other country
> then you need to obtain a certificate from the overseas tax authority confirming that it regards you as resident there under its domestic law for the period in question, which must be stated on the certificate.
> The certificate should be attached to your completed claim on pages 8 to 11 of this helpsheet and sent with your tax return.

A certificate is not needed for the US/UK treaty: see 5.17 (UK/US DTA).

## 5.3 "Person"

The first requirement of treaty-residence is that there must be a "person" and one must identify
(1) who that person is; and
(2) whether that person is an individual or a person other than an individual (because different tie-breaker tests apply).
The term "person" is defined (after a fashion). Article 3.1(a) OECD Model provides:

> 1. For the purposes of this Convention, unless the context otherwise requires:
> a) the term "person" includes an individual, a company[5] and any other body of persons;

For individuals (who are "natural persons") and companies (which are "legal persons") this is straightforward, but partnerships, trusts and some other entities are more problematic. See 5.12 (Treaty residence: Trusts); 5.13 (Treaty residence: Partnerships).

## 5.4 Change of residence during tax year

### 5.4.1 *Change of residence of individual during tax year*

Suppose:

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5 Article 3.1(b) OECD Model defines company: "the term "company" means any body corporate or any entity that is treated as a body corporate for tax purposes".

(1) An individual is resident in state A (under the law of state A) during one part of a tax year ("the resident period").
(2) The individual is *not* resident in state A (under the law of state A) during another part of the tax year ("the non-resident period").
(3) Under the tax law of state A, the individual is liable to tax throughout both periods. (That is of course the position in the UK.[6])

Such a person is a resident of state A under article 4.1 even during the non-resident period, since:
(1) they are liable to tax in state A (during the non-resident period) and
(2) the reason they are so liable is their residence (during the resident period).

Thus if an individual is UK domestic-law UK resident for part of a year and then moves to a treaty state, they need to rely on the tie-breaker provision for treaty relief during the year of departure even if they cease to be UK resident on departure.

This is reasonably clear on first principles, but if authority is needed, see *Smallwood v HMRC.*

### 5.4.2 *Change of residence of trustee during tax year*

In *Smallwood v HMRC*, a trust had three different trustees, resident in different states, in the course of one tax year:

Apr - Dec: Jersey resident trustees
Dec - Mar: Mauritius resident trustees ("the Mauritian period")
Mar onwards: UK resident trustees ("the UK period")

Gains accrued during the Mauritian period. During this period the trustees were residents of Mauritius under article 4.1 as they were liable to Mauritian tax[7] by reason of their residence in Mauritius. The question was whether they were also residents of the UK under article 4.1.[8]

One might have thought that they were not. The Mauritian trustees were liable to tax in the UK during the Mauritian period, but not by reason of

6 For the purpose discussing treaties, the UK split year concessions are not relevant.
7 In fact the trustees were not liable to CGT in Mauritius, because Mauritius did not tax capital gains but only to income tax; but that made no difference because the trustees were liable to "tax" as defined.
8 A further question arose concerning POEM; see 5.16.2 (Short term non-resident periods).

*their* residence: they were so liable by reason of *someone else's* residence (namely, the residence of their successor trustees during the UK period). However the Court of Appeal (citing s.69 TCGA) held that for treaty purposes trustees should be regarded as a continuing body of persons distinct from the actual trustees. The position therefore was just the same as for an individual who is UK resident during part of a year, discussed above. The trustee-body were residents of the UK under article 4.1 during the Mauritian period since:

(1) they were liable to UK tax[9] during that period; and
(2) they were so liable by reason of "their" UK residence in the subsequent UK period.

During the Mauritian period the trustees could not know that they were residents of the UK, as the facts which made them residents of the UK occurred later. That did not matter: "The issue of liability has to be looked at retrospectively".[10]

The Court of Appeal decision is not beyond criticism. Some passages are confused. The Court should not have relied on s.69 TCGA since that provision only applies for the purposes of the TCGA.[11] The High Court decision, which went the other way, may seem more convincing to many readers. However the end result is a sensible one, and the law should be regarded as settled.

In *Smallwood* the law decided by the CA favoured HMRC. However the rule will sometimes favour the taxpayer because income/gains arising at a time when a person does not meet the requirements to be a resident of a treaty state may later meet the requirements and retrospectively qualify for relief. Suppose:

(1) A company within s.13 TCGA is resident in Jersey during part of a tax year ("the Jersey resident period").
(2) The company becomes resident in state A under the law of state A during part of the tax year ("the state A resident period").
(3) Under the tax law of state A the company is liable to tax throughout

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9 In fact it could have been argued that the trustees were *not* liable to tax in the UK, because of s.77 TCGA and s.624 ITTOIA; but the taxpayer did not take that point, perhaps because art.3.1 would justify treating trustees as a body of persons.

10 *Smallwood v HMRC* at [42].

11 Section 69 provides "In relation to settled property the trustees of the settlement shall *for the purpose of this Act* be treated as being a single and continuing body of persons." However the taxpayer did not argue that point.

both periods. That is, state A has a rule similar to that which applies to individuals and trusts in the UK.

(4) The company is at no time domestic-law resident in the UK.

A gain arising in the Jersey resident period may retrospectively qualify for relief under a treaty between the UK and state A, which would benefit a UK participator within the scope of s.13. (Before the Court of Appeal's decision in *Smallwood*, an advisor would probably have said that the company had to be treaty-resident at the time the gain accrued, in order for treaty relief to apply. But now we know the position is looked at retrospectively.)

### 5.4.3 *HMRC view*

The International Manual provides:

> **154040. Individuals** [November 2010]
> Different countries have different fiscal years, for example, the United States tax year ends on 31 December. An individual who wishes to make a treaty claim as a resident of the United States in respect of the United Kingdom tax year 2002-03 will need to demonstrate that he is a resident of the United States during both of the United States tax years 2002 and 2003. If an individual was resident in the United States during the tax year 2002 but ceased to be so resident after 31 December 2002, then he may make a claim as a United States resident for any 2002-03 income which arose during 2002 but no claim is possible in respect of income arising in 2003.
> If income arises partly during a period of residence in the other country and partly during a period of residence in the United Kingdom, the income may be apportioned between the periods on a time basis, unless it is clear that the income arose unevenly over the two periods, for example a bonus payable for duties performed in one of the periods.

## 5.5 Exception where source tax only

Article 4(1) OECD Model Convention continues:

> This term, ["resident of a Contracting State" ] however, does not include any person who is liable to tax in that State in respect only of income from sources in that State or capital situated therein.

The US Department of the Treasury Technical Explanation of the Convention[12] provides:

> A person who is liable to tax in a Contracting State only in respect of income from sources within that State or capital situated therein or of profits attributable to a permanent establishment in that State will not be treated as a resident of that Contracting State for purposes of the Convention. Thus, a consular official of the UK who is posted in the United States, who may be subject to U.S. tax on U.S. source investment income, but is not taxable in the United States on non-U.S. source income, would not be considered a resident of the United States for purposes of the Convention. (See Code section 7701(b)(5)(B)). Similarly, an enterprise of the UK with a permanent establishment in the United States is not, by virtue of that permanent establishment, a resident of the United States. The enterprise generally is subject to U.S. tax only with respect to its income that is attributable to the U.S. permanent establishment, not with respect to its worldwide income, as it would be if it were a U.S. resident.

While this is directed at the US DTA, the wording in point is (more or less) the same and the same argument should apply in other states where the local law is comparable.

## 5.6 Tie-breaker tests for individuals

It is of course possible for a person to be:
(1) a resident of state A under art. 4.1 during the whole of a tax year and
(2) a resident of state B under art. 4.1 during the whole of the same period.
This may arise for various reasons:
(1) Two states may have different domestic-law definitions of residence.
(2) Residence (however defined) is distinct from presence: a person may be domestic-law UK resident throughout a year while only present in the UK during part of the year (or even not present at all); such a person may be regarded by the other state as a resident of the other state.
In such cases the tie-breaker tests are needed. For individuals, there are a series of tie-breaker tests, in order of priority:
(1) permanent home

12 *www.treasury.gov/resource-center/tax-policy/treaties/Documents/teus-uk.pdf.*

(2) centre of vital interests
(3) habitual abode
(4) nationality
(5) mutual agreement.

## 5.7 Permanent home

Article 4 OECD Model Convention provides:

> 2. Where by reason of the provisions of paragraph 1 an individual is a resident of both Contracting States, then his status shall be determined as follows:
> a) he shall be deemed to be a resident only of the State in which he has a permanent home available to him;

For clarity of exposition it might be helpful to consider separately the concepts of:
(1) "home"
(2) "permanent"
(3) "available"
But this neat analysis is not practical: to some extent the three terms interact, for a property which is not "available" or "permanent" is less likely to be a "home".

### 5.7.1 *"Home"*

The OECD commentary provides:

> 13 As regards the concept of home, it should be observed that any form of home may be taken into account (house or apartment belonging to or rented by the individual, rented furnished room).

The meaning of the word "home" is discussed in *Re Y* [1985] Fam 136 at p.140.

> 'Home' is defined thus in the Shorter Oxford English Dictionary:
>> "A dwelling-place, house, abode: the fixed residence of a family or household; one's own house; the dwelling in which one habitually lives, or which one regards as one's proper abode."
>
> It is a definition which, in my judgment, contains the essential elements

> of a "home" as it is to be understood for present purposes.

One fundamental characteristic of a "home" is that one lives there. As Sheldon J said:

> I have no doubt that any individual may have two homes; but each, in my judgment, to be properly so called, must comprise some element of regular occupation (whether past, present, or intended for the future, even if intermittent), with some degree of permanency, based upon some right of occupation whenever it is required, where, in the words of Kekewich J. in *Re Estlin*, *Prichard v. Thomas* (1903) 72 L.J. Ch. 687, 689, "You find the comforts of what is known as home"; the fixed residence of a family or household.

However, the *amount* of time that one spends in a place may not shed much light on whether that place is a "home". One can spend relatively little time in a place which is still home. This point arose in *Frost v Feltham* 55 TC 10. The issue in that case was to identify the taxpayer's "main residence". The expression "main residence" is somewhat narrower than "home", for a "main residence" must almost necessarily be a "home" but a "home" need not be a "main residence". In that case, Mr and Mrs Feltham spent periods of two or three days in each month at a property called "Mount Severn". They spent the rest of the time in "The White Horse", a public house of which Mr Feltham was licensee. Nourse J noted that "viewed in isolation those are not long periods of time to spend at a house which can properly be described as the principal or more important residence of the persons concerned". Nevertheless, Mount Severn was held to be their principal residence:

> A residence is a place where somebody lives, and it is clear that Mr Feltham lived for the greater part of the year at the White Horse, Roydon. Therefore, he could not have used Mount Severn as his only residence. But that does not at all mean that he could not have used it as his principal or more important residence, even though he spent very little time there. If someone lives in two houses the question, which does he use as the principal or more important one, cannot be determined solely by reference to the way in which he divides his time between the two. I can test that by reference to an example far removed from the facts of this case and the conditions of our own times. In his "Lives of the Lord Chancellors" Lord Campbell tells how Lord Eldon

> was often prevented by the burdens of his office from visiting his estate at Encombe in Dorset for long periods at a time. Sometimes he was only able to get down there for three weeks or so in the year, for the partridge shooting in September. True it was that Lord Eldon also had a good house in Hamilton Place, but it could not really have been suggested that he did not use Encombe as his principal or more important residence.

A second fundamental characteristic of a "home" is identified in the Law Commission paper on the law of domicile. The Law Commission observes:

> "Home" conveys ... the combined ideas of physical presence and emotional link.[13]

The folk-saying is true that "home is where the heart is". In the dictionary definition which Sheldon J approved, home is a place which one *regards* as one's proper abode. The views of the individual himself are therefore highly relevant. It would be, to put it at its lowest, surprising if a place which an individual actually regarded as home was not in fact their home. The views of the parties as to which property was the main residence were held to be relevant in *Frost v Feltham*; see 55 TC at p.16; the same applies *a fortiori* in determining whether a property is a "home".

The fact that one does not have a room set aside for oneself in a "home" does not shed much light on whether it is a "home". The more important question is whether space is available when one wishes to use it. In Robert Frost's epigram, "home is the place where, when you have to go there, they have to take you in". This was the attitude taken by the Revenue in relation to the so-called "available accommodation rule" before 1993.

### 5.7.2 *"Permanent"*

The concept of "permanent" is more difficult than the concept of "home". The OECD commentary is untrammelled by the restraint of precision:

> 11 The Article gives preference to the Contracting State in which the individual has a permanent home available to him. This criterion will

13 No. 168 CM 200 (1987), at para 4.20

> frequently be sufficient to solve the conflict, eg where the individual has a permanent home in one Contracting State and has only made a stay of some length in the other Contracting State.
> 12 Subparagraph (a) means, therefore, that in the application of the Convention (that is, where there is a conflict between the laws of the two States) it is considered that the residence is that place where the individual owns or possesses a home; this home must be permanent, that is to say, the individual must have arranged and retained it for his permanent use as opposed to staying at a particular place under such conditions that it is evident that the stay is intended to be of short duration.
> 13. ... But the permanence of the home is essential; this means that the individual has arranged to have the dwelling available to him at all times continuously, and not occasionally for the purpose of a stay which, owing to the reasons for it, is necessarily of short duration (travel for pleasure, business travel, educational travel, attending a course at a school, etc).

Para 11 of the commentary looks at the situation where "the individual has a permanent home in one Contracting State and has only made a stay of some length in the other Contracting State". The commentary is not making a contrast between:
(1) permanent, and
(2) a stay of some length.
The point correctly being made is that the existence of one (undoubtedly) permanent home impacts on whether one regards *another* place as a permanent home.

Paras 12 and 13 contrast:
(1) permanent use, and
(2) a stay of short duration; exemplified as "travel for pleasure, business travel, educational travel, attending a course at a school, etc".
This suggests that a stay of more than short duration qualifies as permanent.

### 5.7.3 *"Available"*

HMRC helpsheet 302 (Dual Residents - 2010/11) provides:

> A permanent home is any form of accommodation which is continuously available to you for your personal use. It does not necessarily have to be owned by you.

## 5.8 Centre of vital interests

Article 4(2)(a) OECD Model Convention provides:

> if he has a permanent home available to him in both States, he shall be deemed to be a resident only of the State with which his personal and economic relations are closer (centre of vital interests);

The OECD commentary provides:

> 15 If the individual has a permanent home in both Contracting States, it is necessary to look at the facts in order to ascertain with which of the two States his personal and economic relations are closer. Thus, regard will be had to his family and social relations, his occupations, his political, cultural or other activities, his place of business, the place from which he administers his property, etc. The circumstances must be examined as a whole, but it is nevertheless obvious that considerations based on the personal acts of the individual must receive special attention. If a person who has a home in one State sets up a second in the other State while retaining the first, the fact that he retains the first in the environment where he has always lived, where he has worked, and where he has his family and possessions, can, together with other elements, go to demonstrate that he has retained his centre of vital interests in the first State.[14]

This is only relevant where the tie-breaker is not decided by the question of a permanent home.

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14 HMRC helpsheet 302 (Dual Residents - 2010/11) is based on this:

> 'Personal and economic relations' is a wide expression intended to cover the full range of social, domestic, financial, political and cultural links. The whole range of these factors must be taken into account, but considerations based upon your personal acts are given special weight.
> For example, if you have a home in the UK and set up another in the other State while retaining the first, the fact that you have retained your home in the UK where you have lived, worked and where your family and possessions are, can, together with other factors, go to demonstrate that your centre of vital interests remains in the UK."

## 5.9 Habitual abode

Article 4(2) OECD Model Convention provides:

> b) if
> [i] the State in which he has his centre of vital interests cannot be determined, or
> [ii] if he has not a permanent home available to him in either State,
> he shall be deemed to be a resident only of the State in which he has an habitual abode;

The OECD commentary provides:

> 16 Subparagraph (b) establishes a secondary criterion for two quite distinct and different situations:
> (a) the case where the individual has a permanent home available to him in both Contracting States and it is not possible to determine in which one he has his centre of vital interests;
> (b) the case where the individual has a permanent home available to him in neither Contracting State.
> Preference is given to the Contracting State where the individual has an habitual abode.
> 17 In the first situation, the case where the individual has a permanent home available to him in both States, the fact of having an habitual abode in one State rather than in the other appears therefore as the circumstance which, in case of doubt as to where the individual has his centre of vital interests, tips the balance towards the State where he stays more frequently. For this purpose regard must be had to stays made by the individual not only at the permanent home in the State in question but also at any other place in the same State.
> 18 The second situation is the case of an individual who has a permanent home available to him in neither Contracting State, as for example, a person going from one hotel to another. In this case also all stays made in a State must be considered without it being necessary to ascertain the reasons for them.
> 19 In stipulating that in the two situations which it contemplates preference is given to the Contracting State where the individual has an habitual abode, subparagraph (b) does not specify over what length of time the comparison must be made. The comparison must cover a sufficient length of time for it to be possible to determine whether the

residence in each of the two States is habitual and to determine also the intervals at which the stays take place.

HMRC helpsheet 302 (Dual Residents - 2010/11) provides:

> This broadly means the State in which you stay more frequently over a reasonable period. The comparison must be made over a sufficient length of time for it to be possible to determine whether residence in either of the two countries has become 'habitual'.

## 5.10 Nationality and mutual agreement procedure

Article 4(2)(c)(d) OECD Model Convention provides:

> c) if he has an habitual abode in both States or in neither of them, he shall be deemed to be a resident only of the State of which he is a national;
> d) if he is a national of both States or of neither of them, the competent authorities of the Contracting States shall settle the question by mutual agreement.

## 5.11 The relevant period of investigation for tie-breaker test

In *Hankinson v HMRC* [2010] STC 2640 at [60] the Tribunal said:

> It seems therefore that while one applies the tie-breaker at the time of alienation in a case concerning capital gains, this does not mean that one cannot look at a longer period in applying the elements of the tie-breaker when appropriate, which it may not be for permanent home, but it is necessarily for habitual abode.

This must be so; contrast 3.16 (The relevant period of investigation).

## 5.12 Treaty residence: Trusts

The first step is to identify who is the "person" for treaty purposes.[15]

15 See 5.3 ("Person").

### 5.12.1 *The trust law background*

The following propositions are well established.

(1) A trust is not a person (ie does not have legal personality) in English law, Scots law[16] or, as far as I know, any other trust law.[17]

(2) A trustee is a person. It is often convenient to distinguish:
(a) a person in their capacity as trustee and
(b) that person in their private capacity.
However a trustee is one person, "trustee capacity" is not a separate person.

(3) For domestic law IT and CGT purposes, a trustee is deemed to be a distinct, notional person.[18] References to "individuals" exclude trustees.

### 5.12.2 *Position of trustees under OECD Model treaty*

Let us consider the cases of a trust with (1) several trustees (2) a single individual trustee (3) a single corporate trustee.

Before considering the treaty, one would expect:

(1) trustees to be treated as a person.

(2) the person to be classified as a non-individual (so the non-individual (POEM) tie-breaker test applies even if the trustee is an individual).

(3) the person to be treated as distinct from the individual or company who is actually a trustee.

There is a little difficulty in reading the model treaty to reach this result, but not much.

(1) Where there is more than one trustee, the trustees should be regarded as a body of persons (and so constitute one person) for treaty purposes.

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16 The Scottish Law Commission discussed but rejected a proposal to give trusts legal or juristic personality: *Discussion Paper on the Nature and the Constitution of Trusts* (October 2006) para 2.29-2.45.

17 Though a trust is close to being a person. Gretton, "Trusts Without Equity" (2000) 49 Int'l & Comp. LQ 599:
"In ordinary language the noun "trust" is a person word. Idiom treats it like "company". "This land is owned by a trust." "These shares are held by a trust". ... "The trust is liable for this debt." Ordinary language is right."
So one should not rule out the possibility that context may show that the word "person" is used (loosely rather than strictly) to mean or include a trust.

18 See 4.4 (Trustee residence for income tax and CGT).

That avoids the difficulty which otherwise arises if a trust had trustees who are resident in different places in their private capacity.

(2) Where there is a sole trustee, it should be regarded as a person (not an individual) distinct from the person who is actually the trustee.

Another possible analysis would be that the trust is a person for OECD model purposes. There are two difficulties with that:

(1) A trust is not a "person" in English law.
(2) If the trust were a person, it is only a resident of a treaty state if it is a person liable to tax. Whether a person is liable to tax is a matter of domestic-law. In UK law, it is the trustees rather than trust which is liable to tax.

These arguments are not insuperable: since treaties can be loosely construed, there are no words from which there is no escape. One could say that a trust is a person (in the treaty sense) even though not a person in English law; and that the trust is "liable to tax" (in the treaty sense) since the trust fund will bear the tax. But there is no need to take this high-handed course, as to regard the trustees as a body of persons (or the sole trustee as a distinct trustee-person) is the simpler and more satisfactory solution.[19]

While it is possible that a foreign law might look at the matter differently, it would be desirable if possible for all countries to adopt the same approach, and in practice this seems to be the case.

HMRC agree. INT Manual provides:

> **162034. Certificates of Residence and trusts and charitable trusts**
> [January 2010]
> Trusts are not themselves liable to tax in the UK, but the trustees on behalf of the trust may be liable to tax in the UK. A trust therefore cannot be a resident of the UK for the purposes of any UK Double Taxation Convention (DTC). Accordingly a certificate of residence cannot be issued in respect of any trust. However, some trusts are included within the definition of 'resident of a Contracting State' in specific DTCs. In those limited circumstances a certificate of residence can be issued in respect of a trust. It is therefore essential that the relevant DTC is checked

19 It has been suggested that the question whether the person for the purposes of the OECD Model is the trustees (as a body) or the trust is purely theoretical and makes no difference in practice. But (1) it is always good to know what one is talking about; (2) it might make a difference on the application of the tie-breaker test; (3) HMRC need to know what name(s) to put on a residence certificate: the trust or the trustee(s).

> on receipt of all applications.
> Trustees as a body (rather than the trust) are regarded as a single person. Where the trustees as a body are regarded as resident in the UK they will be entitled to the benefits of a DTC as they are liable to tax in the UK in respect of the income of the trust. Subject to the comments in the next paragraph a certificate of residence can be issued in respect of a UK resident body of trustees.

The International Manual also provides:

> **353600. Claims by trustees in Ireland** [September 2009]
> Article 4(3) (Fiscal Residence) of the convention makes reference to 'a person other than an individual'. Trustees act as a body of persons and so are persons other than an individual for the purposes of the article, and we therefore refer to the criteria in Article 4(3) to determine whether trustees of an Irish trust are resident in the Ireland for the purposes of the convention.

This is commenting on the Irish treaty but the same would apply generally.

The same would apply to the estate of a deceased person.

On this topic, see Prebble, "Trusts and Double Taxation Agreements" ejournal of Tax Research (2004) vol 2 no 2 p192, accessible *www.atax.unsw.edu.au/ejtr/content/issues/previous/paper3_v2n2.pdf*.

## 5.13 Treaty residence: Partnerships

### 5.13.1 *Is a partnership a "person" for treaty purposes?*

This section considers whether a partnership is a treaty-resident of a state. For other DT issues see 36.9 (DTA relief for partnership).

The first question is whether a partnership is a "person" for treaty purposes.[20] Before turning to the definition, one might expect a partnership to be a person, since:

(1) It avoids difficulty which would arise if a partnership had partners who were resident in different places in their private capacity.

(2) It avoids an undesirable distinction between English partnerships (which are not legal persons) and Scottish partnerships (which are).

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20 See 5.3 ("Person").

(3) "It is highly improbable that so common a vehicle for commercial activity as a partnership should have been intended to be excluded from an Arrangement [a DTA]..."[21]

Article 3.1(a) OECD Model provides:

> 1. For the purposes of this Convention, unless the context otherwise requires:
> a) the term "person" includes an individual, a company[22] and any other body of persons;

There are three bases for arguing that a partnership is a person:

(1) A partnership is a body of persons, and so within the definition (the "body of persons" argument).

(2) A partnership is a person in the ordinary sense of the expression (the "ordinary person" argument.) If so it does not matter whether a partnership is a body of persons.

(3) Partners (being individuals or companies) are persons (in their private capacities) and a partnership is a person because the singular includes the plural (the singular/plural argument).

Discussion is made more difficult because of the variety of wording in different treaties.

The body of persons argument succeeded in *Padmore v IRC*, where the issue was whether a partnership was a person for the purposes of the Jersey/UK DTA. The definition of "person" in this DTA is not quite in OECD model form. Para 2(1)(d) of the Jersey/UK DTA provides:

> The term "person" includes any body of persons, *corporate or not corporate*;

The Court held that a partnership is a body of persons in the ordinary sense of that term.[23] Accordingly it constitutes a person within the Jersey/UK treaty definition.

The Crown's argument was a subtle one:

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21 *Padmore v IRC* 62 TC 352 at p.377.

22 Article 3.1(b) defines company: "the term "company" means any body corporate or any entity that is treated as a body corporate for tax purposes".

23 See 5.3 (Is a partnership a "person"?).

> The Crown's answer is that by Article 2(3) of the Arrangement, a term not otherwise defined has, unless the context otherwise requires, the meaning it has under the laws of the United Kingdom or Jersey, as the case may be, relative to the taxes which are the subject of the Arrangement. "Body of persons", it is contended by the Crown, is a term of art in United Kingdom tax law and is defined in the Taxes Act 1970, s 526(5) as follows:
>
> > " 'Body of persons' means any body politic, corporate or collegiate, and any company, fraternity, fellowship and society of persons whether corporate or not corporate".
>
> The Jersey Law has a provision in the same terms (Article 3(1)).[24]

That is, the Revenue argued that (1) a partnership (although a body of persons in the general sense) was not a body of persons in the UK tax law sense[25] and (2) the UK tax law sense applied in the treaty. The Court's reason for rejecting the argument at point (2) was equally subtle:

> If that [UK tax law] definition [of body of persons] is applicable, a partnership is (I will assume) not within it; because a partnership cannot be brought within any of the groups specified in the definition. I agree with Peter Gibson J., however, that the definition is not applicable. The draftsman of the Arrangement in para 2(1)(d) was giving a comprehensive definition of the word "person". If he was assuming that the statutory definition of "body of persons" would apply, I see no reason why he should have added the words "corporate or not corporate". They form part of the Article 2(1)(d) definition itself, and their inclusion had no purpose if the statutory definition applied. I do not think that they can be dismissed as mere tautology. On the face of the Arrangement they are a specific part of what is intended to be a self-contained definition for the purposes of the Arrangement. They are not, it seems to me, consistent with an intention on the part of the draftsman to utilise the statutory definition. They indicate a contrary intention. A partnership is, as a matter of the ordinary use of English, plainly a body of persons, and the language used by the draftsman does not, in my opinion, indicate that he was intending any different meaning.

24 *Padmore v IRC* 62 TC 352 at p.377.

25 Section 989 ITA provides: "The following definitions apply for the purposes of the Income Tax Acts ... "body of persons" means any body politic, corporate or collegiate and any company, fraternity, fellowship and society of persons whether corporate or not corporate." These terms are now of historical interest and it is a pity that the tax law rewrite failed to modernise and simplify this. Perhaps the Office of Tax Simplification could do so.

Unfortunately that reasoning does not apply to the OECD model wording, since that lacks the words "corporate or not corporate." See Article 3.1(a) OECD Model set out above. It is however considered that "body of persons" in the OECD model should be given its ordinary meaning rather than its UK tax meaning. It is relevant to note that the term does not have a UK tax meaning, only an income tax meaning. There is no similar definition for CGT. Thus a partnership is a body of persons (within the meaning of the Model convention) and so a person within the OECD definition.

Avery Jones agrees:[26]

> ...it is hardly likely that the other State, if it had troubled to ask in the course of negotiations what body of persons meant in UK tax law, would wish to have an 18th century list of bodies govern the interpretation of the treaty. It is therefore not difficult to say that the context otherwise requires, and one should include partnerships either within the ordinary meaning of body of persons, or merely by reading the singular as the plural.[27] On the basis a partnership may be included in those cases where wording similar to the 1977 Model is used.[28]

Alternatively one could fall back on the ordinary person or the singular/plural arguments. The difficulty with that is that some treaties provide:

> the term "person" *comprises* an individual, a company and any other body of persons;

Others provide:

26 J Avery Jones, "Bodies of Persons" [1991] BTR 453 at p.464..

27 [Footnote original] This was mentioned as a possibility in Padmore [1989] STC 493, 498g but Fox L.J. stated that this was not sufficient for the taxpayer to succeed, as those persons were not all resident in Jersey. It is not clear why persons in partnerships should not be given a single residence under TA 1988, s.112, which the court held to be applicable for the purpose of interpreting the treaty. The statutory definition of residence of trustees in FA 1989, s.110 does not give them a residence as a body but deems the resident trustees to be non-residence and vice versa.

28 [Footnote original] See art. 1 Comm. Paras. 2-6 of the application of the OECD Model to partnerships. The UK gives a residence to a partnership: TA 1988, s.112(1).

> the term "person" *means* an individual, a company and any other body of persons;

Avery Jones comments:

> Normally in modern United Kingdom treaties the definition of person is that it *comprises* an individual, a company and any other body of persons, which was the wording of the 1963 model; at first sight this might prevent the ordinary meaning of *person* from being used.[29] The official French version of the Model, however, uses the same word *comprend* in both the 1963 and the 1977 versions. There may therefore be no difference between it and the 1977 Model, which makes it difficult to see why the United Kingdom persists in using the 1963 wording. In eight treaties the word *means* is used instead of the Model's *includes*, in which case the ordinary meaning, in addition to the defined meaning, of person cannot be used. But certainly where *includes* and probably in the light of the French version where *comprises*, is used, the argument that the context includes partnerships under the ordinary meaning of body of persons is still available, as these words are not intended to be comprehensive. It is considered that partnerships are so included under that wording, on the basis that they cannot have been intended to be excluded.[30]

It is considered that any of these arguments will suffice, so a partnership is a person for DTA purposes in all cases, though the precise arguments which arise vary from one wording to another. The commentary to the OECD model convention supports this view. The commentary to article 3 provides:

> Partnerships will also be considered to be "persons" either because they fall within the definition of "company" or, where this is not the case, because they constitute other bodies of persons.

### 5.13.2 *Is a partnership "liable to tax?"*

But even though a partnership is a person, it is only a resident of a treaty state within the OECD definition if it is a person liable to tax. Whether a

29 [Footnote original] The OECD Commentary (Art.3 Comm. Para.2), however, stated that the provision was not worded as an exhaustive definition and should be read as indicating that the term person is used in a very wide sense.

30 J Avery Jones, "Bodies of Persons" [1991] BTR 453 at p.464..

person is liable to tax is a matter of domestic law.

In UK law, it is the partners rather than the partnership which is liable to tax. Partners are of course "persons" in their private capacity. They can be treaty-resident in the UK. It seems that a partnership (though a "person") cannot be treaty-resident in the UK.

INT Manual provides:

> **162033. Certificates of Residence and partnerships** [January 2011]
> UK partnerships (including Scottish partnerships and UK LLPs) cannot be resident in the UK for the purposes of any of the UK's Double Taxation Conventions (DTCs) because they are not themselves liable to tax in the UK. Therefore they cannot claim the benefits of any DTC. However, UK resident partners are entitled to such benefits as they are taxed in the UK on their share of the partnership worldwide profits.

This is correct for OECD Model treaty-residence. Para 5 of the OECD Commentary to article 1 similarly provides:

> Where... a partnership is treated as fiscally transparent in a State, the partnership is not "liable to tax" in that State within the meaning of paragraph 1 of Article 4, and so cannot be a resident thereof for the purposes of the Convention.

The same (more or less) applies to LLPs. BI Manual provides:

> **72145 Limited Liability Partnership (LLP): International aspects** [January 2006]
> ... A UK LLP is not itself 'liable to tax' in the UK as the LLP tax provisions identify other persons (i.e. the members) as the persons who are to be taxed. Accordingly for the purposes of the Double Taxation Agreements (DTAs) the LLP is not regarded as being resident in the UK and cannot itself therefore claim relief from foreign taxes under such agreements. As is now the case with ordinary and limited partnerships the members must make the claim.
> ...In the very narrow circumstances where the LLP is not treated as transparent, but instead as a body corporate for tax purposes (such as when the LLP is in liquidation or being wound up in circumstances where transparency cannot be retained), we take the view that the LLP can itself claim relief for foreign taxes, including if appropriate underlying tax.

However HMRC do not always apply this view in practice[31] and it was rejected in India.[32]

### 5.13.3 *HMRC practice*

For US partnerships this practice is not followed and HMRC allow claims from partnerships.[33] There is no reason why American partnerships should be treated better than other partnerships, and other partnerships could therefore seek to obtain similar treatment, even though there would be no legal remedy if HMRC insist on applying the strict law. In practice HMRC accept such claims. INT Manual provides:

> **335510. Background** [March 2007]
> ***How Double Taxation Agreements treat partnerships***
> Double Taxation Agreements (DTAs) do not normally give a tax-transparent concern such as a partnership the right to claim treaty relief. Instead, in those cases where the income of the partnership is taxable in the hands of the partners (rather than at the level of the partnership) each partner should in strictness make a separate claim to treaty relief...
> ***CAR Residency's approach to Partnerships***
> We recognise that applying the provisions of the DTA in such a literal way would be unwelcome and could possibly hamper the business interests of both countries.
> Accordingly, CAR Residency may accept a single claim from a partnership on behalf of its partners. Where a partnership wishes to take advantage of this departure from the strict position and to claim treaty benefits on behalf of its partners, the general or managing partner should sign the declaration on the claim form. In addition to the normal information that is required by the claim form, a list of the names and addresses (residential addresses for individuals and registered addresses where the partners are companies) of the partners should be supplied. These lists should also normally show for each partner their respective percentage shares of the income that is the subject of the claim. In those cases where all of the partners are resident for tax purposes in the same country as the one in which the partnership is established (the country with which the DTA applies) it is not necessary to insist upon this

31 See 50.21.3 (US partnerships and LLCs).
32 *Linklaters LLP v Income Tax Officer* [2010] ITELR 245.
33 See 50.21.3 (US partnerships and LLCs).

information being provided.

Where any of the partners are resident for tax purposes in a country other than that in which the partnership is established, they should make separate claims to relief from UK tax under the terms of any relevant DTA.

In cases where such a partner is resident in a country which (unusually) does not regard the partnership as fiscally transparent – which would mean that it regards the partnership rather than the UK payer as the source of the payments its resident receives – then that partner may have difficulty in getting a claim form certified as relevant to a DT treaty with the UK. In such rare cases, you should consider accepting an uncertified claim form. If you decide to invite a claim in these circumstances you should ask for the claim form to be supported by additional evidence (for example copies of recent tax returns) to show that the partner is resident for tax purposes in the country concerned. Any such case should be referred to Technical Advice Group at an early stage.

**335520. Examination of claims** [September 2009]

***What CAR Residency will do***

Where you are able to conclude that all of the beneficial owners of the income for which relief is being claimed are "qualifying persons" within the meaning of a DTA, then you should process the claim in the normal way without further enquiry. This includes asking the tax office for the UK payer of the income to complete a report on forms in the 4450 series as appropriate.

If the supplementary information that is supplied with the claim form does not allow you to conclude that each of the partners is resident for tax purposes in the same country as that in which the partnership is established, you will have to ask for further information to be supplied.

If any of the partners that are identified are themselves (at face value) transparent for tax purposes (for instance Limited Partnerships and Limited Liability Companies, as well as Trusts and some types of investment funds) you should ask for similar information to be supplied about these 2nd and 3rd level partners. Your aim should be to reach a reasonable level of assurance that all of the underlying participators in these concerns are themselves "persons" who would be able to claim double taxation relief if they were receiving the money directly rather than through the partnership.

*(This text has been withheld because of exemptions in the Freedom of Information Act 2000)*

Where the partnership is unable to provide sufficient information about the identity of its partners to allow you to be satisfied that each person is entitled to relief from UK tax, the amount of relief to be allowed must be restricted to the percentage share of the income that is attributable to the partners who you accept as being entitled to treaty benefits in their own right.

INT Manual provides:

**162033. Certificates of Residence and partnerships** [January 2011]
UK partnerships (including Scottish partnerships and UK LLPs) cannot be resident in the UK for the purposes of any of the UK's Double Taxation Conventions (DTCs) because they are not themselves liable to tax in the UK. Therefore they cannot claim the benefits of any DTC. However, UK resident partners are entitled to such benefits as they are taxed in the UK on their share of the partnership worldwide profits.
Accordingly, we will do what we can to assist UK resident partners to claim the benefits of a particular DTC to which they are entitled.
*Partnerships with only UK Resident Partners*
For partnerships where all partners are UK resident there should not be a problem as we will, if requested, confirm that although the partnership itself cannot be UK resident the individual partners are, and are therefore entitled to the relevant DTC benefits.
*Partnerships with Non-Resident Partners*
Non-resident partners are not entitled to the benefits arising from DTCs between the UK and its treaty partners because they are not persons resident in the UK as set out in the residence Article of a DTC. But, HM Revenue & Customs will, if requested, confirm that, although the partnership itself cannot be UK resident, the UK resident partners are entitled to the relevant treaty benefits.
*Information required*
A request must be accompanied with the following details in writing before a letter of confirmation (certificate) can be issued:
a. Reason for requiring a certificate of residence;
b. The nature of the relevant transaction; and
c. Details of the income concerned.
For partnerships with UK partners only, HM Revenue and Customs will also need:
a. A list detailing the partners' names with confirmation that each and every partner is UK resident at the date of the request for the certificate of residence.
For partnerships with UK and non-resident partners, HM Revenue and Customs will also need:
a. A contact name and address for the partnership; and
b. A list detailing the partners' names, separately identifying those that are UK resident and those that are not and confirming that each of the UK partners is UK resident at the date of the request for the certificate of residence.
Where the source state has provided a form for claiming relief from its tax on the income in question (see DT 2140+), that form should be used accompanied by the HM Revenue and Customs letter of confirmation where appropriate.
A letter of confirmation should not be issued if you think that to do so would not be in accordance with the relevant DTC. However, before a formal refusal is

issued please refer to Specialist International.

**Wording for letter of Confirmation to Partnership with UK resident partners only**

To whom it may concern

The partnership of …………………………… is not itself resident in the UK for the purposes of the UK/? Convention.

However, I certify that to the best of HM Revenue & Custom's knowledge, the individual partners in …………….. as at [date] are resident in the UK in accordance with Article 4 of the Convention in force between the UK and …….

Date

Office Stamp Name and signature of Officer

Wording for letter of confirmation to Partnership with UK and non-resident partners

To whom it may concern

The partnership of …………………………… is not itself resident in the UK for the purposes of the UK/? Convention.

However, I can confirm that the individual partners that are listed below are resident in the UK in accordance with Article 4 of the Convention in force between the UK and ……. There are other partners in the partnership who are not resident in the UK. Details of those partners can be obtained from the Managing Partner at the following address: ….

--------------------- List of UK Partners ------------------------

Date

Office Stamp Name and signature of Officer

## 5.14 Partnerships under non-OECD model DTAs

Some DTAs do not follow the OECD model. The former ITH provided:

> **1656. Later DT Agreements**
> The significance of 1987 for partnerships and Double Taxation Agreements is that in 1986 the High Court gave its decision on the Padmore case which upset our view that a treaty did not apply to partnerships unless they were specifically mentioned. We look at the Padmore case and its consequences in the next paragraphs. Later treaties will normally have something about partnerships, either specifically excluding some or all of them from the treaty or preserving our right to tax the UK resident partners. The precise provisions may depend on the status of partnerships in the country of the treaty partner. Examples of later treaties where partnerships are mentioned are Italy and Bulgaria.

### 5.14.1 *Partnerships under UK/Switzerland DTA*

Article 4.1 of the UK/Switzerland DTA provides, unusually:

In the case of Switzerland, the term [resident of a Contracting State] includes a partnership created or organised under Swiss law.

The former ITH provided:

**1655. Older DT Agreements**
... the Swiss Agreement which includes as a resident of Switzerland a partnership created or organised under Swiss law. If this were the only provision it could mean that we would not have the right to tax under Case V a UK-resident partner in a Swiss partnership which had no permanent establishment in the UK. But our right to tax our resident partners is specifically protected by a separate provision.

The DTR Manual now provides:

**DT18104 - Switzerland: Partnerships**
The agreement makes it clear that, if a partnership is a resident of Switzerland and is entitled, in accordance with the provisions of the agreement, to exemption from UK tax on any income, the UK nevertheless has the right to tax a UK resident partner on his share of the partnership income. Such income is deemed to be income from a source in Switzerland (Article 27(2)).
The agreement provides in Article 4 (1) that, in the case of Switzerland, the term 'resident of a Contracting State' includes a partnership created or organised under Swiss law. This provision should not be understood to override the general requirement that a resident must be liable to taxation in the relevant Contracting State. Where a claim is received in respect of the income of a Swiss partnership it should be ascertained that the income is actually taxed in Switzerland. Any claim that income of a Swiss partnership which has not been taxed in Switzerland should be relieved from taxation in the UK should be referred to Business Profits, International.

## 5.15 RICs, REITs and REMICs

The US Department of the Treasury Technical Explanation of the Convention[34] provides:

Certain entities that are nominally subject to tax but that in practice are

34 *www.treasury.gov/resource-center/tax-policy/treaties/Documents/teus-uk.pdf.*

> rarely required to pay tax also would generally be treated as residents and therefore accorded treaty benefits. For example, RICs, REITs and REMICs are all residents of the United States for purposes of the treaty. Although the income earned by these entities normally is not subject to U.S. tax in the hands of the entity, they are taxable to the extent that they do not currently distribute their profits, and therefore may be regarded as "liable to tax." They also must satisfy a number of requirements under the Code in order to be entitled to special tax treatment.

While this is directed at the US DTA, the wording in point ("liable to tax") is the same generally and the same argument should apply to REITs in other states.

## 5.16 Place of effective management ("POEM")

Article 4.3 OECD Model Convention provides:

> Where by reason of the provisions of paragraph 1 a person other than an individual is a resident of both Contracting States, then it shall be deemed to be a resident only of the State in which its place of effective management is situated.

This is the tie-breaker for trusts, companies and PRs. The OECD commentary provides:

> 24. ... The place of effective management is the place where key management and commercial decisions that are necessary for the conduct of the entity's business as a whole are in substance made. All relevant facts and circumstances must be examined to determine the place of effective management. An entity may have more than one place of management, but it can have only one place of effective management at any one time.

This has often been cited and adopted in UK cases, as one would expect. The UN commentary provides:

> [The term "place of effective management"] is used in several provisions of the OECD Model Convention, as is the term "place of management". Neither term is defined explicitly in the Convention itself or in the commentary thereon, nor is it made clear whether the two terms are to be construed as having the same meaning or two different meanings. It is,

however, understood that when establishing the place of effective management, circumstances which may, inter alia, be taken into account are the place where a company is actually managed and controlled, the place where the decision-making at the highest level on the important policies essential for the management of the company takes place, the place that plays a leading part in the management of a company from an economic and functional point of view, and the place where the most important accounting books are kept.[35]

The International Manual provides:

**353600. Claims by trustees in Ireland** [September 2009]

***... When you need to determine the place of effective management of an Irish trust***

... So if you have a claim from a trust under the treaty with Ireland and find that the trustees are resident in more than one country, you will need to establish the trust's place of effective management.

You should ask Technical Advice Group to confirm any judgement you make on the residence of a group of individual trustees.

***Criteria for determining the place of effective management of an Irish trust***

You need to find out who generally controls and supervises the work of administering the trust. By administering the trust we mean: keeping accounts, conducting correspondence, arranging the trustees' meetings and putting the trustees' decisions into effect.

***If the trustees are all individuals***

You will need to find out which of the trustees is responsible for the tasks outlined above, and the dates and locations of all trustees' meetings held during the period of the claim.

***If a professional body acts as a trustee***

You can accept that the place of business of the professional body is the place of effective management of the trust.

For this purpose the professional body is appointed by the testator or settlor of the trust, and does not include:

- An individual who is a solicitor or an accountant
- An agent or an attorney administrator appointed by the trustees

***Residence of a professional body***

If a professional body acting as a trustee is a branch in Ireland of a UK bank or similar institution, it is considered to be in Ireland for the purposes of Article 4(3). A UK branch of an Irish bank would however

35 United Nations Manual for the Negotiation of Bilateral Tax Treaties between developed and Developing Countries 2003.

not be considered to be in Ireland.

### 5.16.1 *"Effective" management*

In *Smallwood v HMRC* [2008] STC (SCD) 209 the Special Commissioners said at [112]:

> We believe 'effective' should be understood in the sense of the French 'effective' (siège de direction effective) which connotes real, French being the other official version of the [OECD] model, though not of the [UK-Mauritius] treaty.

This does not take matters very much further. The word "real" never does.

### 5.16.2 *Short term non-resident periods*

In *Smallwood v HMRC*, a trust had different trustees resident in different states, all in one tax year:

Apr - Dec: Jersey resident trustees
Dec - Mar: Mauritius resident trustees ("the Mauritian period")
Mar onwards: UK resident trustees ("the UK period")

It was necessary to apply the tie-breaker test.[36] Everything was done which could reasonably be done to ensure that the Mauritian trustees carried out effective management, but POEM was still in the UK:

> The scheme was devised in the UK by Mr Smallwood on the advice of KPMG Bristol. The steps taken in the scheme were carefully orchestrated throughout from the UK, both by KPMG and by Quilter. And it was integral to the scheme that the trust should be exported to Mauritius for a brief temporary period only and then be returned, within the fiscal year, to the UK, which occurred. Mr Smallwood remained throughout in the UK. There was a scheme of management of this trust which went above and beyond the day to day management exercised by the trustees for the time being, and the control of it was located in the UK.[37]

The dissenting decision of Patten LJ seems more convincing to me, and the

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36 See 5.4.2 (Change of residence of trustee during tax year).
37 *Smallwood v HMRC* at [70].

majority dealt with the point in two short paragraphs, as if a fuller exposition of their reasons would be an embarrassment. However the conclusion must be that tax avoidance schemes requiring short term residence in a treaty state are likely to fail on factual POEM grounds.

### 5.16.3 *Comparison with "central management and control"*

In *Smallwood v HMRC* [2008] STC (SCD) 209 the Special Commissioners discussed POEM in the context of a trust, and said:

> 111. There was thus some debate about whether, or to what extent, POEM differed from CMC [central management and control]. We consider that this misses the point; the two concepts serve entirely different purposes. CMC determines whether a company is resident in the UK or not; POEM is a tie-breaker the purpose of which is to resolve cases of dual residence by determining in which of two states it is to be found. CMC is essentially a one-country test; the purpose is not to decide where residence is situated, but whether or not it is situated in the UK…
> 112. POEM, on the other hand, must be concerned with what happens in both states since its purpose is to resolve residence under domestic law in both states, caused for whatever reason, which could include incorporation in one state and management in the other, or different meanings of management applied in each state, or different interpretations of the same meaning of management applied in each state, or divided management. One must necessarily weigh up what happens in both states and according to the ordinary meaning to be given to the terms of the treaty in their context (to quote art 31 of the Vienna Convention on the Law of Treaties) decide in which state the place of effective management is found.

The same passage was applied in the context of a company.[38]
But in *Smallwood v HMRC* at [58] Patten LJ says:

> [In] *Wood v Holden* 78 TC 1 ... Chadwick LJ expressed the view that it was difficult to draw any meaningful distinction between the two tests [POEM and central management and control] but that even if they did in fact differ in substance, they were unlikely to lead to different results.

38 *Laerstate BV v HMRC* [2009] UKFTT 209 at [48].

See Avery Jones, "The Definition of Company Residence in Early UK Tax Treaties" [2008] BTR 556.

## 5.17 UK/US DTA

This section considers the definition of treaty-residence in the UK/US DTA.

Article 4(1) of the UK/ US DTA provides:

> [a] Except as provided in paragraphs 2 and 3 of this Article, the term "resident of a Contracting State" means, for the purposes of this Convention, any person who, under the laws of that State, is liable to tax therein by reason of his domicile, residence, *citizenship,* place of management, *place of incorporation,* or any other criterion of a similar nature.

This is standard OECD model form except for the addition of the italicised words, which reflect the US rule that citizens and US incorporated companies are liable to tax regardless of residence and other such criteria.

Article 4(1) of the UK/ US DTA continues:

> [b] This term, however, does not include any person who is liable to tax in that State in respect only of income from sources in that State or of profits attributable to a permanent establishment in that State.

This is close to standard OECD model form and the differences do not seem material.

### 5.17.1 *US citizens/green card holders*

Article 4(2) of the UK/ US DTA provides:

> An individual who is a United States citizen or an alien admitted to the United States for permanent residence (a "green card" holder) is a resident of the United States only if
> [a] the individual has a substantial presence, permanent home or habitual abode in the United States and
> [b] if that individual is not a resident of a State other than the UK for the purposes of a double taxation convention between that State and the UK.

The US Department of the Treasury Technical Explanation of the Convention[39] provides:

> Paragraph 2 contains an exception to the general rule of paragraph 1 that residence under internal law also determines residence under the Convention. The exception applies with respect to a U.S. citizen or alien lawfully admitted for permanent residence (i.e., a "green card" holder). Under paragraph 1, a person is considered a resident of a Contracting State for purposes of the Convention if he is liable to tax in that Contracting State by reason of citizenship. Although this rule applies to both Contracting States, only the United States taxes its non-resident citizens in the same manner as its residents. In addition, aliens admitted to the United States for permanent residence ("green card" holders) qualify as U.S. residents under the first sentence of paragraph 1 because they are taxed by the United States as residents, regardless of where they physically reside.
>
> Under the exception of paragraph 2, a U.S. citizen or green card holder will be treated as a resident of the United States for purposes of the Convention, and, thereby entitled to treaty benefits, only if he meets two conditions. First, he must have a substantial presence (see section 7701(b)(3)), permanent home or habitual abode in the United States. This rule requires that the U.S. citizen or green card holder have a reasonably strong economic nexus with the United States. Second, he must not be treated as a resident of a state other than the UK under any treaty between the UK and a third state. This rule prevents a U.S. citizen or green card holder who is a resident of a country other than the United States or the UK from choosing the benefits of the Convention over those provided by the treaty between the UK and his country of residence. If the U.S. citizen or green card holder's country of residence does not have a treaty with the UK, however, then he will be treated as a resident of the United States as long as he meets the first requirement of an economic nexus. If such a person is a resident of both the United States and the UK, whether or not he is to be treated as a resident of the United States for purposes of the Convention is determined by the tie-breaker rules of paragraph 4.

The text goes on to give some examples:

> Thus, for example, an individual resident of Mexico who is a U.S. citizen by birth, or who is a Mexican citizen and holds a U.S. green card, but

39 *www.treasury.gov/resource-center/tax-policy/treaties/Documents/teus-uk.pdf*

who, in either case, has never lived in the United States, would not be entitled to benefits under the Convention. However, a U.S. citizen who is transferred to Mexico for two years would be entitled to benefits under the Convention if he maintains a permanent home or habitual abode in the United States and is not a resident of Mexico for purposes of the U.K.-Mexico tax treaty. If he were treated as a resident of Mexico under the U.K.-Mexico tax treaty, he could claim only the benefits of that treaty, even if the Convention would provide greater benefits.

The fact that a U.S. citizen who does not have close ties to the United States may not be treated as a U.S. resident under the Convention does not alter the application of the saving clause of paragraph 4 of Article 1 (General Scope) to that citizen. For example, a U.S. citizen who pursuant to the "citizen/green card holder" rule is not considered to be a resident of the United States still is taxable on his worldwide income under the generally applicable rules of the Code.

HMRC helpsheet 302 (Dual Residents - 2010/11) provides:

Special rules apply where the other country is the United States of America (US), if you are claiming to be a resident of the US for the purposes of the UK/US Double Taxation Convention (DTC). Statements concerning residence should not normally be sought from the US Internal Revenue Service. This is because the US operates a special system whereby it taxes its 'citizens' on their worldwide income, wherever they may be resident. US citizens are not, however, necessarily 'residents' of the US for the purposes of the DTC.

Article 4(2) of the DTA provides that a citizen or green card holder will be treated as a resident of the US for purposes of the DTA, and thereby entitled to treaty benefits, only if two conditions are met:

• first, you must have a substantial presence (see below), permanent home or habitual abode in the US

• second, you must not be treated as a resident of a State other than the UK under any treaty between the UK and a third State.

### 5.17.2 *Substantial presence*

It appears that "substantial presence" is a technical term in US tax law (whose meaning applies in the treaty). HMRC helpsheet 302 (Dual Residents - 2010/11) provides:

***Substantial presence test***

You will have a substantial presence if:

• you were present in the US on at least 31 days in the calendar year under test, and

• the sum total of days on which you were present in the US in the year under test, and in the two preceding years, adds up to at least 183 days. For the purposes of this calculation a day spent in the US in the year preceding the year under test counts as 1 /3, and a day in the year before that counts as 1 /6. Part days of presence in the US should be treated as if they were whole days for this purpose.

*Example 1*

If you spent 48 days in the US in 2011, 250 days in 2010 and 365 days in 2009, the calculation would be as follows:

Year of test – 2011 (more than 31 days spent in the US)

| | | |
|---|---|---|
| 2011 | 48 days × 1/1 = | 48 |
| 2010 | 250 days × 1/3 = | 84 |
| 2009 | 365 days × 1/6 = | 61 |
| | | 193 |

Both conditions of the substantial presence test are passed and you will be regarded as resident in the US under that country's domestic law.

### 5.17.3 *Miscellaneous bodies*

The US/UK DTA continues:

(3) The term "resident of a Contracting State" includes—

(a) a pension scheme;

(b) a plan, scheme, fund, trust, company or other arrangement established in a Contracting State that is operated exclusively to administer or provide employee benefits and that, by reason of its nature as such, is generally exempt from income taxation in that State;

(c) an organisation that is established exclusively for religious, charitable, scientific, artistic, cultural, or educational purposes and that is a resident of a Contracting State according to its laws, notwithstanding that all or part of its income or gains may be exempt from tax under the domestic law of that State; and

(d) a qualified governmental entity that is, is a part of, or is established in, that State.

The US Department of the Treasury Technical Explanation of the

Convention[40] provides:

> Paragraph 3 provides that certain tax-exempt entities such as pension funds and charitable organizations will be regarded as residents of a Contracting State regardless of whether they are generally liable for income tax in the State where they are established. The inclusion of this provision is intended to clarify the generally accepted practice of treating an entity that would be liable for tax as a resident under the internal law of a State but for a specific exemption from tax (either complete or partial) as a resident of that state for purposes of paragraph 1.
> Subparagraph (a) of paragraph 3 applies to pension schemes, as defined in subparagraph (o) of paragraph 1 of Article 3 (General Definitions). Subparagraph (b) applies to any plan, scheme, fund, trust, company or other arrangement established in a Contracting State that is generally exempt from taxation in that State because it is operated exclusively to administer or provide employee benefits. The reference to a general exemption is intended to reflect the fact that under U.S. law, certain organizations that generally are considered to be tax-exempt entities may be subject to certain excise taxes or to income tax on their unrelated business income. Subparagraph © applies to an organization that is established exclusively for religious, charitable, scientific, artistic, cultural, or educational purposes and that is a resident of a Contracting State. Thus, an exempt section 501© organization (such as a U.S. charity) that is generally exempt from tax under U.S. law is a resident of the United States for all purposes of the Convention. Subparagraph (d) applies to a qualified governmental entity, as defined in subparagraph (k) of paragraph 1 of Article 3, if it is the Contracting State itself, is established in a Contracting State or is a part of that State.

### 5.17.4 *Tie-breaker for individuals*

The US/UK DTA continues:

> (4) Where by reason of the provisions of paragraph 1 of this Article, an individual is a resident of both Contracting States, then his status shall be determined as follows—
> (a) he shall be deemed to be a resident only of the State in which he has a permanent home available to him; if he has a permanent home available to him in both States, he shall be deemed to be a resident only of the State

40 *www.treasury.gov/resource-center/tax-policy/treaties/Documents/teus-uk.pdf.*

> with which his personal and economic relations are closer (centre of vital interests);
> (b) if the State in which he has his centre of vital interests cannot be determined, or if he does not have a permanent home available to him in either State, he shall be deemed to be a resident only of the State in which he has an habitual abode;
> © if he has an habitual abode in both States or in neither of them, he shall be deemed to be a resident only of the State of which he is a national;
> (d) if he is a national of both States or of neither of them, the competent authorities of the Contracting States shall endeavour to settle the question by mutual agreement.

This is standard OECD model wording.

### 5.17.5 *Tie breaker for non-individuals*

Art 1(5) US/UK DTA provides:

> Where by reason of the provisions of paragraph 1 of this Article a person other than an individual is a resident of both Contracting States, the competent authorities of the Contracting States shall endeavour to determine by mutual agreement the mode of application of this Convention to that person. If the competent authorities do not reach such an agreement, that person shall not be entitled to claim any benefit provided by this Convention, except those provided by paragraph 4 of Article 24 (Relief from Double Taxation), Article 25 (Non-discrimination) and Article 26 (Mutual agreement procedure).

The US Department of the Treasury Technical Explanation of the Convention[41] provides:

> Dual residents other than individuals (e.g., companies, trusts, and estates) are addressed by paragraph 5. If such a person is, under the rules of paragraph 1, resident in both Contracting States, the competent authorities shall seek to determine a single State of residence for that person for purposes of the Convention. For example, a company is treated as resident in the United States if it is created or organized under the laws of the United States or a political subdivision. Under U.K. law, a company is

41 *www.treasury.gov/resource-center/tax-policy/treaties/Documents/teus-uk.pdf.*

treated as a resident of the UK if it is either established there or managed and controlled there. Dual residence, therefore, can arise if a U.S. company is managed and controlled in the UK. Paragraph 5 provides that the competent authorities will try to determine a single State of residence for such a company.

If the competent authorities do not reach an agreement on the single State of residence, that person may not claim any benefit provided by the Convention, except those provided by paragraph 4 of Article 24 (Relief from Double Taxation), Article 25 (Non-Discrimination), and Article 26 (Mutual Agreement Procedure). Thus, for example, a State cannot discriminate against a dual resident company, and such a company can bring issues to the competent authorities.

Dual resident companies also may be treated as resident for purposes other than that of obtaining benefits under the Convention. For example, if a dual resident company pays a dividend to a resident of the UK, the U.S. paying agent would withhold on that dividend at the appropriate treaty rate because reduced withholding is a benefit enjoyed by the resident of the UK, not by the dual resident. The dual resident company that paid the dividend would, for this purpose, be treated as a resident of the United States under the Convention. In addition, information relating to dual resident companies can be exchanged under the Convention because, by its terms, Article 27 (Exchange of Information and Administrative Assistance) is not limited to residents of the Contracting States.

CHAPTER SIX

# YEAR OF ARRIVAL AND DEPARTURE

## 6.1 Arrival and departure – Introduction

This chapter is concerned with income and gains accruing in a year during which an individual or a trustee becomes or ceases to be UK resident. I also consider cases where an individual becomes or ceases to be ordinarily resident or UK domiciled.

Of course, a person who is present in the UK for part of a year may have the status of UK resident or ordinarily resident throughout the year and then the issues discussed in this chapter do not arise: we are concerned with those who acquire or lose the status of resident or ordinarily resident during the tax year. It is necessary to consider income tax and CGT separately.

For exit taxes on emigration see 7.1 (Exit taxes). For employment income in the year of arrival and departure, see 12.8 (Pre-commencement and post-cessation earnings). The topic of companies becoming or ceasing to be UK resident is not discussed.

## 6.2 Income tax: statutory split year rule

An individual who is resident during part of a tax year is strictly subject to income tax on all the income of the year, even income arising during the non-resident part of the year. I refer to this as the **"the statutory split year rule."**

Confusingly, there is no clear statutory statement of this principle (though no-one doubts its correctness). There is not even any case which clearly decides or discusses it. However there are some that point clearly enough in that direction.

### 6.2.1 *Residing in the UK "in a tax year" and "for a tax year"*

*Mitchell v IRC* concerned the Special Contribution under the FA 1948 which (in short) was not charged "in the case of an individual who in the year 1947/48 was not domiciled in the UK." The taxpayer ceased to be UK domiciled halfway through the year. The charge applied. The Court held that a person who was UK domiciled during part of the year was domiciled "in the year".[1]

Closer to home, *Neubergh v IRC* 52 TC 79 concerned the Special Charge under the FA 1968 which applied (in short) to a person who was resident and ordinarily resident in the UK *"*in the year 1967/68". The taxpayer ceased to be resident and ordinarily resident during that year. The charged applied because the taxpayer could be said to be resident and ordinarily resident "in the year" even though he was only so resident during part of the year.

The expression residing in the UK *"in* a tax year" is sometimes contrasted with the expression residing in the UK *"for* a tax year". The meaning of the latter expression was one of the issues in *Gubay v Kington*. Vinelott J thought that it generally meant resident *throughout* the year so that a person resident during only part of a tax year was not resident in the UK *for* the year. Dillon LJ took the opposite view. Everyone agreed, however, that the expression could be read either way, and context must decide the meaning. I suggest that it is best not to use that expression at all, and indeed it is rare in tax legislation.[2] It is easy to say clearly whatever is intended, as s.2 TCGA illustrates.

1 33 TC 53. The Court went on to deal with the double negative in the provision, and held that the person domiciled during part of a year could not say that they were not UK domiciled "in the year". I find this point unconvincing, but it does not matter for present purposes.

2 The expression "resident for" a tax year is no longer found in the context of the provision discussed in *Gubay,* though it survives in some double taxation contexts, eg ss.26, 28, 137 TIOPA, s.835O ITA. The special commissioners in *Gubay* 57 TC 601 at p.613 rightly said that "the suggested distinction between being 'a person residing in the UK' and being 'resident in the UK for a year of assessment is excessively refined." I stress this because the special commissioner revived this usage (I think, unhelpfully) in *Genovese v HMRC* [2009] STC (SCD) 373 at [54].

### 6.2.2 *Where is the authority for the statutory split year rule?*

With that in mind one can review the statutory provisions, such as s.368 ITTOIA:

> **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

The terms "UK resident" and non-UK resident are defined in s. 989 ITA:

> The following definitions apply for the purposes of the Income Tax Acts
> ...
> "non-UK resident" means not resident in the UK (and references to a non-UK resident or a non-UK resident person are to a person who is not resident there),
> "UK resident" means resident in the UK (and references to a UK resident or a UK resident person are to a person who is resident there),

*Neubergh* does not, it seems to me, justify the statutory split year rule, as it is a step from "resident in the UK" (the relevant statutory language now) to "resident in the UK in the year" (the terminology considered in *Neubergh*). But for all that, the principle has long been agreed.[3]

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.[4]

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3 Rowlatt J alluded to it in *Back v Whitlock* 16 TC 723 at p.726: "As I understand it, there is no question under the Income Tax Acts of any apportionment or adjustment for Income Tax in time, with regard to the date when a person became resident and so became taxable."

4 Likewise HMRC6 para 2.4 provides:
"Strictly, you are taxed as a UK resident for the whole of a tax year when you are resident here for any part of it. But, if you leave or come to the UK part-way through a tax year, the year may, by concession, be split (extra-statutory concession A11).

I find this a slightly confusing way to express the statutory split year rule, but it is in principle correct.

Having said that, however, the statutory split year rule is subject to two exceptions of such breadth that the principle rarely applies:

(1) Relief is available by concession ESC A11.
(2) Relief may be available under Double Tax Treaties.

## 6.3 Concession A11

The concession continues:

> [2] But where an individual—
> (a) comes to the UK to take up permanent residence or to stay for at least two years; or
> (b) ceases to reside in the UK if he has left for permanent residence abroad,
>
> liability to UK tax which is affected by residence is computed by reference to the period of his residence here during the year.
> [3] It is a condition that the individual should satisfy the Board of Inland Revenue that
> [a] prior to his arrival he was, or
> [b] on his departure is,
> not ordinarily resident in the UK.

This concession is often disapplied: see 9.7.1 (Interaction of £2k limit with split-year concessions); 9.11.1 ("Long-term UK resident") and 9.11.11 (Remittance basis claim charge in year of arrival and departure).

### 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).

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This means that the UK Income Tax you should pay because you are resident here is calculated on the basis of the period you are living here rather than the whole of that tax year. This has the effect of splitting the tax year into resident and not resident periods for the purposes of calculating the tax due."

- 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 (they come 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 IT year of arrival treatment. This is bizarre because they may qualify for IT year of departure treatment and (I think) may qualify for CGT year of arrival treatment.

Condition [3][a] would only affect someone who (prior to arrival) is non-resident but ordinarily UK resident, which in practice never or hardly ever happens.

### 6.3.2 *Year of departure*

The usual conditions for year of departure treatment are:

- The individual must leave for permanent residence abroad: A11 [2](b).
- The individual must cease to be ordinarily resident in the UK: A11 [3][b].

Condition A11 [2](b) – permanent residence abroad – is stricter than the equivalent rule for the year of arrival, A11 [2](a). If "permanent" is read strictly, a person who leaves for a number of years, three years or even five years, does not qualify for year of departure treatment, unless the employment exception applies. But perhaps a reasonable length period abroad, say three years, is regarded as "permanent" for this purpose.

In respect of this condition, ESC A11 continues:

> The concession would not apply, for example, where an individual who had been ordinarily resident in the UK left for intended permanent residence abroad but returned to reside here before the end of the tax year following the tax year of departure.

Why? Does this assume that the individual is not ordinarily resident abroad in the year following the year of departure? I would have said that they were ordinarily resident, until they changed their minds and decided to return. It is however an unusual case, so the question will not often arise.

### 6.3.3 *Absence under contract of employment*

Condition [2](b) (to leave for permanent residence abroad) is relaxed in one case. ESC A11 provides:

> This concession is extended to the years of departure and return where, subject to certain conditions, an individual goes abroad for full time service under a contract of employment. These conditions are—
> – the individual's absence from the UK and the employment itself both extend over a period covering a complete tax year; and
> – any interim visits to the UK during the period do not amount to—
> (i) 183 days or more in any tax year; or
> (ii) an average of 91 days or more in a tax year (the average is taken over the period of absence up to a maximum of four years).

This is mainly relevant to year of departure treatment for an employee who leaves the UK but not for *permanent* residence abroad so they do not meet condition A11 [2](b). It could also apply to year of arrival treatment, for an employee who returns to the UK but only to stay for one year, so they do 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 they cease to be ordinarily resident and will qualify under the usual conditions.

## 6.4 IT computation where ESC A11 applies

ESC A11 simply states:

> liability to UK tax which is affected by residence is computed by reference to the period of his residence here during the year.

There are several possible ways of computing liability by reference to the period of residence. One is straightline time apportionment by reference to the length of the resident and non-resident periods. Another is to identify the income arising in the period of residence.

### 6.4.1 *What is the period of residence?*

ESC A11 refers to "the period of residence here during the year" and the first step is to ascertain this period.[5]

From 2008/09, days of arrival are counted, but days of departure are not: one applies the usual rule that a day only counts if one is present at the end of the day.

There is no other guidance on how to ascertain the period of residence here. Here is just a selection of cases:

| | **Days present: Case 1** | **Case 2** | **Case 3** |
|---|---|---|---|
| April (from 6th) | 0 | 1 | 7 |
| May | 0 | 0 | 0 |
| June | 0 | 0 | 2 |
| July-April | continually present | cont. present | cont. present |

In case 1 the individual's period of residence begins 1 July. Is case 2 different because of the one day visit in April? It is thought not, for one would not describe the individual as resident here in the period April–June if they were 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 they are resident in all of April, then away, and continuously present from October. Are they 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 they did not intend to come in October, they are not resident during that period. In practice no doubt we muddle through.

### 6.4.2 *Habitual visitors*

The Inspectors Manual provided at 1664:

> **Visitors resident from 6 April**
> An individual who, by reason of habitual and substantial visits, becomes

5 ESC A11 also refers to "arrival" and "departure" and clearly the period of residence is between those two.

> chargeable as a resident for and from the fifth year of such visits (see (a)(ii) of IM45)[6] should be treated as resident for the whole of the year for the purpose of this guidance.

The reason is presumably that in the case of a person making sporadic visits, there is often no obvious way of identifying the period of residence.

## 6.5 Computation in year of arrival – RFI

### 6.5.1 *RFI: arising basis*

IR20 (withdrawn from 2009/10) was difficult to follow by the time it reached its 2008 version, because parts of it were out of date, discussing the preceding year basis (abolished 1996/7) and paying and collecting agents rules (abolished in 2000). The 2008 updates to IR20 made no attempt to address this problem. But apart from some curious rules relating to source ceasing (which were anomolous before 2008 and one can assume have no relevance now) IR20 opted for straightline time apportionment. The Inspectors Manual para 1663 (also withdrawn) provided an example which conveniently illustrated this approach:

> ***New arrivals on or after 6 April 1997***
> *Where an individual arrives in the UK on or after 6 April 1997 and is regarded as resident from the date of arrival, his liability in respect of overseas income within Cases IV or V should be determined as follows.*
> *(1) No liability arises where the source of income ceases before permanent residence begins.*
> *(2) Liability for the year of arrival should be based*
> *(a) where the arising basis applies, upon the proportion on a time basis from the date of arrival to the following 5 April, of the full amount of income arising in the year of arrival.*

The Manual then gave an example which helpfully illustrated the rule:

> *For example, an individual arrives in the UK on 6 October 1997 and is regarded as UK-resident from that date. Case V income arose as follows:–*

6 This passage in the Inspectors Manual set out the short term visitors rules.

| | |
|---|---|
| *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×£700 =£350*

I describe this as "**straightline time apportionment**".

However, HMRC6 provides:

> **10.14.1 When you become resident in the UK**
> When you come to the UK during a tax year and are resident from the date of your arrival, you are liable to UK tax on your UK investment income for the whole of the tax year, subject to the terms of any DTA which might apply to you.
> You will not be liable to UK tax on foreign investment income *arising before the date of your arrival* under extra statutory concession A11.

This suggests that HMRC may have altered their practice, and one now should identify when the income arose and income attributable to the pre-arrival period is not taxed. This is consistent with the approach adopted for departure.

Of course one would have expected a major change of practice of that kind to be discussed in advance, and highlighted, and possibly HMRC may continue to accept straightline time apportionment, at least when it gives roughly the same result as identifying the actual income of the resident and non-resident periods.

### 6.5.2 *RFI: remittance basis*

The terms of the ESC require that tax is "computed by reference to the period of residence here during the year" which suggests that where the remittance basis applies:

(1) income arising prior to that period of residence, time apportioned, should be disregarded; and
(2) remittances made prior to that period of residence, should be disregarded.

HMRC accept this view. The January 2009 Qs & As provides:

**Q14:** A Polish plumber comes to the UK in September 2008, having worked until August 2008 in Poland. He will be caught by 809D as ESC A11 does not apply but will not be caught by 809X as ESC A11 does apply. It appears anomalous that the April to August income can be treated as unremitted and potentially taxable income for one purpose and then not taxed when remitted for another purpose.
**A:** The disregard of split year treatment applies solely for the purposes of determining whether an individual will need to claim the remittance basis under s809B ITA or whether they can rely upon s809D to use the remittance basis without making a claim because their total foreign income and gains are below the £2,000 threshold (and thereby retain their personal allowances and AEA). ESC A11 continues to apply in terms of what income is chargeable to tax.
Remittances of foreign income arising in the months before an individual came to the UK (assuming the individual was not temporarily non-resident) will not be taxable under the terms of the A11 concession.

## 6.6 IT Computation in year of departure

### 6.6.1 *RFI: arising basis*

The method of computation for the year of departure was formerly entirely different, and more generous, than for the year of arrival. IR20 (withdrawn from 2009/10) provided:

*Investment income of those who leave, or come to, the UK part way through a tax year*
***Leaving the UK***
*6.15 For tax years up to the year ending 5 April 2008, for overseas investment income where you are **not** taxed on the remittance basis, you will pay tax on the smaller of*
*[a] the actual overseas investment income arising for the period from 6 April to the date of your departure, and*
*[b] the same fraction of your total overseas income for the year of departure as the fraction of the full tax year for which you are resident in this country. For example, if you are resident in the UK from 6 April until 6 October in the same tax year, i.e. 6 months, the fraction is 6/12.*
*For tax years from 6 April 2008 onwards, the same rules will apply, depending on your personal circumstances. If you have chosen not to claim the remittance basis in the tax year of your departure you will be*

*liable to pay UK tax on all of your income, including your overseas investment income, up to your departure from the UK – see paragraph 5.12.*

However the practice seems to have been quietly changed. HMRC6 provides:

> **10.14.2 When you stop being resident in the UK**
> When you leave the UK during a tax year and become non-resident here on the day after your departure, you will be liable to UK tax on your UK investment income for the whole of the year.
> If you meet the requirements of extra-statutory concession A11 you will not be liable to UK tax on your foreign investment income following the date of your departure. Up to the date of your departure from the UK you will be liable to UK tax on your foreign investment income, subject to whether you use the remittance basis in the tax year of your departure.
> **10.14.3 When you do not use the remittance basis**
> If you do not use the remittance basis in the year of departure you will, where you are entitled to apply extra-statutory concession A11, be liable to UK tax on your foreign investment income which arose before your departure from the UK.

### 6.6.2 *RFI: remittance basis*

IR20 (withdrawn from 2009/10) provided:

> *6.16 For overseas investment income where you are taxed on the* ***remittance basis*** *(see para 6.2), you will pay tax on the smaller of*
> *[a] the actual overseas investment income remitted to the UK in the period from 6 April to the date of your departure, and*
> *[b] the same fraction of the total overseas income you remit to the UK in the year of departure as the fraction of the full tax year for which you are resident in this country.*[7]

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7 Similarly, the Inspectors Manual provided:
**1667. Persons ceasing to be resident in UK**
Where a person (other than an individual of the type referred to in IM45 [See 6.4.2 (Habitual visitors)]) takes up permanent residence abroad and ceases to be resident in this country, any liability under Case IV or V for the year in which residence here ceases should be based on—
(a) the proportion, appropriate to the period from 6 April to the date of departure,

However the practice seems to have been quietly changed. HMRC6 provides:

> **10.14.4 When you use the remittance basis**
> If you use the remittance basis in the year of departure you will, where you are entitled to apply extra-statutory concession A11, be liable to UK tax on your foreign investment income which you remitted to the UK before your departure.

## 6.7 Interest from FOTRA securities

IR20 (withdrawn from 2009/10) para 6.6 provided:

> *UK tax is not chargeable on interest arising on **UK Government 'FOTRA' securities**, if you are not ordinarily resident in the UK. 'FOTRA' stands for 'Free of Tax to Residents Abroad'. Where we treat you as becoming, or ceasing to be, ordinarily resident in the UK part way through the tax year, no tax will normally be charged on interest payable while you are not ordinarily resident—that is, before the date you arrive here or after the date you leave.*

HMRC6 contains no guidance on the point, but there is no reason to think that HMRC practice has changed.

## 6.8 Income within s.624 ITTOIA

The Manuals do not deal with this expressly, but ESC A11 is in general terms, so it must be assumed that the RFI rules set out above apply.

## 6.9 Income within s.720 and s.731 ITA

It is considered that one can split years by reference to the periods of

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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.

ordinary residence.[8]

## 6.10 UK source investment 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.[9] That section only applies to complete years of non-residence.

In particular, although a non-resident is not chargeable on UK source dividends, pre-arrival UK dividends and post-departure UK dividends of a split year are taxed in full.

There is no good reason for this anomaly, but there it is.

## 6.11 Gains from life policies, etc.

ESC A11 does not apply to chargeable event gains.[10] There is some sense in this, because policies already qualify for non-resident period relief.[11]

## 6.12 Accrued income scheme

HMRC6 provides:

> **10.13.2 UK Government securities**
> ... If you hold securities with a nominal value of more than £5,000 during a tax year in which you are resident in the UK at any time, special tax provisions (the 'accrued income scheme') will apply when the securities are transferred. You will be charged UK Income Tax on the interest that has built up ('accrued') over the period you owned the securities following the last interest payment, even if you were not resident in the UK for part of that period.

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8 See 3.2.3 (Ordinary residence during part of tax year).
9 For a full discussion of the relief, see 37.1 (Non-residents Income Tax relief).
10 See 30.4.5 (Individual non-resident in year of chargeable event).
11 See 30.4.6 (Non-resident period relief).

In principle this is of course right, but it is not (I think) addressing the position in the year or arrival or departure. It is suggested that ESC A11 applies.

## 6.13 Withholding tax on interest

If an individual becomes non-ordinarily resident during a tax year, they are entitled to receive interest from UK deposit-takers free of withholding tax for the non-ordinarily resident part of the year.[12] The relevant form must be completed. In this context, note that the TDSI Guidance Notes (February 2009) provide:

> **4.52 Emigration**
> Strictly, a declaration made in contemplation of, but before, leaving the UK is not acceptable. But Financial Institutions may accept such declarations provided they satisfy themselves, before paying interest without deduction of BRT, that the investor has left the UK. A note of any enquires made should be kept in the investor's records.

Similarly if a person ceases to have a usual place of abode outside the UK, non-resident's withholding tax ceases to apply at that time.[13]

## 6.14 UK resident individual becoming ordinarily resident during the year

So far we have considered the position of an individual who becomes or ceases to be UK resident. This section considers the position of an individual who is UK resident throughout a tax year but becomes ordinarily resident during the year. In practice HMRC will generally accept that ordinary resident status begins at the start of a tax year, so this issue should not arise.

### 6.14.1 *Remittance basis claims*

Section 809B ITA provides:

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12 See 17.11 (Withholding tax on interest from deposit-takers).
13 See 17.6 (Non-resident's withholding tax).

> (1) This section applies to an individual for a tax year if the individual—
> (a) is UK resident in that year,
> (b) is not domiciled in the United Kingdom in that year or is not ordinarily UK resident in that year, and
> (c) makes a claim under this section for that year.

If the individual is not UK domiciled they may claim the remittance basis (ordinary residence is not relevant). If the individual is UK domiciled they may make a remittance basis claim only if they are "not ordinarily UK resident in that year". On the basis of *Mitchell*[14], it is considered that the individual who becomes ordinarily resident during the year does not meet this condition, so a s.809B claim cannot be made.

### 6.14.2 *Employment income*

Section 26(1) ITEPA provides:

> This section applies to general earnings for a tax year where section 809B, 809D or 809E of ITA 2007 (remittance basis) applies to the employee for that year and the employee is not ordinarily UK resident in that year...

On the basis of *Mitchell*,[15] it is considered that the individual who becomes ordinarily resident during the year does not meet this condition, so a s.809B claim cannot be made.[16]

## 6.15 Income tax on trustees

If a trust changes residence the HMRC view is that the tax year is split into UK and non-UK resident periods for income tax purposes. HMRC Residency: Non-resident Trusts (published 1 April 2008) provides:

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14 See 6.2.1 (Residing in the UK "in a tax year" and "for a tax year").

15 See 6.2.1 (Residing in the UK "in a tax year" and "for a tax year").

16 In *Genovese v HMRC* [2009] STC (SCD) 373 the Special Commissioner reached the same conclusion, at [51] to [54] (though without much discussion and without reference to the relevant cases; the taxpayer was not represented by counsel). Similarly in *Turberville v HMRC* [2010] UKFTT 69 at [8].

> **Change in residence status of body of trustees**
> A change in the residence status of a body of trustees is usually caused by a change in the trustees who make up the body. It can also happen where the trustees remain the same but one of them changes their residence status.
>
> For income tax purposes if the residence status of a body of trustees changes during the tax year then the trustees are potentially liable for income tax on all their worldwide income for the period they were actually resident. They are only liable for income tax on their UK source income for the period they were actually non-resident.[17]

This view was probably formulated before the introduction in 2006 of the rule that trustees are a single and distinct person for IT;[18] but HMRC do not argue that that rule has altered the position.

## 6.16 CGT statutory split year rule

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
> [a] during any part of which he is resident in the UK, or
> [b] during which he is ordinarily resident in the UK.

This is better drafted than IT, as the CGT statutory split year rule is clearly expressed. CGT is charged on gains of a year *during any part of which* the individual is UK resident. A UK resident individual who ceases to be UK resident is strictly subject to CGT on gains accruing until the following 6 April; a non-resident who realises a gain is strictly subject to CGT if they become UK resident before the following 6 April.

As with income tax, the CGT statutory split year rule 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 treaty-resident and treaty-non-resident periods.

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17 See *www.hmrc.gov.uk/cnr/nr_trusts.htm*. The statement in ESC A11 [1] that years are not split refers to an individual: see 6.2 (Income tax: statutory split year rule)

18 See 4.3 (Trustees treated as single and distinct person).

### 6.16.1 *Section 13 TCGA*

Section 13 TCGA is an exception: the charge only applies if the individual is resident at the time the gain arises, so it is not necessary to rely on ESC D2.

## 6.17 **Concession D2**

ESC D2 provides:

1. [a] An individual who
   [i] comes to live in the UK and
   [ii] is treated as resident here for any year of assessment from the date of arrival
   is charged to capital gains tax only in respect of chargeable gains from disposals made after arrival,
   [b] provided that the individual has not been resident or ordinarily resident in the UK at any time during the five years of assessment immediately preceding the year of assessment in which he or she arrived in the UK.
2. [a] An individual who
   [i] leaves the UK and
   [ii] is treated on departure as not resident and not ordinarily resident here
   is not charged to capital gains tax on gains from disposals made after the date of departure,
   [b] provided that the individual was not resident and not ordinarily resident in the UK for the whole of at least four out of the seven years of assessment immediately preceding the year of assessment in which he or she left the UK.[19]

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19 The concession continues:
"3. This concession does not apply to any individual in relation to gains on the disposal of assets which are situated in the UK and which, at any time between the individual's departure from the UK and the end of the year of assessment, are either:
(i) used in or for the purposes of a trade, profession or vocation carried on by that individual in the UK through a branch or agency; or
(ii) used or held for, or acquired for the use by or for the purposes of such a branch or agency."

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

### 6.17.1 *Year of arrival*

The conditions for year of arrival treatment are:
- the individual comes to live in the UK: D2 1[a][i]
- the individual is treated as resident here from the date of arrival: D2 1[a][ii]
- the individual has not been resident at any time during the 5 years of assessment before the year of arrival: D2 1[b]

Condition 1[a][i] is not in fact a separate condition, since anyone who meets condition 1[a][ii] must come to live in the UK.

Condition 1[a][ii] is puzzling. If the concession applies the individual is treated as resident here from the date of arrival, if it does not, they are 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.[20]

Condition 1[b] was introduced as a consequence of the temporary non-residence rules in 1998. But the condition is stricter than the temporary non-residence rules.

It is necessary to ascertain the date of arrival and departure: see 6.4.1 (What is the period of residence?).

### 6.17.2 *Year of departure*

The conditions for year of departure treatment are:
- the individual leaves the UK: D2 2[a][i]
- the individual is treated on departure as not resident: D2 2[a][ii]
- the individual was not UK resident for at least 4 out of 7 of the years of assessment before the year of departure: D2 2[b].

Once again, condition 2[a][i] is otiose, but it does not matter. Condition 2[b] was introduced as a consequence of the temporary non-residence 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

agency.

20 See 6.4.2 (Habitual visitors).

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.[21]

## 6.18 Computation of CGT

ESC D2 operates differently from A11. One does not compute the total gains of the year and time apportion. D2 states that one ignores disposals in the non-resident part of the year.

Under the remittance basis, gains are treated as accruing when remitted.[22] It is suggested that this does not change the date of disposal for the purposes of the remittance basis, or else a foreign domiciliary who remits gains pays more CGT than a UK domiciled individual.

### 6.18.1 *Losses*

The concession says nothing about allowable losses accruing in the non-resident part of the year. The possibilities are:

(1) losses of the period remain allowable although gains of the same period are not;
(2) losses of the period are allowable only so far as they exceed the gains of the same period;
(3) Losses of the period are not allowable at all.

Solution (1) is too good to be fair, but it is the most consistent with the words of the concession and it is tentatively considered that this is correct. Solution (3) is the most sensible, but cannot be applied, since it imposes more tax than would be the case without the concession. If the concession were made statutory (as is proposed in the residence consultation paper) this problem would not arise.

## 6.19 CGT on trusts – year of arrival and departure

ESC D2 provides:

21 See 8.11 (Time limit for assessment).
22 See 43.2.1 (Date of disposal under remittance basis).

4. This concession does not apply to
[a] the trustees of a settlement who commence or cease residence in the UK[23] 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][24] TCGA section 86 and Sch 5.

The CGT concession does not apply to trustees or to a settlor who is chargeable on the gains of a non-resident settlement. This is an anomaly, but a necessary one, because if by concession the trustees or settlor were not charged to tax in a split year, the untaxed gains would not be s.2(2) amounts (trust gains), and so may escape tax altogether. Though if the concession was made statutory as it ought to be, this anomaly could easily be corrected.

Where UK trustees are considering retiring in favour of non-resident trustees, they should consider the alternative course of transferring trust assets to a separate non-resident trust. The chargeable gain on the transfer to a new trust is in principle the same as the exit charge on the appointment of non-resident trustees. However the new trust will not be within the scope of CGT for gains accruing after the transfer, whereas the migrating trust will remain within the scope of CGT for the rest of the tax year.

## 6.20 CGT planning – postponing disposals until non-resident

The obvious CGT planning for individuals 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:

23 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.

24 The reference to s.77-79 TCGA is not applicable from 2008/09 as these sections have been repealed.

**25800. Attempted avoidance on emigration**
When an individual plans to emigrate from the UK, he or she will often want to dispose of their assets located in the UK before departure. This is particularly true of privately run businesses carried on in the UK but it is often also true of other property located in the UK. For such assets it may be necessary, or at least convenient, for the individual to be in the UK to deal with negotiations for the sale. The individual may also need to have a definite sale arranged in order to 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. Establishing the correct time when a gain arises** [May 2010]

...

There are three circumstances in which Capital Gains Tax liability may arise notwithstanding that the date of disposal appears to be after the date of emigration. These are where it can be shown that

- there was a binding agreement or contract for sale on or before the date of emigration or
- 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
- an attempt has been made to use ESCD2 for tax avoidance.

Detailed guidance on each of these is contained in the following paragraphs.

**25820. Establishing basic facts** [May 2010]

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?

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 individuals and/or their agents to quote the date of completion as the disposal date.

Oh dear.

It can therefore be worth checking that the date quoted is not in fact the completion date. Once you are satisfied on this point the next step is to establish whether, and if so, on what date the individual became not resident and not ordinarily resident.

**25831. Establishing the basic facts** [June 2003]

You should obtain a residence ruling from Centre for Non-Residents, CNR1 before proceeding further with the case. You should follow the procedure laid down in IM32 in doing this.

### 6.20.1 *Binding agreement before departure?*

The CG Manual turns to the first of the three lines of attack:

**25850. Delayed written contracts** [May 2010]

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. Cases have been seen where the vendor leaves the UK with a copy of the contract in his possession and posts it from the foreign airport on arrival there. Alternatively, he gives his solicitor a power of attorney under which the solicitor can sign and exchange the contracts on behalf of the vendor once he is outside the UK. There are many other variations.

The author's indignation is misplaced and somewhat naive.

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'.
It may be possible to displace that presumption if evidence can be obtained either that the benefit of ESCD2 is being sought as a means of avoidance, see CG25980+, or that the disposal was not in fact conditional or 'subject to contract' at the time of emigration, see CG25805.
**25853 Binding contract pre-dating emigration** [May 2010]
Legislation enacted with effect from 27 September 1989 requires all disposals of interests in land in England and Wales to be evidenced in writing if there is to be a valid contract, see CG70280 and CG14263. (This has always been the requirement for land in Scotland.) For disposals after that date an oral contract will not be a valid contract. This means that in cases where the written contract is delayed until after 5 April following departure from the UK you will not be able to establish the existence of a binding agreement preceding the date of sale (see CG25860).
In such circumstances it is still possible for there to be a gain chargeable to tax if any of the following apply:

- Section 10 TCGA 1992 (non-resident with United Kingdom branch or agency, see CG25500+)
- Section 10A TCGA 1992 (temporary non-residents, see CG26100+)
- Section 25 TCGA 1992 (non-residents: deemed disposals, see CG25570+)

You should note that the above applies only when the land is situated in England or Wales or Scotland. It does not apply if the land is situated in 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.
**25854–25859**
**25860 Binding contract pre-dating emigration** [May 2010]
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 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.
Establishing the existence of a binding contract or agreement, oral or written, in advance of the formal contract presents considerable difficulty, see CG25850 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 constitutes 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.
If a binding agreement prior to the date of formal documentation can be established, the date of the earlier agreement is the date of disposal for Capital Gains Tax purposes.

### 6.20.2 *Branch/agency*

This is the second line of HMRC attack, though the circumstances in which it arises will be rare:

**25900. Business through branch/agency**
If an individual is carrying on a trade or profession (and possibly even if he or she is carrying on a vocation) in the UK prior to his or her emigration, that individual may find it necessary to sell the business as a going concern if the best price is to be realised. If the written contract for sale of the business assets is to be delayed until after departure, the individual will need to make arrangements for the business to continue operating in his or her absence. In most such cases we will be able to argue that in the period between departure and the date the contract is signed the activity has been carried on in the UK through a branch or agency.
In those circumstances
· if the disposal occurs after the date of emigration but before the following 6 April the disposal will be within Section 2 TCGA 1992 and ESC D2 will not apply (see CG25770)
· if the disposal takes place after 5 April following the date of emigration TCGA 1992, S 10 will apply (see CG25520+).
In either case the individual will be within the charge to Capital Gains Tax...

### 6.20.3 *Withdrawal of concession*

This is the third line of HMRC attack:

**25980. Withholding benefit of ESC D2** [May 2010]
A warning is published as part of the introduction to HMRC's guide to 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** [May 2010]
>
> 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 Commissioners for HMRC 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 straightforward cases where the contract of sale is delayed until after the date of emigration, see CG25850, the Commissioners for HMRC 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."[25] The CG Manual continues:

> Where the facts support the withholding of the concession and there is also an argument about the existence of a pre-emigration agreement which could be arbitrated by a hearing before Tribunal (see CG25880 above), the Commissioners for HMRC will normally wish to withhold the benefit of the concession as its primary action.
>
> **25984. Withholding benefit of ESC D2: Enquiries** [May 2010]
>
> 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.
>
> 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.
>
> However, if you conclude that your case is one where the benefit of ESC/D2 should be withheld you MUST submit your papers to CAR (Capital Gains Technical Group) in Solihull before any mention of this is made to the taxpayer.

25 See 29.17.3 ("Genuine").

**26010. Other devices** [May 2010]
Individuals may make use of a number of devices to cause at least part of the gain to appear to 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. CAR (Capital Gains Technical Group) in Solihull will be pleased to advise on any of these types of case but they must be submitted before any suggestion is made that the concession might be withheld.

**26020. Splitting a single contract** [May 2010]
In this type of case, what would normally have been included in a single contract for sale is split into two contracts. For example, a farmer owning a farmhouse and associated farmland emigrates; he claims to have sold the farmhouse prior to departure (possibly to give immediate access to capital) and the farmland after the date of departure, and points to the fact that two separate contracts have been entered into. Relief under TCGA 1992, S 222 is claimed on the disposal of the farmhouse. In such cases, it may be possible to sustain an argument that, in reality, there is only a single disposal for capital gains purposes, the date of disposal of the farmland and the farmhouse being the same: that is to say, the earlier of the two dates.

**26030. Conditional contracts** [May 2010]
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. There is guidance on dates of disposal and conditional contracts at CG14250+ and CG14270+.

**26040. Options and cross-options** [May 2010]
Sometimes the owner, before emigrating, grants an option to a potential purchaser to buy the asset, that option to be exercised during a specified period following the owner's emigration. If there is genuine uncertainty in the vendor's mind at the time of emigration as to whether the grantee will exercise the option, there are no grounds for withholding the benefit of the concession. As with pure delay cases, however, there may be evidence to show that the option was a sham and that the vendor is assured of his sale before he leaves the UK.

These are cases where the vendor and purchaser each grant an option to the other party to sell/buy the asset which is the subject of the agreements. Invariably in these cross-options cases, the options are granted before the vendor leaves the UK, but one of the options is exercised (usually by the purchaser) after the vendor's date of departure. The Board will consider withholding the benefit of ESC D2 if there appears to be no commercial reason for the issue of the cross-options.

**26060. Transfer to émigré spouse or civil partner under no gain/no loss rule** [May 2010]
In this type of case, a husband or wife or a civil partner owns a valuable asset which he or she wishes to sell. The spouse or civil partner of the owner of the

asset is leaving the UK – probably for a limited period such as a fixed term employment abroad. The owner transfers the asset to the departing spouse or civil partner prior to departure and claims the protection of Section 58 TCGA 1992. The asset is subsequently sold by the transferee after the date of departure. This tactic was adopted – unsuccessfully – in the case of *R v HMIT ex p. Fulford-Dobson* (60 TC 168).

Cases of this type need to be distinguished from those where the transfer to the non-resident spouse or civil partner is made after that spouse or civil partner has become non-resident and in a year throughout the whole of which that spouse or civil partner is non-resident. In such cases the benefit of Section 58 can effectively be obtained as a result of the decision in *Gubay v Kington* (57 TC 601), see CG22300+.

## 6.21 CGT planning before arrival in the UK

The Manual discusses planning by emigration but gives no guidance to the converse situation where:

(1) a taxpayer arrives in the UK during a tax year;

(2) a disposal takes place before arrival (but in the same tax year so that ESC D2 is in point).

In order to take advantage of the concession, a taxpayer might arrange disposals just before arriving in the UK. They 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.

### 6.21.1 *Appeal against withdrawal of concession*

There is no appeal to the tax tribunal against a decision by HMRC to withdraw a concession. The CG Manual provides

> **25880. Dispute over binding agreement** [May 2010]
> 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 First Tier Tribunal. 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.
> 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 the First-tier Tribunal cannot concern themselves with the operation of Extra Statutory Concessions the Tribunal would be unable to discharge an assessment made on gains arising in this period.
> **25882. Dispute over binding agreement** [May 2010]
> If the pre-emigration agreement and the written contract are said to have been made in the same tax year then the gain computed at the time of either will be the same as the other. This means that a dispute about the existence of the pre-emigration agreement cannot be resolved by the First-Tier Tribunal, because the amount of any assessment depends only on whether ESCD2 applies and the Tribunal cannot consider the effects of an Extra Statutory Concession: they would be bound to determine the assessment at the figure of the gain. In such cases, where the taxpayer does not accept that a pre-emigration agreement existed, CAR (Capital Gains Technical Group) in Solihull will advise on what further action may be taken.
> **25883. Dispute over binding agreement** [April 2009]
> Reference of the question of whether a pre-emigration agreement existed to the First-tier Tribunal in circumstances where the Commissioners for HMRC would, in any event, withhold the benefit of ESC D2 could give rise to criticism of HMRC. This is because such action would substantially remove the benefit of any Tribunal decision made in the individual's favour. You should therefore consider early the possibility of withholding the benefit of ESC D2 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** [April 2009]
>
> 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 Tribunal 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 Tribunal. In such cases, where the taxpayer does not accept that a pre-emigration agreement existed, Capital Gains Technical Group will be pleased to advise on what further action may be taken.

It is possible to challenge HMRC by way of judicial review (or by application to HMRC adjudicator). It is an interesting question whether the taxpayer must show:

(1) the HMRC decision that there is tax avoidance is one which no reasonable person could reach, or merely
(2) the HMRC view is (in the Court's judgment) wrong (even if not unreasonable).

In practice few, if any, cases would turn on that fine distinction and either contention would be difficult to sustain.

## 6.22 CGT planning before arrival in the UK

There are many possible strategies. A minimum course would be for the individual to dispose of UK situate assets with inherent gains so as to bring their base cost up to market value. This need only apply to UK situate assets which might be disposed of while the individual is resident here. The individual might go further and dispose of non-UK situate assets if they wish to have the ability to sell the asset and remit the gain.

Watch the pre-owned asset rules: see 66.1 (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 they should not dispose of securities and re-acquire securities of the same class within 30 days: s.106A TCGA; RI 226.

Of course foreign tax on the disposal would need to be considered. It is sometimes possible to arrange a disposal which under UK rules takes place while non-resident but under foreign rules takes place while UK resident.

It may be appropriate to make capital payments from UK trusts before becoming UK resident.

## 6.23 Reforms proposed for 2012/13

The Residence Consultation Paper provides:

> 3.41 Under the current rules an individual is either resident or not resident in the UK for the whole of a tax year. However, by ESC A11, the tax year can be split into periods of residence and non-residence in certain circumstances when an individual comes to, or leaves, the UK part way through a tax year. This prevents some individuals being taxed as if they were resident for the parts of the year before they came to the UK or after they left.
>
> 3.42 Split year treatment can apply where an individual:
>
> • comes to the UK to take up permanent residence; or
>
> • leaves the UK to take up permanent residence abroad; or
>
> • loses UK residence when leaving to work full-time outside the UK.
>
> 3.43 As part of introducing an SRT [Statutory Residence Test], the intention is broadly to recreate the circumstances in which split year treatment currently applies and to put it on a statutory footing. This will mean that ESCs A11, D2 and A78 (which applies where an individual is accompanied, or later joined, by his or her spouse who is not in full-time employment abroad) will be withdrawn and replaced by legislative rules.
>
> 3.44 It is not possible to recreate the conditions of the current extra statutory concessions exactly because they rely on the subjective and imprecise concept of becoming 'permanently' resident in the UK or elsewhere. Therefore, in keeping with the intention of introducing clear and objective rules, the statutory provisions on split years will be linked to the conditions contained in the SRT. This means the new rules will treat a tax year as being split into periods of residence and non-residence if a person:

> • becomes resident in the UK by virtue of their only home being in the UK;
> • becomes resident by starting full-time employment in the UK;
> • establishes their only home in a country outside the UK and becomes tax resident in that country and does not come back to the UK in that tax year;
> • loses UK residence by virtue of working full-time abroad; or
> • returns to the UK following a period of working full-time abroad.
>
> 3.45 A tax year will not be treated as split where an individual's residence status changes due to changes in the number of connection factors under Part C, such as the arrival or departure of their family.
>
> 3.46 If a person becomes not resident by virtue of leaving the UK to work full-time abroad and is accompanied by their spouse or civil partner, split year treatment would also apply to the spouse or civil partner provided their sole or main home is outside the UK.[26]

## 6.24 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). The strict rule is probably that the remittance basis is not available to a person who acquires a UK domicile in the year: see 43.2 (CGT remittance basis).

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26 HM Treasury, *Statutory Definition of Tax Residence: a Consultation* (June 2011) *www.hm-treasury.gov.uk/d/consult_condoc_statutory_residence.pdf.*

CHAPTER SEVEN

# EXIT TAXES

## 7.1 Exit taxes – Introduction

This chapter considers exit taxes, that is, taxes imposed on emigration from the UK by individuals or trustees. They are as follows:

(1) Clawbacks of holdover and EIS relief on emigration of individual.
(2) Charges on emigration of a trust.
(3) Charges on emigration of persons carrying on a trade.

I hope in a future edition to discuss restrictions on CGT share exchange relief which are akin to an exit charge; see *Coll v HMRC* [2010] STC 1849. Exit taxes on companies are not considered.

I use the term **"emigration"** to refer to a person becoming domestic law non-UK resident, and **"treaty-emigration"** to refer to a person becoming treaty-resident in another state (ie resident for the purposes of a DTA.)

## 7.2 Clawback of hold-over relief on emigration of individual

Section 168(1) TCGA 1992 provides a clawback of hold-over relief on emigration of individuals.

> If—
> (a) relief is given under section 165 in respect of a disposal to an individual or under section 260 in respect of a disposal to an individual ("the relevant disposal"); and
> (b) at a time when he has not disposed of the asset in question, the transferee becomes neither resident nor ordinarily resident in the UK,
>
> then, subject to the following provisions of this section, a chargeable gain shall be deemed to have accrued to the transferee immediately before that time, and its amount shall be equal to the held-over gain (within the meaning of section 165 or 260) on the relevant disposal.

There is no charge if the individual becomes treaty non-resident but remains UK resident. This gives some scope for tax planning. But given the EU issues discussed below, and the CGT temporary non-residence rules, this may not matter much.

### 7.2.1 *Disposal prior to emigration*

The clawback charge does not apply if the individual disposes of the asset before emigration. Section 168(2) TCGA deals with part disposals:

> For the purposes of subsection (1) above the transferee shall be taken to have disposed of an asset before the time there referred to only if he has made a disposal or disposals in connection with which the whole of the held-over gain on the relevant disposal was represented by reductions made in accordance with section 165(4)(b) or 260(3)(b) and where he has made a disposal in connection with which part of that gain was so represented, the amount of the chargeable gain deemed by virtue of this section to accrue to him shall be correspondingly reduced.

Section 168(3) TCGA provides that inter-spouse disposals are disregarded:

> The disposals by the transferee that are to be taken into account under subsection (2) above shall not include any disposal to which section 58 applies; but where any such disposal is made by the transferee, disposals by his spouse or civil partner shall be taken into account under subsection (2) above as if they had been made by him.

This is obviously right.

### 7.2.2 *Time limit*

Section 168(4) TCGA contains a time limit:

> Subsection (1) above shall not apply by reason of a person becoming neither resident nor ordinarily resident more than 6 years after the end of the year of assessment in which the relevant disposal was made.

### 7.2.3 *Relief for short term postings abroad*

Section 168(5) TCGA contains a relief for short term postings abroad:

> Subsection (1) above shall not apply in relation to a disposal made to an individual if—
> (a) the reason for his becoming neither resident nor ordinarily resident in the UK is that he works in an employment or office all the duties of which are performed outside the UK, and
> (b) he again becomes resident or ordinarily resident in the UK within the period of 3 years from the time when he ceases to be so, without having meanwhile disposed of the asset in question;
> and accordingly no assessment shall be made by virtue of subsection (1) above before the end of that period in any case where the condition in para (a) above is, and the condition in para (b) above may be, satisfied.

Section 168(6) TCGA deals with part disposals and inter-spouse disposals by the short term non-resident. The wording is based on s.168(2)(3) but its effect is different:

> For the purposes of subsection (5) above a person shall be taken to have disposed of an asset if he has made a disposal in connection with which the whole or part of the held-over gain on the relevant disposal would, had he been resident in the UK, have been represented by a reduction made in accordance with section 165(4)(b) or 260(3)(b) ...

This is a strict rule, since even a part disposal loses the benefit of the relief for the entire asset. The subsection continues:

> and subsection (3) above shall have effect for the purposes of this subsection as it has effect for the purposes of subsection (2) above.

Thus there is no exit charge on an asset if T goes non-resident, and gives the asset to the spouse, provided that T becomes UK resident again within 3 years and the spouse does not dispose of the asset during that period. It is irrelevant whether the spouse becomes UK resident.

### 7.2.4 *Collection of clawback charge from donor*

The tax may be collected from the donor or transferor. This is not usually so important to individual donors (because they will generally be prepared to take a view about the future actions of their donees). It is important for trustees who transfer assets to beneficiaries and wish to claim hold-over relief to avoid a charge under s.71 TCGA 1992. Section 168(7) TCGA provides:

> Where an amount of tax assessed on a transferee by virtue of subsection (1) above is not paid within the period of 12 months beginning with the date when the tax becomes payable then, subject to subsection (8) below, the transferor may be assessed and charged (in the name of the transferee) to all or any part of that tax.

Section 168(8) sets out a time limit:

> No assessment shall be made under subsection (7) above more than 6 years after the end of the year of assessment in which the relevant disposal was made.

Thus a donor who makes a claim for hold-over relief is at risk of a clawback if the donee emigrates within (approximately) 4 years of the gift. Suppose:
(1) In 2001/02 D makes a gift to T, and T emigrates in 2005/06.
(2) The exit charge is payable on 31 January 2007.
D cannot be assessed until 12 months later, 31 January 2008. That is just within "6 years after the end of the year of assessment in which the relevant disposal was made". But if D had made the gift in 2000/01 it would have been too late for HMRC to collect the tax from D.

Section 168(9) TCGA provides an indemnity (for what it may be worth):

> Where the transferor pays an amount of tax in pursuance of subsection (7) above, he shall be entitled to recover a corresponding sum from the transferee.

### 7.2.5 *Prevention of double charge*

Section 168(10) TCGA provides:

> Gains on disposals made after a chargeable gain has under this section been deemed to accrue by reference to a held-over gain shall be computed without any reduction under section 165(4)(b) or 260(3)(b)

in respect of that held-over gain.

This prevents double UK taxation (if the individual later makes a disposal within the charge to CGT, eg if they return 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 yet.

## 7.3 Clawback of EIS relief

There is a similar clawback of EIS relief if (in short) an individual becomes non-resident (and non-ordinarily resident) within three years of acquiring EIS shares: para 3 Sch 5B TCGA 1992.

## 7.4 Charge on emigration of trust

Section 80 TCGA provides an exit charge for trusts:

> (1) This section applies if the trustees of a settlement become at any time ("the relevant time") neither resident nor ordinarily resident in the UK.
> (2) The trustees shall be deemed for all purposes of this Act—
> (a) to have disposed of the defined assets immediately before the relevant time, and
> (b) immediately to have reacquired them,
> at their market value at that time.

Unlike the rule for individuals, this applies to all gains, not just held-over gains.

### 7.4.1 *Defined assets*

"Defined assets" is a label which brings in a number of rules which limit the scope of the charge. Section 80(3) TCGA provides:

> Subject to subsections (4) and (5) below, the defined assets are all assets constituting settled property of the settlement immediately before the relevant time.

### 7.4.2 *Assets of UK trade*

Section 80(4) TCGA brings in an exception for UK trades:

> If immediately after the relevant time—
> (a) the trustees carry on a trade in the UK through a branch or agency, and
> (b) any assets are situated in the UK and either used in or for the purposes of the trade or used or held for the purposes of the branch or agency,
> the assets falling within para (b) above shall not be defined assets.

No charge is needed as such assets remain within the charge to CGT.

### 7.4.3 *DTA exemption*

Section 80(5) TCGA brings in an exception for assets protected by DTAs:

> 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.

No charge is needed as such assets never were within the charge to CGT.

### 7.4.4 *Restriction of roll-over relief*

Section 80 TCGA provides:

> (6) Section 152 shall not apply where the trustees—
> (a) have disposed of the old assets, or their interest in them, before the relevant time, and
> (b) acquire the new assets, or their interest in them, after that time, unless the new assets are excepted from this subsection by subsection (7) below.
> (7) If at the time when the new assets are acquired—
> (a) the trustees carry on a trade in the UK through a branch or agency, and

(b) any new assets are situated in the UK and either used in or for the purposes of the trade or used or held for the purposes of the branch or agency,

the assets falling within para (b) above shall be excepted from subsection (6) above.

(8) In this section "the old assets" and "the new assets" have the same meanings as in section 152.

The CG Manual explains:

**38357. Roll-over relief**

Section 80(6) prevents roll-over relief under TCGA 1992, s.152 from applying so as to avoid the new exit charge where trustees dispose of assets before, then acquire new assets after becoming non-resident where the new assets are outside the UK tax charge.

### 7.4.5 *Accidental emigration on death of trustee*

Section 81 TCGA 1992 provides:

**81 Death of trustee: special rules**

(1) Subsection (2) below applies where—

(a) section 80 applies as a result of the death of a trustee of the settlement, and

(b) within the period of 6 months beginning with the death, the trustees of the settlement become resident and ordinarily resident in the UK.

This could apply if for instance a trust has a UK and a foreign trustee, and the UK trustee dies.

(2) That section shall apply as if the defined assets were restricted to such assets (if any) as—

(a) would be defined assets apart from this section, and

(b) fall within subsection (3) or (4) below.

That is, there is no charge apart from the exceptional cases of (3) and (4). Section 81(3) TCGA provides:

Assets fall within this subsection if they were disposed of by the trustees in the period which—

(a) begins with the death, and

(b) ends when the trustees become resident and ordinarily resident in the UK.

Since the trust will be UK resident in the year and subject to CGT on its gains, it is difficult to see the point of this. Section 81(4) TCGA provides:

> Assets fall within this subsection if—
> (a) they are of a description specified in any double taxation relief arrangements,
> (b) they constitute settled property of the settlement at the time immediately after the trustees become resident and ordinarily resident in the UK, and
> (c) were the trustees to dispose of them at that time, the trustees would fall to be regarded for the purposes of the arrangements as not liable in the UK to tax on gains accruing to them on the disposal.

### 7.4.6 *Accidental immigration on death of trustee*

Section 81 goes on to give a relief where there has been an accidental immigration to the UK followed by emigration:

> (5) Subsection (6) below applies where—
> (a) at any time the trustees of a settlement become resident and ordinarily resident in the UK as a result of the death of a trustee of the settlement, and
> (b) section 80 applies as regards the trustees of the settlement in circumstances where the relevant time (within the meaning of that section) falls within the period of 6 months beginning with the death.
> (6) That section shall apply as if the defined assets were restricted to such assets (if any) as—
> (a) would be defined assets apart from this section, and
> (b) fall within subsection (7) below.

There is only one exceptional case:

> (7) Assets fall within this subsection if—
> (a) the trustees acquired them in the period beginning with the death and ending with the relevant time, and
> (b) they acquired them as a result of a disposal in respect of which relief is given under section 165 or in relation to which section 260(3)

applies.

This is only a limited relief, since it does not avoid the CGT charge on actual disposals of assets by the trustees in a year when accidentally UK resident.

## 7.5 Liability of trustees for exit charge

There are special rules. The usual rule for liability of trustees for CGT is in s.65(1) TCGA 1992:

> Subject to subsection (3) below, capital gains tax chargeable in respect of chargeable gains accruing to the trustees of a settlement or capital gains tax due from the personal representatives of a deceased person may be assessed and charged on and in the name of any one or more of the relevant trustees ....[1]

Section 65(3) has an exemption for trustees who retired before an emigration without knowing of a proposed emigration:

> Where section 80 applies as regards the trustees of a settlement ("the migrating trustees"), nothing in subsection (1) above shall enable any person—
> (a) who ceased to be a trustee of the settlement before the end of the relevant period,[2] and
> (b) who 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,
> to be assessed and charged to any capital gains tax which is payable by the migrating trustees by virtue of section 80(2).

Section 82 TCGA provides:

> (1) This section applies where—

1 Defined in s.65(4): "In this section ...
"the relevant trustees", in relation to any chargeable gains, means the trustees in the year of assessment in which the chargeable gains accrue and any subsequent trustees of the settlement..."

2 Defined by reference in s.65(4): In this section—
"the relevant period" has the same meaning as in section 82;..."

(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,[3] 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.

## 7.5.1 *The relevant period*

This term is defined in s.82(6):

For the purposes of this section—
(a) [this is a spent transitional rule for an emigration in 1991-2];
(b) in any other case, the relevant period is the period of 12 months

3 Defined in s.82(6) as (in effect) one year.

ending with the relevant time.

### 7.5.2 *Commentary*

In short, a trustee at the time of the emigration is liable, and a trustee who retired up to a year before is liable if aware of the proposal to migrate the trust. This may help HMRC (because they can go back to trustees in an earlier year) and it may help the trustees (if they can say that they were not aware of a migration). But it is not likely to make any difference either way. There is no good reason for special rules and s.82 and s.65(3) TCGA should be repealed, resulting in a small but worthwhile tax simplification.

## 7.6 Charge on treaty-emigration of trust

Section 83 TCGA 1992 provides:

> (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 and has no special rules for trustee liability.

### 7.6.1 *Restriction of roll-over relief*

Section 84 TCGA provides:

> (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.

This is the equivalent of s.80(6): see 7.4.4 (Restriction of roll-over relief).

## 7.7 Disclosure of emigration or treaty-emigration of trust

Para 5 Sch 5A TCGA provides:

(1) This paragraph applies if—
(a) the trustees of a settlement become at any time (the relevant time) on or after the commencement day neither resident nor ordinarily resident in the UK, or
(b) the trustees of a settlement, while continuing to be resident and ordinarily resident in the UK, become at any time (the relevant time) on or after the commencement day trustees who fall to be regarded for the purposes of any double taxation relief arrangements as resident in a territory outside the UK.
(2) Any person who was a trustee of the settlement immediately before the relevant time shall, before the expiry of the period of twelve months beginning with the relevant day, deliver to the Board a return specifying—
(a) the day on which the settlement was created,
(b) the name and address of each person who is a settlor in relation to the settlement immediately before the delivery of the return, and
(c) the names and addresses of the persons who are the trustees immediately before the delivery of the return.
(3) For the purposes of sub-paragraph (2) above the relevant day is the day when the relevant time falls.

There are minor exceptions in para 6 which need not be set out here.

## 7.8 Emigration of individual trader[4]

Section 17 ITTOIA provides:

> (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 BI 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.

This is not correct, because the statutory provisions refer to "the time of the change of residence" which suggests that the deemed cessation and commencement take place at that moment, not at the end of the tax year. However the point does not arise in practice because the Manual continues:

> 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 practice is not referred to in ESC A11, but it is consistent with the approval of ESC A11. (It is considered that this is the law, rather than concession, but in practice that will not matter.)

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

### 7.8.1 *Emigration of partner in trading partnership*

For the equivalent rules for partnerships, see s.852(6) ITTOIA:

> If—
> (a) the firm carries on the actual trade wholly or partly outside the UK, 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.

## 7.9 EU restriction on exit taxes

### 7.9.1 *Exit charge on emigration of individual to EU state*

An EU communication on exit taxes[5] provides:

> **2. EXIT TAXES: LEGAL FRAMEWORK**
> **2.1. The decision of the ECJ in *de Lasteyrie*[6] 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

5 "Exit taxation and the need for co-ordination of Member States' tax policies" 19.12.2006 COM(2006) 825 final, accessible *ec.europa.eu/taxation_customs/resources/documents/taxation/COM(2006)825_en.pdf.*

6 *de Lasteyrie du Saillant v Ministère de l'Économie, des Finances et de l'Industrie,* [2005] STC 1722.

> 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 MS.

The communication then considers permitted forms of charges on departing residents (not applicable in the UK)[7] and concludes:

> Most MSs which had exit tax rules on individual shareholders similar to those at issue in *de Lasteyrie* have since abolished or amended them in line with the ruling. This has enabled the Commission to suspend infringement proceedings against a number of MSs on this particular aspect. The Commission will, however, continue to monitor MSs' rules

7 "The ECJ ruled in *de Lasteyrie* and in *N* [*N v Inspecteur van de Belastingsdienst Oost/kantoor Almelo*, [2008] STC 436] 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 EU 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."

in this area with a view to ensuring their EC law compatibility.

The UK has three exit charges on individuals, the hold-over clawback, the EIS clawback, and the charge on migrating traders. So far they seem to have escaped direct EU attention. If the migration is to a member state, these can hardly be described as compliant with EU law, freedom of establishment[8] and freedom to reside.[9]

### 7.9.2 *Exit charge on emigration of trust to EU state*

What about the exit charge for trusts? The EU communication does not discuss trusts, but it does discuss companies:

> **3.1. Implications of *de Lasteyrie* for companies**
> The Commission is of the opinion that the interpretation of the freedom of establishment given by the ECJ in *de Lasteyrie* in respect of exit tax rules on individuals also has direct implications for MSs' exit tax rules on companies.

This is obviously correct since freedom of establishment applies to companies as well as individuals.[10] The same will apply to a trust either on the grounds that it is an "undertaking" within the meaning of the freedom of establishment rule[11] or on the grounds of the freedom of movement or of establishment of the trustee in its personal capacity.

### 7.9.3 *Exit charge on emigration to EEA state*[12]

The EU communication continues:

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8 See 51.3 (Freedom of establishment).

9 Art. 21 TFEU provides:

> "Every citizen of the Union shall have the right to move and reside freely within the territory of the Member States, subject to the limitations and conditions laid down in the Treaties and by the measures adopted to give them effect."

10 See 51.3 (Freedom of establishment).

11 See 51.10 (Section 86 TCGA).

12 The states within the EEA (European Economic Area) are Norway, Iceland and Liechtenstein.

**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.

Council Directive 2010/24/EU[13] applies to MSs but not to EEA states.

13 16 March 2010, concerning mutual assistance for the recovery of claims relating to taxes, duties and other measures.

However, the UK/Norway and the UK/Iceland DTTs have an information exchange article which should suffice. In the of an emigration to an EEA state, it would be necessary to review the treaties between the UK and that state in order to ascertain the position.

### 7.9.4 *Exit charge on emigration to other countries*

The EU communication continues:

> **5. EXIT TAXES IN RESPECT OF THIRD COUNTRIES**
> Of the four basic freedoms, only the free movement of capital and payments (Article 56) applies to third countries.
> In respect of the emigration or transfer of seat to other third countries as such, the provisions on the free movement of persons do not apply and MSs remain free to assess and collect their taxes at the moment of departure. However, the emigration of an individual or the transfer of seat of a company may involve transactions which are covered by the provisions on the free movement of capital. The transfer of assets to a PE in a third country may also fall to be examined from the perspective of the free movement of capital.
> Since the result of the application of the different freedoms should be the same, it would appear that an immediate collection of tax at the moment of transfer of such assets constitutes a restriction on the free movement of capital. However, as noted above, the Commission believes that a lack of administrative co-operation may justify a restriction in these circumstances. The Commission would encourage MSs, where appropriate, to enhance administrative co-operation with their non-EU partners, as this is the best means of ensuring tax compliance and preventing tax evasion.[14]

The European Parliament supports this view.[15]

In the case of an emigration to a third country (not a MS or EEA state), it would be necessary to review the treaties between the UK and that state in order to ascertain the position.

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14 In EU terminology, "tax evasion" includes tax avoidance.

15 European Parliament resolution of 24 October 2007 on the contribution of taxation and customs policies to the Lisbon Strategy.

## 7.10 Council Resolution on coordinating exit taxation

The Council of the European Union (the Council of Ministers) adopted a resolution on 2 December 2008 which invites Member States to adopt the following guiding principles:

> A. "Transfer of economic activities" means any operation whereby a taxpayer subject to corporation tax or a natural person engaged in a business:
> 1) ceases to be subject to corporate or personal income tax in a Member State (the exit State) while at the same time becoming subject to corporate or personal income tax in another Member State (the host State); or
> 2) transfers a combination of assets and liabilities from a head office or a permanent establishment in the exit State to a permanent establishment or a head office in the host State.
> B. When, in connection with a transfer of economic activities, the exit State reserves the option to exercise its taxing rights on the reserves made (profits realised but not yet taken into account for tax purposes) and to take back, in full or in part, the provisions made (expenditure not yet incurred but already taken into account for tax purposes), the host State may provide for the creation of reserves or provisions of identical or different amounts, in accordance with the rules governing the tax base in that State, and allow deduction from taxable results for the year in which they were established.
> C. When, in connection with a transfer of economic activities, the exit State reserves the option to exercise its taxing rights on the unrealised gains corresponding to the assets held by the taxpayer, calculated as the difference between the market value of these assets on the transfer date and their book value, the host State takes the market value on the transfer date when calculating the subsequent added value in the event of disposal.
> D. In case of disagreement between the host State and the exit State regarding the market value of the assets on the transfer date, the two States settle their dispute using the appropriate procedure.
> E. The host State can require the taxpayer engaged in a transfer of economic activities to provide evidence that the exit State has exercised or will exercise its rights under the conditions set out above, as well as evidence of the market value applied by the exit State.
> F. The provisions laid down at Community level in relation to Mutual Assistance provide the framework for the host State to assist the exit State, in particular for the purposes of determining the disposal date.

This does not seem to have much impact yet, at least in the UK, but the law is not stable. In the area of company migration (outside the scope of this work) the CIOT have been lobbying the EU for action.[16]

16 Letter dated 20 March 2007 accessible *www.tax.org.uk* (search for *Heydt*).

CHAPTER EIGHT

# TEMPORARY NON-RESIDENCE

## 8.1 Temporary non-residence - Introduction

This chapter discusses the temporary non-residence rules (**"TNR rules"**). The rules were introduced in 1998 and have been amended several times, resulting in a very fine tangle.

### 8.1.1 *Terminology*

In this book I use the term **"treaty-residence"** to mean residence for the purposes of a DTA, and "**domestic-law residence"** means residence for UK tax purposes (it is essential in this chapter to distinguish the two).

Where a person is resident in the UK for UK law purposes, I therefore describe them as **"domestic-law UK resident"** and similarly non residents are described as **"domestic-law non-UK resident"**.

Where a person is treaty-resident in the UK I refer to them as **"treaty UK resident"**. Where a person is treaty-resident in a state outside the UK, I adopt the statutory terminology **"treaty non-resident"** though it might be clearer to say "treaty non-UK resident".

**"CGT treaty relief"** is CGT relief provided by a DTA.

These are somewhat clumsy terms but it is difficult to think of better.

## 8.2 Purpose of the temporary non-residence provisions

It is helpful to outline the two sets of problems which the provisions are intended to address.

### 8.2.1 *Gains accruing to temporary non-resident*

Until 1998, a possible method of CGT planning for a UK resident was as follows. An individual could become domestic-law non-UK resident and dispose of assets during a year of non-residence; in the following tax year they could become UK resident again. Thus relatively brief periods of domestic-law non-residence offered the opportunity of CGT-free disposals. Section 10A(2) TCGA is intended to prevent this.

Until 2005, a variant of this planning was: an individual could remain domestic-law UK resident but become treaty non-resident (ie treaty-resident in a state with a DTA conferring CGT relief); the individual disposed of assets while treaty non-resident; following the disposal the individual could cease to be treaty non-resident. Thus relatively brief periods of treaty non-residence offered some opportunity of CGT-free disposals (so far as CGT treaty relief could be available). Section 10A(2) TCGA is also intended to prevent this.

In 2009 the rule was extended to catch OIGs accruing to temporary non-residents.

### 8.2.2 *Remittance by temporary non-resident*

Similarly, until 2008 a possible method of remitting RFI or gains tax free was as follows. Suppose an individual had RFI/gains taxable on remittance (in this chapter called "**pre-departure income/gains**").

The individual could become domestic-law non-UK resident and remit the pre-departure income/gains during a year of non-residence; in the following tax year they could become UK resident again. Thus relatively brief periods of domestic-law non-residence offered the opportunity of tax-free remittances. Section s.832A ITTOIA is intended to prevent this for income. The drafting of s.832A was based on the existing s.10A which was designed for a different situation, resulting in more anomalies.

The reader may wonder if a variant of this planning was possible: suppose an individual remained domestic-law UK resident but became treaty-resident in a state with a DTA conferring the necessary relief (ie "treaty non-resident"); the individual remitted the pre-departure income/gains while treaty non-resident. However treaties do not provide relief in this situation so planning of this kind was not possible. Nevertheless s.832A does apply in this case. The drafter may perhaps have thought that this planning was possible, or they may have introduced the rule unintentionally by copying across in s.832A the s.10A rules which were designed for a different situation.

Thus there are two distinct sets of rules, though they share a common

framework:
(1) Gains and losses accruing in intervening years: s.10A(2).
(2) Pre-departure income remitted during intervening years: s.832A.

### 8.2.3 *Income of temporary non-resident: the future*

At present a possible method of IT planning for a UK resident is as follows. An individual could become domestic-law non-UK resident and arrange income to arise during a year of non-residence; in the following tax year they could become UK resident again. Thus relatively brief periods of domestic-law non-residence offer the opportunity of receiving income which would not be subject to UK tax if foreign source income or if it qualified for non-residents income tax relief (eg dividends).

A variant of this planning is: an individual could remain domestic-law UK resident but become treaty non-resident (ie treaty-resident in a state with a DTA conferring IT relief); the individual may arrange income to arise while treaty non-resident; later the individual could cease to be treaty non-resident. Thus relatively brief periods of treaty non-residence offer some opportunity of IT free receipts of income (so far as treaty relief could be available).

The Residence Consultation Paper proposes to extend the TNR rules to catch this from 2012/13:

> 3.47 Ceasing to be UK resident means that an individual is no longer liable to UK tax on income from non-UK sources. In many instances there can also be a reduced tax liability on income from UK sources. This can result in people finding it advantageous to become not resident for a short period of time if they expect substantial amounts of income to arise which otherwise would be liable to tax in the UK. This leads to a cost to the Exchequer.
> 3.48 A similar position used to arise for CGT. It was possible for individuals to leave the UK temporarily and realise capital gains in the period of non-residence and therefore be exempt from liability to UK tax on those gains. Legislation was enacted in Finance Act 1998 to counter such avoidance of CGT.
> 3.49 Introducing a statutory definition will make it clearer when a person is tax resident or not resident in the UK. This could enable those who want to avoid liability on substantial amounts of income to plan short periods of temporary non-residence with more certainty.
> 3.50 The SRT [statutory residence test] rules will therefore need to

> counteract the risk of individuals creating artificial short periods of non-residence, during which they receive a large amount of income (which accrued during periods of UK residence) free of UK tax and then bring the income back into the UK tax-free. This activity would undermine the effectiveness of an SRT and present an unacceptable risk to the Exchequer.
> 3.51 The existing anti-avoidance provision to prevent individuals avoiding CGT in this way works broadly as follows:
> • it applies where an individual has been resident in four out of the seven tax years prior to the tax year in which they become non-resident; and
> • if the individual becomes resident again in any of the following five tax years then, with certain exceptions, chargeable gains or allowable losses that arose during the years of non-residence are treated as arising instead in the tax year in which the individual becomes resident again.
> 3.52 This treatment has the effect of making such gains liable to tax; any losses can be set off in arriving at the net amount chargeable to CGT.
> 3.53 The SRT will include an anti-avoidance rule for some forms of investment income along the lines of the model of the CGT rule described above. In particular, it will apply to dividends paid by closely controlled companies[1] that reflect profits that have built up during a period of residence and which are then taken out during a short period of non-residence.
> 3.54 The rule would not apply to all types of income that are received when a person is non-resident. For example, it would not apply to earnings from employment or self-employment or to normal types of regular investment income, such as bank interest or dividends from listed companies.[2]

Individuals who are currently temporary non-resident should arrange to receive income in 2011/12 as next year will probably be too late.

## 8.3 Temporary non-resident conditions

Section 10A TCGA sets out four conditions which must all be satisfied if the section is to take effect. I refer to these as the "**TNR conditions**". Section 10A(1) TCGA provides:

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1 I expect the author intends to refer to close companies.

2 HM Treasury, *Statutory Definition of Tax Residence: a Consultation* (June 2011) *www.hm-treasury.gov.uk/d/consult_condoc_statutory_residence.pdf*.

> 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;[3]
> (c) there are fewer than five years of assessment falling between the year of departure and the year of return; and
> (d) four out of the seven years of assessment immediately preceding the year of departure are also years of assessment for each of which he satisfied those requirements.

Section 832A(1) ITTOIA is the same for IT.[4]

The legislation uses three defined terms with commonsense definitions:

(1) Year of departure.[5]

(2) Intervening year.[6]

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3 Limb [ii] appears to be otiose, given para (d); but it does not matter.

4 Section 832A(1) ITTOIA provides:

"This section applies if—
(a) an individual satisfies the residence requirements for any tax year ("the year of return"),
(b) the individual did not satisfy those requirements for one or more tax years immediately before the year of return but did satisfy those requirements for an earlier tax year,
(c) there are fewer than 5 tax years between—
(i) the last tax year before the year of return for which the individual satisfied those requirements ('the year of departure'), and
(ii) the year of return, and
(d) the individual satisfied those requirements for at least 4 out of the 7 tax years immediately before the year of departure."

5 Section 10A(8) TCGA provides:

"'the year of departure' means the last year of assessment before the year of return for which the taxpayer satisfied the residence requirements."

6 Section 10A(8) TCGA provides:

"'intervening year' means any year of assessment which, in a case where the conditions in paras (a) to (d) of subsection (1) above are satisfied, falls between the year of departure and the year of return."

That is, an intervening year is one in which the temporary non-resident conditions are satisfied.

(3) Year of return.[7]

### 8.3.1 *Avoiding the TNR conditions*

The conditions allow (indeed invite) tax planning by ensuring that a person does not satisfy the residence requirements for at least a five year period. The way to do this is to remain domestic law non-resident or treaty non-resident for a five-year period.

### 8.3.2 *EU law compliance*

The rules can give rise to an exit charge and where the charge arises on ceasing to be resident in an EU member state, it is an interesting question whether the charge is EU law compliant.

## 8.4 "Residence requirements"

"Residence requirements" is defined in s.10A(9) TCGA:

> For the purposes of this section an individual satisfies the residence requirements for a year of assessment—
> (a) if, during any part of that year of assessment, he is resident in the UK and not Treaty non-resident, or
> (b) if he is ordinarily resident in the UK during that year of assessment, unless he is Treaty non-resident during that year of assessment.

Section 832A(4) ITTOIA is the same for IT.[8]

One has to read s.10A(9) more than once, to assimilate the double negatives (s.832A(4) is better drafted), but the matter can be set out in a table:

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7 Defined in s.10A(1)(a) TCGA as the year in which the temporary non-resident again satisfies the residence requirements.

8 Section 832A(4) ITTOIA provides:
"For the purposes of subsection (1) an individual 'satisfies the residence requirements' for a tax year if—
(a) at any time in that year, the individual is UK resident and not Treaty non-resident, or
(b) the individual is ordinarily UK resident, and is not Treaty non-resident, for that year."

| Resident | Ord Resident | Treaty non-res. | Resident Reqs met |
|---|---|---|---|
| Y | Non relevant | N | Y |
| Y | Non relevant | Y | N |
| Not relevant | Y | N | Y |
| Not relevant | Y | Y | N |
| N | N | Not relevant | N |

Section 10A(9)(b) only applies to the theoretical case of a person who is non-resident but ordinarily resident.

### 8.4.1 "*Treaty non-resident*"

"Treaty non-resident" is defined for CGT in s.288(7B) TCGA:

> For the purposes of this Act, a person is Treaty non-resident at any time if, at that time, he falls to be regarded as resident in a territory outside the UK for the purposes of double taxation relief arrangements having effect at that time.

Section 832A(5) is the same for IT.[9]

The key term is "double taxation relief arrangements" (here called "DTR arrangements").

### 8.4.2 *"DTR arrangements" – IT*

Section 832A(6) ITTOIA defines DTR arrangements for the purposes of the IT provision:

> In subsection (5) "double taxation relief arrangements" means arrangements which have effect under section 2(1) of TIOPA 2010.

### 8.4.3 *"DTR arrangements" – CGT*

Section 288(1) TCGA defines double taxation relief arrangements ("DTR

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9 Section 832A(5) ITTOIA provides:
"For the purposes of subsection (4) an individual is 'Treaty non-resident' at any time if, at that time, he is regarded as resident in a territory outside the UK for the purposes of double taxation relief arrangements having effect at that time."

arrangements") for the purpose of CGT:

> "double taxation relief arrangements"—
> (a) in relation to a company[10] means arrangements that have effect under section 2(1) of TIOPA 2010 except so far as they have effect in relation to petroleum revenue tax, and
> (b) in relation to any other person means arrangements that have effect under section 2(1) of TIOPA 2010 but only so far as they have effect in relation to capital gains tax;

This is different from the IT definition because the treaty needs to contain a CGT provision. For instance, the Jersey DTA counts as "DTR arrangements" for IT but not for CGT because it has no CGT article.

## 8.5 Gains and losses accruing in intervening years

Section 10A(2) TCGA sets out the consequence if the TNR conditions are met:

> Subject to the following provisions of this section and section 86A, the taxpayer shall be chargeable to CGT as if—
> (a) all the chargeable gains and losses which (apart from this subsection) would have accrued to him in an intervening year,
> (b) all the chargeable gains which under section 13 or 86 would be treated as having accrued to him in an intervening year if he had been resident in the UK throughout that intervening year ...[11]
> were gains or, as the case may be, losses accruing to the taxpayer in the year of return.

Para (a) works because gains accruing on disposals of assets by individuals are in principle chargeable gains even if the individual is non-resident. This needs to be supplemented by para (b) because s.13 gains and s.86 gains do not accrue to participators or settlors who are non-resident.

Section 10A(2) is a deeming provision. Gains which actually accrued in

10 Companies are not relevant to this chapter but one needs to read para (a) in order to follow para (b).

11 S.10A(2)(c) deals with losses of non-resident companies: see 8.10.1 (Losses of non-resident company within s.13 TCGA).

an intervening year are deemed to have accrued in the year of return. I refer to this as "**the s.10A(2) fiction**". Applying the s.10A(2) fiction the intervening year gains are in principle taxable in the year of return.

Losses can be carried back, ie losses accruing in a later intervening year can be set against gains accruing in an earlier intervening year.

### 8.5.1 *Rate of tax*

The rate of tax is the rate in the year of return, even though the rate in the year the gain actually accrued may have been lower.[12] Annual exemptions of intervening years are also lost.

## 8.6 Interaction with remittance basis

For a remittance basis taxpayer there could be a conflict between two deeming rules:

(1) Section 12 TCGA (the CGT remittance basis) provides that gains are treated as accruing when remitted.

(2) The s.10A(2) fiction which provides that gains are treated as accruing in the year of return.

Section 10A(9ZA) TCGA provides:

> If—
> (a) section 809B, 809D or 809E of ITA 2007 (remittance basis) applies to the taxpayer for the year of return, and
> (b) the taxpayer is not domiciled in the UK in that year,
> any foreign chargeable gains[13] falling within subsection (2)(a) which were

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12 Where the year of return was 2010/11, the 18% rate applied: Para 19 sch 1 F(No.2)A 2010 provided: "Gains treated as accruing to an individual under section 10A of TCGA 1992 (temporary non-residents) in the tax year 2010-11 are to be treated for the purposes of this Schedule as accruing before 23 June 2010."

13 Section 10A(9ZA) adds: "For this purpose 'foreign chargeable gains' has the meaning given by section 12(4)." If there were a TCGA-wide definition this would not be necessary.
Suppose (1) an individual has a UK foreign currency account (2) the individual disposes of the account when temporarily resident abroad. The account is non-UK situate for CGT purposes; the gain is a foreign chargeable gain and is charged under the temporary non resident rules when the individual returns to the UK, but qualifies for the remittance basis.

remitted in an intervening year are treated as remitted in the year of return.

### 8.6.1 *"Subsection (2)(a) gains"*

Section 10A(9ZA) only applies to gains "falling within subsection (2)(a)" that is:

> chargeable gains ... which (apart from subsection 2(a)) would have accrued to him in an intervening year,

That is, gains accruing in an intervening year and remitted in an intervening year: they are treated as accruing in the year of return, not when remitted. I refer to those as **"subsection (2)(a) gains"**. It is an interesting question how to treat gains accruing in an intervening year and not remitted until after the year of return.

I had previously considered that s.10A(9ZA) applied to pre-departure gains (foreign gains accruing while the individual was UK resident, ie gains before departure) which were remitted during an intervening year, but on reflection that does not appear to be the case because these are not subsection 2(a) gains.

### *8.6.2 Treaty users*

Section 10A(9B) TCGA provides:

> Where this section applies in the case of any individual in circumstances in which one or more intervening years would, but for his being Treaty non-resident during some or all of that year or those years, not be an intervening year, ...

That is a case of an individual who is domestic-law UK resident but treaty non-resident.[14] It is useful to have a label for individuals in this position and I refer to them as **"treaty-users"**. The position of treaty users is different from individuals who are not domestic-law UK resident, since treaty-users are subject to CGT unless treaty relief applies.

Where no CGT treaty relief applies, there is no need for the TNR provisions, and the TNR rules should simply have been disapplied.

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14 See row 2 of the table in 8.4 ("Residence requirements").

Instead the rules are disapplied in part, in a complex manner, and the problems have not been fully thought through.

Section 10A(9B) makes four modifications to s.10A:

> this section shall have effect in the taxpayer's case—
> (a) as if subsection (2)(a) above did not apply in the case of any amount treated by virtue of section 87 or 89(2) as an amount of chargeable gains accruing to the taxpayer in any such intervening year,

Section 10A(9B)(a) disapplies the TNR rules for s.87 deemed gains: such gains accrue in the year that the s.87 code provides (under the s.87 matching rules and s.87 remittance basis) and not in the year of return. This is sensible on the view (taken in this book) that such gains do not qualify for DT exemption.

Secondly:

> this section shall have effect in the taxpayer's case ...
> (b) as if any such intervening year were not an intervening year for the purposes of subsections (2)(b) and (c) and (6) above.

There are three amendments here. They are best considered separately.

To follow the first we need to refer back to s.10A(2)(b):

> Subject to the following provisions of this section and section 86A, the taxpayer shall be chargeable to CGT as if—
> (b) all the chargeable gains which under section 13 or 86 would be treated as having accrued to him in an intervening year if he had been resident in the UK throughout that intervening year ...
> were gains ...accruing to the taxpayer in the year of return.

Section 10A(9B)(b) disapplies the TNR rules for s.13 deemed gains: such gains accrue in the year that the s.13 code provides (the year of accrual, subject to the s.13 remittance basis) and not in the year of return. Similarly, the subsection disapplies the TNR rules for s.86 deemed gains: such gains accrue in the year that s.86 provides (the year of accrual) and not in the year of return. This would be sensible on the view that s.13 deemed gains and s.86 deemed gains do not qualify for DT exemption but in some cases they do.

The other amendments made by s.10A(9B)(b) concern s.10A(2)(c) and s.10A(6): these are consequential amendments relating to losses.[15]

What about gains of an individual who is domestic-law UK resident, treaty non-resident, but which do not qualify for treaty relief (eg gains on a disposal of UK land)? They fall within the TNR rules, so the gain accrues in the year of disposal (and tax is paid) but it accrues instead in the year of return (and the former computation is revised, and tax paid or repaid accordingly).

## 8.7 Pre-departure income

Section 832A(3) ITTOIA provides:

> Relevant foreign income is within this subsection if—
> (a) it is for the year of departure or any earlier tax year,[16] and
> (b) section 832 applies to it.

In the following discussion I refer to such income as **"pre-departure income"**; in other words, that means RFI which:

(1) is taxed on a remittance basis, ie accruing to a remittance basis taxpayer while the individual was UK resident; and
(2) which was not remitted prior to departure (so was not subject to tax before departure).

Section 832A(2) ITTOIA sets out the taxation of pre-departure income if the TNR conditions are met:

> Treat any of the individual's relevant foreign income within subsection (3) which is remitted to the UK after the year of departure and before the year of return as remitted to the UK in the year of return.

Pre-departure income which is remitted during an intervening year is treated as remitted in the year of return. This makes sense for an individual who is domestic-law non-UK resident during the intervening year. It makes no sense for someone who is domestic-law UK resident but treaty non-resident, unless one takes the view that treaty relief is available

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15 See 8.10.1 (Losses of non-resident company within s.13 TCGA).

16 "Any earlier year" would include a year in which a person was non-resident, but income of such a year is not relevant foreign income: see 9.3.1 (Relevant foreign income).

on remitted income during the intervening year, which would not seem to be the case.

Income arising after the year of departure is not caught.

The RDR manual provides a straightforward example. Omitting irrelevant detail (and rewriting slightly to enhance clarity) this provides:[17]

> T is UK resident in 2007-08 and 2008-09 and a remittance basis taxpayer in both years.
> T is non-resident in 2009-10 and 2010-11.
> T is UK resident again in 2011-12 and the temporary non residence conditions of s.832A ITTOIA are satisfied.
> He had £6,000 of unremitted relevant foreign income from 2007-08, and £8,000 of relevant foreign income from 2008-09.
> In 2009-10 and 2010-11 he remits all of this relevant foreign income to the UK.
> T will be taxed on £14,000 in 2011-12 (the 'year of return') in respect of his remittances of his relevant foreign income in the years of 'temporary non-residence'.

It is evident that the rules may work unfairly in that they bunch remitted income of up to four years into the year of return, which may put lower rate taxpayers up into the higher or additional rates of tax. However that is always a possible downside of the remittance basis and any other rule would be unduly complex.

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17 The example including its irrelevant detail in full is as follows:
**32520 Temporary Non Residents: qualifying conditions** *Example (Travis)*
T, a long-term UK resident has been a remittance basis user since 2000-01. He leaves the UK for a work secondment in January 2009 (2008-09) and is not resident in 2009-10 and 2010-11.
T returns to the UK in August 2011 and meets the residence requirements in s832A in 2011-12.
He has £6,000 of relevant foreign income from 2007-08, a year in which he had claimed the remittance basis under ITA07/s831. He also has £8,000 of relevant foreign income from 2008-09, a year in which he claimed the remittance basis under the new rules at ITA07/s809B.
In 2009-10 and 2010-11 he remits all of this relevant foreign income to the UK to meet certain ongoing UK financial commitments.
T will be taxed on £14,000 in 2011-12 (the 'year of return') in respect of his remittances of his relevant foreign income in the years of 'temporary non-residence'.

### 8.7.1 *Transitional rules*

Para 83(4) Sch 7 FA 2008 provides:

> Nothing in section 832A of that Act applies in relation to anything remitted to the UK in the tax year 2007-08 or any earlier tax year.

Thus pre-2008 income is caught by the new rule if remitted after 2008/09. This retrospective rule is intentional. The RDR manual provides a straightforward example of a case where transitional relief is available. Omitting irrelevant detail (and slightly rewriting for enhanced clarity) this provides:[18]

> J is non-resident in 2007-08 but meets the temporary non-residence conditions of s.832A when he returns to the UK in 2008-09.
> He has unremitted relevant foreign income from 2006-07, a year in which he was resident and had claimed the remittance basis.
> In 2007-08 he remits this relevant foreign income to the UK.
> This transitional provision means that J will not be taxed in 2008-09 (the "year of return") in respect of this remittance of the RFI from 2006-07, although all of the 'temporary non-resident' conditions at s.832A ITTOIA are otherwise met.

## 8.8 Interaction with double taxation relief

### 8.8.1 *DT exemption*

Most DTAs with a capital gains article broadly adopt the OECD Model

18 The example including its irrelevant detail in full is as follows:
**31440 Relevant foreign income and the temporary non-residents rule** [July 2010]
*Example (Johan)*
J is not-resident in 2007-08 but meets the residence requirements in s832A when he returns to the UK in 2008-09.
He has £6,000 of relevant foreign income from 2006-07, a year in which he was resident and had claimed the remittance basis under ITA07/s831.
In 2007-08 he remits all of this relevant foreign income to the UK to meet certain ongoing UK financial commitments.
This transitional provision means that J will not be taxed in 2008-09 (the 'year of return') in respect of this remittance of the £6,000 relevant foreign income from 2006-07, although all of the 'temporary non-resident' conditions at ITTOIA05/s832A are otherwise met.

form:

> Gains from the alienation of any property, other than [specified exceptions] shall be taxable only in the Contracting State of which the alienator is a resident.

Gains accruing to an individual when treaty non-resident appear in principle to qualify for this relief even if within the scope of s.10A. However s.10A(9C) TCGA provides:

> Nothing in any double taxation relief arrangements shall be read as preventing the taxpayer from being chargeable to capital gains tax in respect of any of the chargeable gains treated by virtue of subsection (2)(a) above as accruing to the taxpayer in the year of return (or as preventing a charge to that tax from arising as a result).[19]

This appears to be a breach of any treaty in OECD Model form.[20] However the intention of Parliament is reasonably clear and that prevails over the treaty.[21]

### 8.8.2 *Foreign tax credit relief*

EN FB 2005 provides:

> The application of section 10A in relation to an individual does not prevent the individual obtaining relief for foreign tax paid in respect of chargeable gains which are treated as arising to him or her in the year of return.

## 8.9 Post-departure acquisitions

Section 10A(3) TCGA provides:

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19 I would be grateful to any reader who could explain why the words in brackets are needed.

20 This is recognised in many treaties, which have an additional provision specifically to authorise a s.10A charge (and any foreign state's equivalent). See 8.13 (DTA and other short term non-residence rules).

21 *Padmore (No 2) v IRC* 73 TC 470.

Subject to subsection (4) below, the gains and losses which by virtue of subsection (2) above are to be treated as accruing to the taxpayer in the year of return shall not include any gain or loss accruing on the disposal by the taxpayer of any asset if—

(a) that asset was acquired by the taxpayer at a time in the year of departure or any intervening year when—
   (i) he was neither resident nor ordinarily resident in the UK, or
   (ii) he was resident or ordinarily resident in the UK but was Treaty non-resident; ...

The CG Manual provides:

**26230. Temporary non-residence: Gains or losses excluded from scope of s. 10A** [April 2010]
An individual may acquire assets after leaving the UK for a period of temporary residence abroad. If such assets are disposed of during the period of temporary non-residence, during an intervening year, see CG26111, any gains or losses on such assets are, in general, excluded from the scope of section 10A TCGA 1992, but see CG26240 which tells you about the exceptions to this general rule.
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.
You should note that the general exclusion of gains on assets acquired and disposed of during temporary non residence applies only to gains and losses which would otherwise be chargeable or allowable 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 (and not in an intervening year) 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 ESCD2 is available to the individual, see CG26300+.
**Example**
Mr Smith, who has lived all his life in the UK, leaves the UK on 10 July 2008 for a four year contract of employment abroad.
He resumes tax residence in the UK on 15 August 2012.
On 8 May 2009 Mr Smith buys 20,000 shares in a UK Company. He sells all of the shares on 10 January 2011, realising a gain of £12,000.
Mr Smith fulfils all of the conditions for Section 10A to apply, see CG26156, but because the shares were acquired after his departure from the UK the gain is **not** treated as chargeable in the year of return.

### 8.9.1 *Exceptions to relief*

The CG Manual provides:

> **26240 Temporary non-residence: Exceptions to the exclusion from section 10A** [April 2010]
> Sometimes the exclusion from the scope of Section 10A TCGA 1992 afforded to gains accruing during intervening years on assets acquired after departure from the UK is not appropriate. Some assets acquired by an individual after departure 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. These exceptional assets fall under three headings (see below). Where they apply, any gains or losses on the disposal of the assets during intervening years are treated as chargeable in the tax year of return, that is to say they are within the scope of section 10A.

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 sections referred to are:
Section 58 TCGA (transfers between husband and wife or between civil partners),
Section 73 TCGA (death of life tenant),
Section 258(4) TCGA (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 sections referred to are:

Section 23(4)(b) or 23(5)(b) TCGA (compensation and insurance),
Section 152(1)(b) and s.153(1)(b) TCGA (business assets roll-over relief),
Section 162(3)(b) TCGA (transfer of business to a company),
Section 247(2)(b) or 247(3)(b) TCGA (compulsory acquisition).
The asset must be acquired "by the taxpayer". The CG Manual provides:

> **26231. Assets acquired by an offshore trust** [October 2009]
> 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** [October 2009]
> 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 paras (a) to (d) of subsection (3) above but the first asset is not,
>
> subsection (3) above shall not exclude that gain from the gains which by virtue of subsection (2) above are to be treated as accruing to the taxpayer in the year of return.

The CG Manual provides:

**26250 Temporary non-residence: Held-over gains** [April 2010]

Sometimes a gain on disposal of an asset (the first asset) is 'held over' and not charged until another asset is disposed of. Where this happens under one of the provisions listed below then the gains which eventually accrue when the other asset is disposed of are not excluded from the scope of Section 10A TCGA 1992 by subsection (3) of that section, where subsection (3) would otherwise apply because the other asset was within its scope (see CG26230 and CG26240). Note that for subsection (3) to be disapplied in this way, the first asset must not be within its scope.

Where Section 10A(4) TCGA 1992 applies, a held-over gain which accrues on a disposal in an intervening year when a taxpayer is not UK resident will be treated as accruing in the year of return to the UK, even if the asset which is disposed of was acquired after the taxpayer became non-resident, see CG26111.

The Capital Gains Tax 'hold-over' provisions to which this subsection 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) TCGA 1992 or (4) (depreciating assets), see CG60370+.

*Example*

Mr Priestley goes to live in France for political reasons. As a result, he is not resident in the UK for the next three full years of assessment. During the first of those years he sells his shares in Priestley Chemicals Ltd and receives qualifying corporate bonds issued by the purchaser, Davy Plc. In the following year he redeems the qualifying corporate bonds and receives cash.

Although he has actually disposed of his shares, Section 116(10) TCGA 1992 applies and so he is treated for the purposes of TCGA 1992 as if he had not done so. Instead, a gain is computed as if he had disposed of the shares and that gain is 'held over' or 'frozen' until he disposes of the qualifying corporate bonds. Without the special provision at Section 10A(4) TCGA 1992 the gain which accrued when the qualifying corporate bonds were disposed of would not be within the scope of section 10A because they are assets both acquired and disposed of whilst Mr Priestley was not UK resident. Note that the first asset, the shares, is not within the scope of subsection (3) because it was acquired before Mr Priestley left the UK: it is appropriate to bring the gain latent in those shares within the potential scope of section 10A even though the gain did not arise until some other asset was disposed of.

## 8.10 Section 10A and non-resident trusts/companies

### 8.10.1 *Losses of non-resident company within s.13 TCGA*

Section 10A provides:

> (2) Subject to the following provisions of this section and section 86A, the taxpayer shall be chargeable to CGT as if— ...
> (c) any losses which by virtue of section 13(8) would have been allowable in his case in any intervening year if he had been resident in the UK throughout that intervening year,
>
> were ... 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 Temporary non-residence: Losses attributed to participators in non-resident companies** [April 2010]
> Losses on the disposal of an asset by a non-resident company are only attributed to a participator under Section 13 TCGA 1992 in certain circumstances, Section 13(8) TCGA 1992. A loss is attributed only if it will be set off against a gain attributed to the same person from the same company in the same year of assessment or against a gain made by another non-resident company which has been attributed to the taxpayer in the same year of assessment, see CG57250+, in particular, CG57295-CG57299.
> Section 10A TCGA 1992 can apply to losses which are attributed to a UK resident participator under section 13 just as it applies to attributed gains, so that the losses are treated as accruing in the year the individual returns to the UK. However, the restriction to the attribution contained in Section 13(8) TCGA 1992 has a parallel at Section 10A(6) TCGA 1992, which restricts the amount of losses within the scope of section 10A to the amount which would be available under section 13, subsection (8) to set against attributed gains. Losses of a year in excess

of the gains attributed in that year are not within the scope of section 10A.
**26203. Temporary non-residents** [October 2009]
**Example** (Mrs Adams)[22]

The CG Manual provides an example where the facts (stripping out irrelevancies) are as follows:

A is non-UK resident in 1999/00 - 2001/02 inclusive.
A has owned all of the shares in a non-resident company. During A's period of non-residence gains and losses accrue to the company as follows:
1999/00 gain £20,000; loss £5,000
2000/01 loss £10,000
2001/02 gain £20,000
The TNR conditions apply to A. Under Section 10A(2)(b) all the gains which would have been treated as accruing to A in the intervening years

22 The example including all its irrelevant detail in full is as follows:
**26203. Temporary non-residence: Losses** [April 2010]
*Example*
Mrs. Adams, who has lived in the UK all of her life, leaves the UK on 1 September 2008 to take up a four year contract of employment abroad.
She resumes tax residence in the UK on 31 August 2012.
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 2009 gain £20,000 (year of assessment 2009-10)
23 October 2009 loss £ 5,000 (year of assessment 2009-10)
14 July 2010 loss £10,000 (year of assessment 2010-11)
4 September 2011 gain £20,000 (year of assessment 2011-12)
Mrs Adams fulfils all of the conditions for Section 10A to apply, see CG26156. 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 attributed to her, and section 10A applies to them, to the extent that they may be set against gains attributed in the same year.
Mrs Adams is therefore chargeable in the year of return, 2012-13 as follows
* net gains of £15,000 (gain £20,000 less loss £5000) from 2009-10
* a gain of £20,000 for 2011-12.
The total gains chargeable are therefore £35,000.
The loss arising in 2000-2001 is not allowable because no gains from that year were attributed to her.

> 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.
> A 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 losses are not wasted.

### 8.10.2 *Temporarily non-resident beneficiaries: s.87 charge*

Section 10A TCGA does not mention s.87 TCGA. So at first sight it might seem that s.87 deemed gains are not caught; but this is not the case. Section 10A(2)(a) TCGA applies to gains accruing to the individual on actual disposals. If a non-resident individual disposes of assets, chargeable gains do accrue to then (even though under s.2 TCGA they are 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 they are non-resident. However, subsection (a) would not catch s.86 or s.13 gains, as gains under these sections do *not* accrue to a non-resident. The sections only apply to a UK resident settlor or participator. Hence the drafter correctly extends s.10A(2) by subsection (b), which applies ss.13 and 86 by deeming the taxpayer to be UK resident. It was not necessary to do this for s.87.

### 8.10.3 *Temporarily non-resident settlor: s.86 charge*

CG Manual provides:

> **26220 Attribution of gains to settlor** [April 2010]
> 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 on 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 from the extended charge on the settlor under Section 86.
> Any case involving Section 86 or Section 86A is to be reported to CAR Trusts (Bootle) in accordance with CG38223. No attempt to agree or dispute entries in the return should be made until guidance has been received from CAR Truss (Bootle), see CG38222.

The last sentence tacitly acknowledges that s.86A is a difficult section. The amendments in 2008 have created a fine mess. I do not attempt to consider the transitional rules.

Section 86A(1) TCGA provides:

> (1) Subsection (2) below applies in the case of a person who is a settlor in relation to any settlement ("the relevant settlement") where—
> (a) by virtue of section 10A, amounts falling within section 86(1)(e) for any intervening year or years would (apart from this section) be treated as accruing to the settlor in the year of return; and
> (b) there is an excess of the relevant chargeable amounts for the non-residence period over the amount of the section 87 pool at the end of the year of departure.

"Relevant chargeable amounts" is defined in s.86A(3) TCGA:

> In subsection (1) above, the reference to the relevant chargeable amounts for the non-residence period is (subject to subsection (5) below) a reference to the aggregate of the amounts on which beneficiaries of the relevant settlement are charged to tax under section 87 or 89(2) for the intervening year or years in respect of any capital payments received by them.

"Section 87 pool" is defined in s.86A(4) TCGA:

> In subsection (1) above, the reference to the section 87 pool at the end of the year of departure is (subject to subsection (5) below) a reference to the amount (if any) which, *in accordance with subsection (2) of that section,* fell in relation to the relevant settlement to be carried forward from the year of departure to be included in the amount of the *trust gains*

for the year of assessment immediately following the year of departure.

The definition of "s.87 pool" refers back to s.87(2) TCGA. That worked by reference to the original s.87(2) TCGA. Unfortunately s.87 was redrafted in 2008 and by reference to the current s.87(2) the italicised words make no sense. This can be seen by comparing the two provisions:

*Original s.87(2):*
*(2) There shall be computed in respect of every year of assessment for which this section applies the amount on which the trustees would have been chargeable to tax under section 2(2) if they had been resident and ordinarily resident in the 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 chargeable gains accruing to beneficiaries under the settlement, is in this section and sections 89 and 90 referred to as the trust gains for the year.*

Current s.87(2):
(2) Chargeable gains are treated as accruing in the relevant tax year to a beneficiary of the settlement who has received a capital payment from the trustees in the relevant tax year or any earlier tax year if all or part of the capital payment is matched (under section 87A as it applies for the relevant tax year) with the section 2(2) amount for the relevant tax year or any earlier tax year.

The drafter in 2008 failed to spot that consequential amendments were needed here. Taken literally, therefore, the definition of "section 87 pool" is nonsense and the amount of the s.87 pool should be zero. If one could adopt a position of sufficient indifference to statutory words, one might rewrite the section to say what Parliament would presumably have said, had the point been noticed, in which case the "section 87 pool" means s.2(2) amounts; though this really amounts to legislation and not construction.

Section 86A(5) deals with settlements with more than one settlor.[23]

23 "Where the property comprised in the relevant settlement has at any time included property not originating from the settlor, only so much (if any) of any capital payment or amount carried forward in accordance with section 87(2) as, on a just and

Section 86A(6)(7) was intended to deal with the computation of trust gains, now s.2(2) amounts:

> Where any reduction falls to be made by virtue of subsection (2) above in any amount to be attributed in accordance with section 10A to any settlor for any year of assessment, the reduction to be treated as made for that year *in accordance with section 87(3)* in the case of the settlement in question shall not be made until—
> (a) the reduction (if any) falling to be made by virtue of that subsection has been made in the case of every settlor to whom any amount is so attributed; and
> (b) effect has been given to any reduction required to be made under subsection (7) below.

This provision refers to s.87(3) TCGA. That worked by reference to the original s.87(3) TCGA. Unfortunately s.87 was redrafted in 2008 and by reference to the current s.87(3) the italicised words again make no sense. The same problem affects s.86A(7)(8):

> Where in the case of any settlement there is (after the making of any reduction or reductions in accordance with subsection (2) above) any amount or amounts falling in accordance with section 10A to be attributed for any year of assessment to settlors of the settlement, the amount (or aggregate amount) falling in accordance with that section to be so attributed shall be applied in reducing the amount carried forward to that year in accordance with section 87(2).
> (8) Where an amount has been applied, in accordance with subsection (7)) above, in reducing the amount which in the case of any settlement is carried forward to any year in accordance with section 87(2), that amount (or, as the case may be, so much of it as does not exceed the amount which it is applied in reducing) shall be deducted from the amount used for that year for making the reduction under section 87(3) in the case of that settlement.

Lastly, for completeness, s. 86A(9) provides some referential definitions.[24]

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reasonable apportionment, is properly referable to property originating from the settlor shall be taken into account for the purposes of subsections (3) and (4) above."

24 "Expressions used in this section and section 10A have the same meanings in this section as in that section; and paragraph 8 of Schedule 5 shall apply for the construction of the references in subsection (5) above to property originating from the

## 8.11 Time limit 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:

> **26270. Assessment time limits** [October 2009]
> 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.

## 8.12 Offshore funds

In the absence of express provision, s.10A TCGA would not apply to offshore funds as OIGs are not chargeable gains. Regulation 23 OFTR provides:

> (1) Section 10A of TCGA 1992 (temporary non-residents) applies for the purposes of this Part with the following modifications.
> (2) The section applies as if, in subsection (2)—
> (a) the reference to section 86A were omitted;

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settlor as it applies for the purposes of that Schedule."

(b) for the reference to capital gains tax there were substituted a reference to income tax;
(c) in paragraph (a), for the reference to chargeable gains and losses there were substituted a reference to offshore income gains;
(d) in paragraph (b)—
   (i) for the reference to chargeable gains there were substituted a reference to offshore income gains;
   (ii) for the reference to section 13 or 86 there were substituted a reference to regulation 24;
(e) paragraph (c) were omitted; and
(f) for the reference to gains or, as the case may be, losses there were substituted a reference to offshore income gains.

(3) The section applies as if, in subsection (3)—
(a) for the reference to gains and losses there were substituted a reference to offshore income gains; and
(b) for the reference to any gain or loss there were substituted a reference to any offshore income gains.

(4) The section applies as if subsection (4) were omitted.

(5) The section applies as if, in subsection (5)—
(a) for the reference to gains and losses there were substituted a reference to offshore income gains;
(b) for the reference to any chargeable gain or allowable loss there were substituted a reference to an offshore income gain; and
(c) for the reference to section 10 or 16(3) there were substituted a reference to regulation 22(1)(b).

(6) The section applies as if subsection (6) were omitted.

(7) The section applies as if, in subsection (7), for the reference to capital gains tax there were substituted a reference to income tax.

(8) The section applies as if, in subsection (9ZA)—
(a) for the reference to foreign chargeable gains there were substituted a reference to offshore income gains to which regulation 19 applied; and
(b) the second sentence of that subsection were omitted.

(9) The section applies as if, in subsection (9B)—
(a) in paragraph (a)—
   (i) for the reference to section 87 or 89(2) there were substituted a reference to regulation 20;
   (ii) for the reference to chargeable gains there were substituted a reference to offshore income gains; and
(b) in paragraph (b) the references to subsections (2)(c) and (6) were omitted.

(10) The section applies as if, in subsection (9C)—
(a) for the reference to capital gains tax there were substituted a reference to income tax; and
(b) for the reference to chargeable gains there were substituted a reference to offshore income gains.

In the following discussion **“CGT s.10A”** means s.10A as it applies to

CGT, ie in its original form; **"OIG s.10A"** means s.10A as it applies to OIGs, ie amended as reg.23 directs. OIG s.10A TCGA provides:

> (1) This section applies in the case of any individual ("the taxpayer") if—
> *[This sets out the TNR conditions which are the same as CGT s.10A.]*
> (2) Subject to the following provisions of this section ~~and section 86A~~, the taxpayer shall be chargeable to ~~capital gains tax~~ income tax as if—
> (a) all the ~~chargeable gains and losses~~ offshore income gains which (apart from this subsection) would have accrued to him in an intervening year,
> (b) all the ~~chargeable gains~~ offshore income gains which under ~~section 13 or 86~~ regulation 24[25] 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
> ~~(c) any losses which by virtue of section 13(8) would have been allowable in his case in any intervening year if he had been resident in the UK throughout that intervening year,~~
> were ~~gains or, as the case may be, losses~~ offshore income gains accruing to the taxpayer in the year of return.
> (3) Subject to subsection (4) below, the ~~gains and losses~~ offshore income gains which by virtue of subsection (2) above are to be treated as accruing to the taxpayer in the year of return shall not include any ~~gain or loss~~ offshore income gains 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;
> (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;
> (c) that asset is not an interest created by or arising under a settlement; and
> (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).
> ~~(4) Where—~~

25 See 32.13 (OIG s.13 charge).

~~(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 by virtue of subsection (2) above are to be treated as accruing to the taxpayer in the year of return.~~

(5) The ~~gains and losses~~ offshore income gains which by virtue of subsection (2) above are to be treated as accruing to the taxpayer in the year of return shall not include ~~any chargeable gain or allowable loss~~ an offshore income gain accruing to the taxpayer in an intervening year which, in the taxpayer's case, has fallen to be brought into account for that year by virtue of ~~section 10 or 16(3)~~ regulation 22(1)(b).[26]

~~(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.~~

(7) 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~~ income 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.

(8) *[This sets out the definitions of "intervening year" "relevant disposal" and "the year of departure" which are the same as CGT s.10A]*

(9) For the purposes of this section an individual satisfies the residence requirements for a year of assessment—

(a) if, during any part of that year of assessment, he is resident in the UK and not Treaty non-resident, or

(b) if he is ordinarily resident in the UK during that year of assessment, unless he is Treaty non-resident during that year of assessment.

(9ZA) If—

(a) section 809B, 809D or 809E of ITA 2007 (remittance basis) applies

26 See 30.15 (OIG non-residence defence).

to the taxpayer for the year of return, and
(b) the taxpayer is not domiciled in the UK in that year,
any ~~foreign chargeable gains~~ offshore income gains to which regulation 19 applied[27] falling within subsection (2)(a) which were remitted in an intervening year are treated as remitted in the year of return.
~~For this purpose "foreign chargeable gains" has the meaning given by section 12(4).~~
(9B) Where this section applies in the case of any individual in circumstances in which one or more intervening years would, but for his being Treaty non-resident during some or all of that year or those years, not be an intervening year, this section shall have effect in the taxpayer's case—
(a) as if subsection (2)(a) above did not apply in the case of any amount treated by virtue of ~~section 87 or 89(2)~~ regulation 20 as an amount of ~~chargeable gains~~ offshore income gains accruing to the taxpayer in any such intervening year, and
(b) as if any such intervening year were not an intervening year for the purposes of subsections ~~(2)(b) and (c) and~~ (6) above.
(9C) Nothing in any double taxation relief arrangements shall be read as preventing the taxpayer from being chargeable to ~~capital gains tax~~ income tax in respect of any of the ~~chargeable gains~~ offshore income gains treated by virtue of subsection (2)(a) above as accruing to the taxpayer in the year of return (or as preventing a charge to that tax from arising as a result).

Regulation 23 OFTR only amends s.10A TCGA. It does not amend the definition of "DTR arrangements" which is in s.288 TCGA.[28] However that definition is subject to context, and it is suggested that the context requires that the reference here includes any DTA which confers relief from OIGs.

## 8.13 DTA and other short term non-residence rules

Some DTAs impose a short-term non-residence rule in their CGT article. This is not in the OECD model treaty, but about one third of UK treaties have a restriction of this kind.

Treaties are easier to follow if one notes in the text which contracting state is which. A variety of wordings are used and Italy will serve as an

27 See 32.6 (OIG remittance basis).
28 See 8.4.2 ("DTR arrangements" - IT) and 8.4.3 ("DTR arrangements" - CGT).

example. We are considering a claim for UK CGT relief by a person treaty resident in Italy. Article 13 of the UK/Italy DTA provides:

> (4) Gains from the alienation of any property other than that referred to in the preceding paragraphs of this Article shall be taxable only in the Contracting State of which the alienator is a resident [Italy]

This is (more or less) the OECD model form; the restriction then follows:

> (5) The provisions of paragraph (4) of this Article shall not affect the right of a Contracting State [UK] to levy according to its law a tax on gains from the alienation of any property derived by an individual who:
> (a) is a resident of the other Contracting State [Italy]; and
> (b) has been a resident of the first-mentioned Contracting State [UK] at any time during the five years immediately preceding the alienation of the property; and
> (c) is not subject to tax on those gains in the other Contracting State [Italy]

This is not strictly a *temporary* non-residence rule as it applies to those who do not return to the UK, but the idea is similar.

The IHT deemed domicile rule can be considered in part a similar short term non-residence rule, since its effect is that a person who ceases to be UK resident (or domiciled) continues for a 3 or 4 year period to be regarded as UK domiciled for IHT purposes and so within the scope of IHT.

CHAPTER NINE

# THE REMITTANCE BASIS

## 9.1 Remittance basis – Introduction

Income tax and CGT employ two types or bases of assessment:
(1) An **arising basis** under which tax is charged on the amount of income or gains which arise.
(2) A **remittance basis** under which tax is charged on the amount of income or gains which are received in the UK.
A remittance basis applies (in short) when a foreign domiciliary receives:
(1) Foreign income and gains
(2) Deemed income/gains under various anti-avoidance provisions: the settlement provisions, the TAA provisions and s.87 TCGA.
Before 2008 there were differences between the remittances bases for RFI, employment income and CGT. From 2008/09 there is one common remittance basis for all three, which is also the basis of the remittance basis for the anti-avoidance provisions. I use the following self-explanatory terminology:
(1) "**The ITA remittance basis**" (which applies from 2008/09).
(2) "**The pre-2008 remittance basis**" (which applied until 2008/2009); more specifically, one might refer to "**the pre-2008 RFI, employment income or CGT remittance basis**".
For rates of tax see 41.1 (Rates of income tax). For the position of trustees of IP trusts where the life tenant is a remittance basis taxpayer, see 23.2.3 (Life tenant remittance basis taxpayer).

## 9.2 HMRC guidance

Most of the HMRC guidance is to be found in section 3 of the vast RDR Manual. The first edition was published 31 March 2009, a second edition August 2009 and an online version including paragraph numbering was published in the Manuals section of the HMRC website in about June 2010.

The RDR Manual frequently makes its point by examples. In some cases the examples are completely straightforward and would have been better omitted for the sake of brevity.[1] In almost all cases the examples are padded out with many extraneous and irrelevant facts. (No doubt in the spirit of *The Mikado*, "intended to give artistic verisimilitude to an otherwise bald narrative".) This is about as unhelpful a method of explaining statutory provisions as could be devised. The consequence is to make it quite unnecessarily difficult to identify the important points from the examples. I try to deal with this by recasting the example so the reader can more easily see the relevant point; where a wholesale rewrite is needed, I set the original text of the manual in a footnote, so that the reader can see what I have done.

The RDR Manual was out of date when published, because it took no account of the changes (retrospective and prospective) of the FA 2009. The 2nd edition was not up to date because of more retrospective legislation in the F(no.1)A 2010. Of course, no guidance can ever be up to date while tax reform continues at its present frenetic pace.

Earlier guidance was in three lengthy sets of questions and answers:
"**December 2008 Qs & As**" published 10 December 2008.
"**January 2009 Qs & As**" published 13 January 2009.
"**March 2009 Qs & As**" published 3 March 2009.
Most of the Qs and As are now superceded by the RDR Manual but they are still sometimes relevant.[2]

Guidance published before then, under the name of FAQs, is now almost all of historic interest only.

## 9.3 "Foreign income and gains"

Section 809Z7 ITA provides:

> (1) This section applies for the purposes of this Chapter.

1 But for the sake of completeness, and just in case some readers should find them helpful, I sometimes set them out in footnotes.

2 HMRC has removed the Qs & As from their website but they are accessible on www.kessler.co.uk.

These are chapter-wide definitions though in accordance with the principles of Plain English drafting, the legislation contains occasional and somewhat unnecessary pointers to the definitions.[3]

> (2) An individual's "foreign income and gains" for a tax year are—
> (a) the individual's relevant foreign earnings for that year,
> (b) the individual's foreign specific employment income for that year,
> (c) the individual's relevant foreign income for that year, and
> (d) if the individual is not domiciled in the UK in that year, the individual's foreign chargeable gains for that year.

### 9.3.1 *Relevant foreign income*

Section 830(1) ITTOIA provides the definition of "RFI":

> In this Act "relevant foreign income" means income which
> (a) arises from a source outside the UK, and
> (b) is chargeable under any of the provisions specified in subs.(2) (or would be so chargeable if s.832 did not apply to it).

Subsections (2)–(4) set out a list of the categories of RFI, not repeated here. It includes almost all foreign income, including trading income, property income, interest and dividends. This is income formerly taxed under Schedule D Cases IV and V. "Relevant foreign income" is not a helpful label but it is difficult to think of a better one.

A non-resident's income is not RFI as (if it arises from a non-UK source) it is not "chargeable" and does not meet the condition in s.830(1)(b).

### 9.3.2 *Relevant foreign earnings ("RFE")*

Section 809Z7(3) ITA provides the definition of RFE:

> An individual's "relevant foreign earnings" for a tax year are—
> (a) if the individual is ordinarily UK resident in that year, the

3 Eg s.809C(6) ITA: "See s.809Z7 for the meaning of an individual's foreign income and gains for a tax year".

individual's chargeable overseas earnings[4] for that year, and
(b) otherwise, the individual's general earnings within s.26(1) of ITEPA 2003 for that year (non-UK earnings).

### 9.3.3 *Foreign specific employment income*

Section 809Z7(4) ITA incorporates the definition from ITEPA:

> An individual's "foreign specific employment income" for a tax year is such of the individual's specific employment income for that year as is are regarded as foreign securities income for the purposes of s.41A of ITEPA 2003.

Foreign specific employment income is not discussed in this book.

### 9.3.4 *Foreign chargeable gains*

Section 12(4) TCGA provides a commonsense definition:

> In this section "foreign chargeable gains" means chargeable gains accruing from the disposal of an asset which is situated outside the UK.

This is only a section-wide definition, so it has to be repeated or incorporated when the expression is used elsewhere.

Section 809Z7(5) ITA incorporates this definition:

> An individual's "foreign chargeable gains" for a tax year are the individual's foreign chargeable gains (within the meaning of s.12(4) of TCGA 1992) accruing to the individual in that year.

### 9.3.5 *Capital/income terminology in remittance basis context*

One might start off by thinking that a remittance of income is subject to income tax and a remittance of capital is not. It is not that simple. The terminology of "capital" and "income" in the context of the remittance

4 Section 809Z7(7) provides: "In subs.(3)(a) 'chargeable overseas earnings' has the same meaning as in s.22 of ITEPA 2003 (see s.23 of that Act)." See 12.11 (Chargeable overseas earnings).

basis is potentially confusing.

A sum received in the UK may not be taxable under the remittance basis because it is derived not from income but from some fund easily identified as capital in the hands of the taxpayer, such as a gift or inheritance, or borrowing. In cases in this category it makes sense to say that the remittance is tax free because it is one of capital.

A sum received in the UK may not be taxable under the remittance basis because:

(1) the donor was non-resident when the remitted sum accrued; or
(2) the remitted sum has already been subject to income tax.

Such sums might be said to be "income" in the normal sense of the word. These examples show that a remittance of a sum which is income in nature may nevertheless be remittance free of tax under the remittance basis.

(3) Conversely, suppose a remittance basis taxpayer accumulates income offshore for many years; the accumulated fund might be said to be their "capital" in the normal sense of the word. Yet for the purposes of the remittance basis, it is in principle taxable if remitted.[5] Perhaps it is better described as "income".

It is best not to use the terminology of capital/income in any of cases (1) to (3): it is unnecessary to do so.

## 9.4 History of the remittance basis

It is not necessary for a practitioner to know the history of the remittance basis but it makes an interesting story and is helpful to understand the

5 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."

background to the older cases.[6]

Until 1914 all foreign income was taxed on a remittance basis: s.100 Income Tax Act 1842. Since then the remittance basis has been withdrawn, in stages, except for foreign domiciliaries. In 1914 income from "securities, stocks, shares, or rents in any place out of the UK" was brought onto an arising basis: s.5 FA 1914. This did not apply to foreign domiciliaries and non-ordinarily resident British subjects. Even those who were domiciled and ordinarily resident in the UK retained the remittance basis for any foreign source income which did not consist of securities or rents. Hence the need for cases to decide whether trust income was to be regarded as income arising from securities or from the trust.[7] In 1940 the general remittance basis was further restricted, to (a) income from offshore trades, professions or vocations, and (b) income from offshore offices, employments or pensions: s.19 FA 1940. The exception was intended, perhaps, to encourage foreign trade. However, it did enable tax planning by splitting a single mixed UK and foreign based trade into separate UK and foreign source trades, the latter qualifying for the remittance basis. An arrangement of this kind was held to be successful in *Newstead v Frost* 53 TC 525. So in 1974 this was abolished: ss.22, 23 FA 1974.

The same rules applied to companies as to individuals, until the introduction of corporation tax in 1965, which put UK resident companies onto an arising basis.

In 2008 the remittance basis was recast, and restricted by the remittance basis claim charge.

## 9.5 Who qualifies for the remittance basis?

After a (somewhat unnecessary) overview in accordance with the principles of plain English drafting,[8] s.809B, 809D and 809E ITA set out three categories of individuals to whom the remittance basis applies:

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

7 See 23.1 (Taxation of life tenant).

8 Section 809A ITA provides: "This Chapter provides for an alternative basis for charge in the case of individuals who are not domiciled in the UK or are not ordinarily UK resident".

(1) Section 809B is the main category, those who make a claim for the remittance basis. I refer to these as "**remittance basis claimants**".

The other two categories are classes of *de minimis* taxpayers, defined with complex and pernickety detail.

(2) Section 809D applies to individuals whose unremitted foreign income and gains are less than £2,000. I refer to these as "**sub-£2k taxpayers**".

(3) Section 809E applies to those with no (or virtually no) taxable (UK source) income and gains who do not remit any foreign income or gains. I refer to these as "**non-taxpayers**".

The advantages of being in one of the two de minimis categories are as follows:

(1) no claim is needed and so the taxpayer may not need to make a tax return.

(2) the remittance basis claim charge does not apply, personal allowances remain available, and the individual is not forced to make a CGT loss election.

I refer to the three groups together as "**remittance basis taxpayers**". HMRC use the term "remittance basis user". (Since about 2001, HMRC do not like to use the word "taxpayer".)

## 9.6 Remittance basis claimants: s.809B

### 9.6.1 *Entitlement to claim remittance basis*

Section 809B ITA provides:

> (1) This section applies to an individual for a tax year if the individual-
> (a) is UK resident in that year,
> (b) is not domiciled in the UK in that year or is not ordinarily UK resident in that year, and
> (c) makes a claim under this section for that year.
> (2) The claim must contain one or both of the following statements-
> (a) that the individual is not domiciled in the UK in that year;
> (b) that the individual is not ordinarily UK resident in that year.

Thus two categories of individual may claim the remittance basis:

(1) A UK resident foreign domiciliary.

(2) A person who is:

(a) resident but not ordinarily resident in the UK; and
(b) domiciled in the UK (or they would fall within the first category anyway).

Category (2) must be a rare case. HMRC agree. The RDR Manual 32220 provides:

> **32220 Counting years of UK residence (seven out of nine) - Section 809 ITA 2007** [July 2010]
> ...
> Most long-term UK Residents will also be Ordinarily Resident in the UK, so most, although not necessarily all, individuals who pay the remittance basis charge will use the remittance basis on account of their non-dom status. Cases involving individuals who are UK-domiciled but claim to be NOR and who pay the remittance basis charge should be referred to CAR PTI Advisory for a review of their NOR status claim.

Category (2) does not qualify for the CGT remittance basis. It is suggested that the law could be simplified, and the anomaly fairly corrected, by abolishing this category and bringing such persons on to the arising basis. However the 2008 reforms chose not to do this, so the anomaly is likely to remain for the foreseeable future. For simplicity I will on most occasions ignore this possibility and simply refer to "foreign domicile".

### 9.6.2 *Is a claim worthwhile?*

A claim gives the advantages of the remittance basis but has the following drawbacks:
(1) For all claimants: loss of personal allowances.
(2) For long-term residents: the £30k remittance basis charge.
(3) The need to make a CGT loss election.
(4) Remitted dividends are taxed at a higher rate than dividends taxed on an arising basis.

The effect of the £30k remittance basis charge is to withdraw the remittance basis from long-term residents except the most wealthy, since a claim is not likely to be worthwhile for individuals whose income is much less than £150,000 in the year in question, though the position varies a great deal from one case to another.

### 9.6.3 *Is a claim worthwhile: US taxpayers*

Bober states:

> Generally, the ability to claim double tax relief will mean that an adult US citizen (or green- card holder) who is a long-term UK resident will achieve a better overall tax result (meaning that less tax will be payable overall) by being subject to UK tax on the arising basis. This is because the individual will generally be subject to US tax on a worldwide basis anyway. For many, while UK tax rates are in excess of US tax rates, the additional UK tax that will be payable on the arising basis will not be in excess of the GBP30,000 RBC payable if the remittance basis claim is made. This will not always be the case, though, as:
>
> - the individual may have specific issues meaning that some of their foreign income or gains are sheltered from the US tax net, and/or
> - the individual might be sufficiently wealthy that the difference between the higher UK tax rates and the US tax rate will mean that paying the GBP30,000 is worthwhile.
> - In addition, some US citizens (or green-card holders) may prefer to pay tax on the remittance basis in the UK rather than try to determine the UK tax treatment with respect to some of the offshore investments they have, and make the necessary disclosure. Since the US and the UK tax systems are different the fact that an individual has to submit a US tax return showing worldwide income and gains will not necessarily mean he or she is in a position to complete a UK return without incurring significant additional compliance costs. Paying the RBC will avoid the need for this work and may result in privacy gains.[9]

### 9.6.4 *How to claim and time limits*

The claim is made by ticking the relevant box in the tax return.[10] Section 809B(3) ITA provides:

> Sections 42 and 43 of TMA 1970 (procedure and time limit for making claims), except s.42(1A) of that Act, apply in relation to a claim under this section as they apply in relation to a claim for relief.

The RDR Manual provides:

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9 Bober "The remittance basis charge – US issues" (2001) 9 TQR p.8

10 Box 27 form SA109 (Residence remittance basis, etc) 2009/10.

**32030 Claiming the remittance basis: Claims - Time Limits** [July 2010]
The time limits for making claims are set out in s.43 TMA 1970.
The general time limit as set out in s.43(1) TMA70 for making a claim also applies to making a claim for the remittance basis.
... The present limits are changing as a result of changes introduced at Schedule 39 FA 2008. From 1 April 2010 the new time limits will be 4 years after the end of the year of assessment to which it relates. Please refer to the Self Assessment Claims Manual (SACM) for further details.
The Taxes Acts may prescribe a longer or shorter period in respect of certain claims, and if that is the case then that time limit will override the general rule of s.43(1).
S.43(2) extends the time limit in certain circumstances. This information is held in the Self Assessment Claims Manual (SACM 9000 onwards).

The RDR Manual provides:

**32020 Claiming the remittance basis: Making a claim** [July 2010]
...
If the return is subsequently amended, the claim may be included then or a previously made claim may be amended or deleted (s.42(5) TMA 1970). However when the time period for making an amendment has passed, the claim may not be withdrawn even if the making of the claim turns out to have been an error. This is because error or mistake relief does not apply to claims made to use the remittance basis under s.809B ITA 2007 (s.33(2A)(c) TMA 1970).

It is possible to claim the remittance basis in one year and not in another year, thus opting in and out of the remittance basis.

## 9.7 Sub-£2k taxpayer: s.809D

Section 809D ITA provides:

(1) This section applies to an individual for a tax year if-
(a) the individual is UK resident in that year,
(b) the individual is not domiciled in the UK in that year or is not ordinarily UK resident in that year, and

(c) the individual's unremitted[11] foreign income and gains for that year are less than £2,000.

unless condition A or condition B is met.

(1A) Condition A is that the individual is not domiciled in the UK in that year and conditions A to F in section 828B are met.[12]

(1B) Condition B is that the individual gives notice in a return under section 8 of TMA 1970 that this section is not to apply in relation to the individual for that year.

Why should anyone wish to make a claim under s.809D(1B) and move from the remittance basis to the arising basis? The reason may be that the remittance basis (for those without very large incomes) involves simply too much trouble and expense to operate: it is more cost effective to pay tax on an arising basis. Another reason might be to facilitate double taxation relief.

### 9.7.1 *Interaction of £2k limit with split-year concessions*

The RDR Manual provides:

**32120 Below £2,000 threshold users: Years of arrival and departure - interaction with Extra Statutory Concession (ESC) A11**

ESC A11 may apply to an individual for the year in which they arrive or leave the UK; it effectively splits the tax year into periods of residence and non-residence and computes liability accordingly. This generally means that foreign income from the period of "non-residence" is not subject to UK tax.

However in considering whether the "below £2,000 threshold" limit applies in respect of use of the remittance basis of taxation under ITA07/s809D, the level of unremitted foreign income and gains for the

11 Section 809D(2) provides a commonsense definition of "unremitted":

"The amount of an individual's "unremitted" foreign income and gains for a tax year is—

(a) the total amount of what would (if this section applied) be the individual's foreign income and gains for that year, minus

(b) the total amount of those income and gains that are remitted to the United Kingdom in that year.."

12 This relates to lower-paid employees see 12.30 (Lower-paid employee exemption). I do not understand the reason for condition A.

entire tax year must be taken into account.

This is straightforward but the Manual gives an example to drive the point home:[13]

> F enters the UK on 20 October 2010, and is resident for the tax year 2010-11. He claims[14] split-year treatment under ESC A11.
> F's foreign income is as follows:
> 6 April to 19 October 2010 £2,200.
> 20 October 2010 to 5 April 2011 £1,300.
> F remits £1,000 to the UK in that year.
> At the end of the year his total unremitted foreign income is £2,500.

The HMRC analysis is as follows:

> Even though F has claimed split-year treatment for 2010-11, he still has to include any foreign income that arose before he entered the UK.
> As F's unremitted foreign income is above the £2k threshold he cannot use the remittance basis under s809D. If he wishes to use the remittance basis he will need to claim under ITA07/s809B, and will lose his personal allowances and the annual exempt amount.

In practice, F (if well advised) would not make a claim for the remittance basis but could save a few pounds of tax by remitting £1,500.01 to the UK instead of £1,000.

The same applies for chargeable gains under ESC D2. But in practice it hardly matters.

### 9.7.2 *Procedure*

HMRC Business Brief 17/09 provides:

> There is a new box on the supplementary "Residence and Remittance Basis etc." pages (SA109) for such individuals to advise HMRC of their use of the remittance basis under section 809D. This ensures they continue to get their Personal Allowances and the Annual Exempt

13 I have slightly altered the wording of the example for enhanced clarity.

14 *Sic*. It would be more accurate to say "qualifies for split-year treatment" since the concessions do not need a claim. But nothing turns on that.

Amount.

This is box 28 in the 2008/09 SA100 form.

### 9.7.3 *Concession for remittances by sub-£2k taxpayer*

HMRC Business Brief 17/09 provides:

> **Remittance basis users whose foreign income and gains is less than £2,000**
> Individuals making use of section 809D are still taxable on any foreign income or gains remitted to the UK. ...
> It is recognised that some individuals, in particular those on low income, may make small cash remittances to the UK, out of foreign income or gains, and as a result have to complete a Self Assessment tax return possibly to pay only a small amount of tax. This is particularly the case where foreign tax has already been paid on the income or gains. Where an individual who is making use of section 809D remits less than a total of £500 in cash, which arises from foreign income or gains, into the UK during the tax year, then HMRC will accept that such an individual does not need to make a Self Assessment Tax return simply to pay the tax on those cash remittances. However where such an individual is required to complete a Self Assessment tax return for any other reason, or HMRC serves them with a notice to make a return, then they will need to include those remittances on the return and pay the tax due. This practice will apply for 2008-09 and subsequent years.

This is a concession (the word concession is not used, perhaps because HMRC are not now supposed to issue concessions). A concession which only applies if HMRC chose not to require a SA return is a new development in tax, and setting the limit at £500 is difficult to defend, but the manner of introduction of the concession precluded any possibility of debate on it.

## 9.8 Non-taxpayers: s.809E

Section 809E(1) ITA provides:

> This section applies to an individual for a tax year if—
> (a) the individual is UK resident in that year,

> (b) the individual is not domiciled in the UK in that year or is not ordinarily UK resident in that year,
> (c) for that year the individual either has no UK income or gains or has no UK income and gains other than taxed investment income not exceeding £100.
> (d) no relevant income or gains are remitted to the UK in that year, and
> (e) either—
>   (i) the individual has been UK resident in not more than 6 of the 9 tax years immediately preceding that year, or
>   (ii) the individual is under 18 throughout that year.
>
> unless the individual gives notice in a return under s.8 of TMA 1970 that this section is not to apply in relation to the individual for that year.

I refer to a person within s.809E as **"a non-taxpayer"**. Thus there are five requirements which must all be met. Requirements (a), (b) and (e) do not need comment.

### 9.8.1 *(Virtually) no UK income/gains*

The requirement in s.809E(1)(c) is:

> for that year the individual either has no UK income or gains or has no UK income and gains other than taxed investment income not exceeding £100.

Section 809E(2) ITA provides a commonsense definition:

> For the purposes of subs.(1)(c) the individual's "UK income and gains" for the tax year are the individual's income and chargeable gains for that year other than what would (if this section applied) be the individual's foreign income and gains for that year.

There is a paltry exemption for £100 "taxed investment income". This term is defined in s.809E(2A) ITA:

> For the purposes of subsection (1)(c) "taxed investment income" means UK income or gains consisting of payments within s.946 from which a sum representing income tax has been deducted.

### 9.8.2 *No relevant income or gains remitted*

The requirement in s.809E(1)(d) is:

> (d) no relevant income or gains are remitted to the UK in that year

Section 809E(3) ITA provides the definition:

> For the purposes of subs.(1)(d) "relevant" income and gains are—
> (a) what would (if this section applied) be the individual's foreign income and gains for the tax year mentioned in subs.(1), and
> (b) the individual's foreign income and gains for every other tax year for which s.809B or 809D or this section applies to the individual.

Para 85 Sch 7 FA 2008 contains transitional provisions for pre-2008 income and gains:

> (1) In s.809E(3)(b) of ITA 2007, the reference to a tax year for which s.809B, 809D or 809E of that Act applies to an individual includes a tax year (not later than the tax year 2007-08) in which the individual—
> (a) was UK resident, but
> (b) was not domiciled in the UK or was not ordinarily UK resident.
> (2) In relation to such a tax year, the reference there to the individual's foreign income and gains includes the individual's relevant foreign income if (and only if)—
> (a) the individual made a claim under s.831 of ITTOIA 2005 for the year, or
> (b) s.65(5) of ICTA (or any earlier superseded enactment corresponding to that provision) applied in relation to the individual for the year.

### 9.8.3 *What is the purpose of s.809E?*

EN FB 2008 provides:

> Individuals entitled to claim the remittance basis who have no UK income or gains, and who don't remit any foreign income or gains, won't have to claim the remittance basis in years they are not liable to the RBC. This avoids them having to complete a self assessment return only so they can claim the remittance basis and then have no tax to pay.

There will not be many non-taxpayers within s.809E – mainly spouses accompanying their partners, children and some students, perhaps.

## 9.9 Time of foreign domicile

Section 809B(1) ITA requires (in short) that the foreign domiciliary is not domiciled in the UK in the year that the income arises.

It is an interesting question what is the position if a person changes domicile during a year. The 2008 reforms declined the opportunity to address the question, perhaps because that would have required a consideration of the unsatisfactory ESC A11, raising too many difficult questions.

## 9.10 Effect of remittance basis claim on personal allowances

Section 809G ITA disapplies IT personal allowances for remittance basis claimants:

> (1) This section applies if s.809B (claim for remittance basis to apply) applies to an individual for a tax year.
> (2) For that year, the individual is not entitled to-
> (a) any allowance under Chapter 2 of Part 3 (personal allowance and blind person's allowance),
> (b) any tax reduction under Chapter 3 of that Part (tax reductions for married couples and civil partners), or
> (c) any relief under s.457, 458 or 459 (payments for life insurance etc).

This does not apply to remittance basis taxpayers in the de minimis categories (sub-£2k taxpayers and non-taxpayers): they retain their allowances.

The editor of *Taxation* comments acerbically on s.809G(2)(c):

> So what are these valuable reliefs which it would be unfair to allow those claiming the remittance basis to enjoy? They are relief from tax on half of the premiums paid to trade unions and police organisations for superannuation, life insurance or funeral benefits, or to the employer so that benefits can be paid after the employee's death to their dependants, but limited to £100 a year of relief in each case.

> What on earth is the point of removing a relief like that for the non-domiciles? It is pointless complexity for the sake of a few tenners in tax which will have no impact whatsoever on the non-domiciles concerned. Unless there is some issue related to European law, or human rights (which seem to be the normal culprits in these situations) I really cannot see why the parliamentary draftsman should have been troubled with the need to include them. And, frankly, if there is some such problem, then given the minuscule levels of relief they offer even to those not on the remittance basis, wouldn't it be simpler to just abolish the sections altogether? That would at least be simplification.[15]

Likewise s.3 TCGA[16] disapplies the CGT annual exemption:

> (1) An individual shall not be chargeable to capital gains tax in respect of so much of his taxable amount for any year of assessment as does not exceed the exempt amount for the year.
> (1A) Subs.(1) does not apply to an individual for a tax year if s.809B of ITA 2007 (claim for remittance basis to apply) applies to the individual for that year.

This applies even to a person who is UK domiciled but not ordinarily resident, even though such a person pays CGT on an arising basis.

In consequence the usual restrictions on reporting limits are disapplied. Section 3A TCGA provides:

> (1) Where in the case of an individual—
> (a) the amount of chargeable gains accruing to him in any year of assessment does not exceed the exempt amount for that year, and
> (b) the aggregate amount or value of the consideration for all chargeable disposals of assets made by him in that year does not exceed four times the exempt amount for that year,
>
> a statement to that effect is sufficient compliance with so much of any notice under section 8 of the Management Act as requires information for the purposes of establishing the amount in which he is chargeable to capital gains tax for that year. ...
> (5A) Subsection (1) does not apply to an individual for a tax year if—
> (a) section 809B of ITA 2007 (claim for remittance basis to apply), or

15 Mike Truman, *Taxation* 21 Feb 2008 p.161.
16 Flagged (somewhat unnecessarily) in s.809G(3) ITA.

(b) section 16ZB below (certain chargeable gains charged on remittance basis),

applies to the individual for that year.

Personal allowances which are disapplied for remittance basis claimants may be restored under a DTA. See 41.7.4 (Personal allowances under DTAs: remittance basis claimants).

## 9.11 Remittance basis claim charge

### 9.11.1 *"Long-term UK resident"*

Section 809H ITA provides:

**809H Claim for remittance basis by long-term UK resident: charge**

(1) This section applies if—

(a) s.809B (claim for remittance basis to apply) applies to an individual for a tax year ("the relevant tax year"),

(b) the individual is aged 18 or over in the relevant tax year, and

(c) the individual has been UK resident in at least 7 of the 9 tax years immediately preceding the relevant tax year.

I adopt the statutory terminology and refer to individuals to whom s.809H(1)(c) applies as "**long-term residents**".

The period of residence might be continuous or broken.

While an individual is under 18:

(1) they are not subject to the £30k charge; but
(2) any UK resident years do count in determining their status as a long-term resident.

In the year a long-term resident attains 18, the charge is payable in full. The RDR Manual 32230 provides a straightforward example of a case involving a minor.[17]

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17 **32230 Counting years of UK residence - Minors**

...

*Example (Pranav)*

"P was born on 23 October 1991. He came to the UK as a school boarder in August 2001 (tax year 01-02). He is domiciled outside the UK. He has stayed in education in the UK for every tax year since.

The RDR Manual provides:

> **32240 Interaction with Extra Statutory Concession (ESC) A11**
> ... Even if this "split-year" treatment is given, these years [of arrival and departure] count as a full year of residence in determining whether an individual meets the long-term residents rule, that is, whether he has been in the UK for at least 7 out of the 9 tax years immediately preceding the current tax year.

The RDR Manual 32220 offers a straightforward example of a case involving a split year.[18]

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| | |
|---|---|
| 99-00 Not Resident | 05-06 Resident |
| 00-01 Not Resident | 06-07 Resident |
| 01-02 Resident | 07-08 Resident |
| 02-03 Resident | 08-09 Resident |
| 03-04 Resident | 09-10 Resident |
| 04-05 Resident | |

In 08-09 P has foreign income of £300,000 and he claims to use the remittance basis in that year. He is a long-term resident in the UK as he has been UK resident for eight years, but as he is under 18 he may use the remittance basis in 08-09 without paying the remittance basis charge.

In October 2009 (tax year 2009-10) P turns 18. He has foreign income of £400,000. If he wishes to claim the remittance basis for that tax year he will be liable to the remittance basis charge."

Of course the (implausibly large) income specified is strictly irrelevant to the application of the remittance basis charge: the position is the same whatever is P's income.

18 **32220 Counting years of UK residence (seven out of nine) - Section 809 ITA 2007** [July 2010]

...

*"Example (Dominic)*

*D*, a non-dom, is resident in the UK for the tax year 2008-2009.

- D came to the UK in May 1999 (99-00 tax year)
- He left to live in Spain in January 2001 (00-01 tax year)
- He returned to the UK on 12 October 2002 (02-03 tax year)
- He left to work in the Republic of Ireland on 29 April 2004 (04-05 tax year)
- He then returned to the UK on 16 May 2006 (06-07 tax year) and has been resident here since.

D is resident in the UK for the current tax year (08-09). He has chargeable overseas earnings of £150,000 in that year, paid into his Spanish bank account and he does not remit anything. For the last nine tax years he has been resident/not resident as follows:

### 9.11.2 *Nomination of income and gains*

Section 809C ITA provides:

> **809C Claim for remittance basis by long-term UK resident: nomination of foreign income and gains to which s.809H(2) is to apply**
> (1) This section applies to an individual for a tax year if the individual-
> (a) is aged 18 or over in that year, and
> (b) has been UK resident in at least 7 of the 9 tax years immediately preceding that year.
> (2) A claim under s.809B by the individual for that year must contain a nomination of the income or chargeable gains of the individual for that year to which s.809H(2) is to apply.

Following the statutory terminology,[19] I refer to the income or gains so nominated as "**nominated income/gains**". Section 809C continues:

> (3) The income or chargeable gains nominated must be part (or all) of the individual's foreign income and gains for that year.
> (4) The income and chargeable gains nominated must be such that the relevant tax increase does not exceed £30,000.

Section 809C(5) ITA provides a commonsense definition of "the relevant tax increase":

> "The relevant tax increase" is-
> (a) the total amount of income tax and capital gains tax payable by the individual for that year, minus

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1 99-00 Resident
2 00-01 Resident (year he went to Spain)
3 01-02 Non Resident
4 02-03 Resident
5 03-04 Resident
6 04-05 Resident (year he went to Ireland)
7 05-06 Non Resident
8 06-07 Resident
9 07-08 Resident

D is a long term resident; if he claims the remittance basis in 2008-2009 he will be liable for the remittance basis charge."

19 Section 809H(3) ITA provides: "'Nominated' income or chargeable gains means income or chargeable gains nominated under s.809C in the individual's claim under s.809C for the relevant tax year." The definition is repeated in s.809I(3) and s.809J(3) ITA. (If a chapter-wide definition had been used the repetition would have been unnecessary.)

(b) the total amount of income tax and capital gains tax that would be payable by the individual for that year apart from s.809H(2).

EN Amendments to the Remittance Basis Charge explains the reason for the £30k cap in s.809C(4):

> This stops an individual from nominating too much income and gains and as a result paying a remittance basis charge of more than £30,000.

The legislation does not say what happens if an individual fails to nominate any income/gains or if they nominate income/gains but the relevant tax increase exceeds £30k. The RDR Manual provides:

> **32310 Nomination of foreign income and gains - overview**
> ... Any claim that does not include a nominated amount is not valid. ...
> **32330 Relevant tax increase**
> The remittance basis charge cannot exceed £30,000. Any nominations which produce an excessive relevant tax increase may invalidate the claim under section 809B to be taxed on the remittance basis.
> If this occurs you should try to contact the taxpayer, or their agent to advise them of their excessive nomination and to assist them to amend their claim to ensure it is valid. To do that the amount of nominated income or gains must be adjusted so that the relevant tax increase equals £30,000.

The following example from the RDR Manual shows how complicated this will be:

> **32350 Relevant tax increase - Example 2** [July 2010]
> ...
> Relevant tax increase: Example 2 (Lorna)
> L, a non domiciled long-term UK resident makes a claim to use the remittance basis in 201X and must pay the £30,000 remittance basis charge (RBC). She is a higher rate taxpayer paying tax at 40%, with UK source employment income of £80,000.
> She also has £150,000 of interest (relevant foreign income) from an overseas investment in Country X paid to her.
> Because nominated income is taxed on the "arising basis", a remittance basis user is in the same position as any other UK resident person and is, subject to the ordinary rules that apply in such cases (s.793 ICTA 1988+), entitled to credit against UK tax for certain amounts of overseas tax that is payable on

that same income.
Under the domestic law of Country X in which the investment was made, the interest was paid after deduction of 15% withholding tax. The Double Taxation Agreement between the UK and Country X provides that tax on this interest may be retained in the "source" country at the rate of 15%.
L is therefore entitled to a credit, which she takes in the form of foreign tax credit relief (FTCR), against UK tax for the tax withheld in the other country.
...
*Foreign tax credit relief calculation – general principles*
Ignoring the remittance basis issue for the moment:
L has received foreign interest of £150,000, on which Country X's tax of £22,500 (15% as provided for in the DT treaty) has been deducted.
L's income is chargeable to tax at 40%. The UK tax charge is respect of this £150,000 would be £60,000 (40%×£150,000).
If she claims foreign tax credit relief her net liability to UK tax after the foreign tax credit relief will be:
£60,000 minus £22,500 = £37,500
*Relevant tax increase including FTCR*
Foreign tax credit relief is only due to the extent that the foreign income on which it is given is brought into the UK tax charge. So for remittance basis users, relief for foreign tax paid on foreign income chargeable on the remittance basis is given when that income is remitted.
However for remittance basis charge payers like L, any foreign income which she nominates is chargeable on the arising basis so foreign tax credit relief can be given in relation to that nominated income.
Because the "relevant tax increase" must be £30,000, L will need to nominate £120,000 of her foreign interest if she wishes to create an overall remittance basis charge of £30,000.

- FTCR calculation

| | |
|---|---|
| Foreign tax that relates to the £120,000 nominated (at 15%) | £18,000 |
| UK tax on £120,000 (at 40%) | £48,000 |
| Net liability to UK tax after the FTCR (£48,000 minus £18,000) | £30,000 |

(refer to note 2 below)

- Relevant tax increase calculation

To determine the relevant tax increase we must complete two calculations.
The first calculation (a) is of the total amount of L's income tax and capital gains tax actually payable in the year, as a remittance basis user and RBC payer.
The second calculation (b) is the total amount of L's income tax and capital gains tax that would be payable by L in the year as a remittance basis user, as if no nomination was required and the RBC was not due that is, as if there was no income tax or capital gains tax payable on her nominated foreign income or gains.
The relevant tax increase is the total of calculation (a) minus calculation (b)

| | Calculation (a) | | | Calculation (b) | | |
|---|---|---|---|---|---|---|
| Non-savings income | | | | | | |
| 20%[1] on | **£34,800** | = | **£6,960** | **£34,800** | = | **£6,960** |
| 40% on | **£45,200** | = | **£18,080** | **£45,200** | = | **£18,080** |
| | £80,000 | | £25,040 | £80,000 | | £25,040 |
| Savings | | | | | | |
| 40% on | £120,000[2] | = | **£30,000** | Note 4 | | |
| Total Income Tax Due | | | **£55,040**[3] | | | **£25,040**[4] |

1 Rates and thresholds used here for the purposes of this example only; use the rates applying in the relevant tax year.
2 This is the foreign income that is nominated, and charged to tax on the arising basis in the year. FTCR is given, which has reduced the tax to £30,000.
3 As a remittance basis user, L has no personal allowances due.
4 L is a remittance basis user so would not be subject to tax on her unremitted foreign income, nor would any FTCR be due.

| | | | |
|---|---|---|---|
| **Relevant Tax Increase** is | Total (a) | | £55,040 |
| less | Total (b) | | £25,040 |
| | | Total | **£30,000** |

March 2009 Qs & As provides:

> **Q3:** HM Revenue & Customs (HMRC) have indicated that individuals do not have to specify which account the nominated income comes from, and from this it could be inferred that without further disclosure of the particulars of the account the taxpayer may be at risk of "tainting" every other source of income of that type. For example if an individual has an account with one bank in Jersey and another bank in a different jurisdiction, he could nominate bank interest on his Jersey account, so that it would be obvious that if he remitted income from his other account, he might not fall foul of re-characterisation provisions. However, this may not be the case if he had three different accounts with the same bank in Jersey and he wishes to nominate income from one of those accounts without disclosing the account number of that account. Can HMRC clarify what their approach to this will be?
> **A:** It is up to the individual to decide how much information to give HMRC on their Self Assessment returns in order to identify the source of the nominated income or gains; if, as in this example, there is more than one account the individual should provide sufficient detail to distinguish between them and identify the "nominated" account. That might be the entire account number, or the account "name", or some

other unique identifying feature of the account.

The RDR Manual 32380 provides:

**Completing the SA Return - How is this done in practice?**
SA109 "Residence, remittance basis etc" is the supplementary page to the SA100 main tax return for remittance basis users to complete under Self Assessment.
There is a box to claim the remittance basis on the SA109 and two boxes where the "amount of nominated income" and the "amount of nominated capital gains" must be entered. The amount nominated can be either income or gains or a combination of the two. The source(s) of the amount nominated is the individual's personal choice.
When either or both of these boxes are completed the SA109 notes say that details of the nominations are to be shown in the "Any other information" box.
The required information is:

- the precise amounts of income and gains that have been nominated, (this should include the country of origin and the type and source of the income)
- the computation of the gain (if applicable)
- the exchange rates used[20]
- the calculation of the tax due in relation to the nominated income and gains.

Also if there have been deductions for expenses or losses from either foreign income or foreign gains in arriving at the final taxable amount, full details of the amounts and nature of those expenses or losses must also be provided.
All of this information is required to validate the nomination or nominations that have been made.

### 9.11.3 *Nominated income/gains charge*

Section 809H(2) ITA provides:

Income tax is charged on nominated income, and capital gains tax is charged on nominated chargeable gains, as if s.809B did not apply to the individual for the relevant tax year (and neither did s.809D).

20 See 49.9 (Nominated income and gains: currency conversion date).

This disapplies the remittance basis, so nominated income and gains are taxed on the arising basis. I refer to this as the "**nominated income/gains charge**".

EN FB 2008 provides:

> 14. This charge is in addition to the tax liability for the year in question on any income and gains remitted to the UK, and any UK income or gains taxed on the arising basis. The £30,000 will be paid on nominated income and gains not remitted to the UK in the year. (These income and gains are called "nominated" income and gains because the taxpayer is free to nominate the income and gains not remitted to the UK in the year on which tax of £30,000 is payable. For example, this could be £75,000 of unremitted foreign deposit interest on which UK tax was due at 40 per cent, so leading to an income tax charge of £30,000.)

### 9.11.4 *Remittance basis deficit charge*

The removal of the remittance basis for nominated income/gains might not yield the desired additional £30k tax for various reasons. The individual might under-nominate, ie, they might not nominate enough income/gains. There is no requirement to nominate enough to give rise to a £30k IT or CGT charge. Indeed, it is not always possible to know how much that would be. One could nominate just £1, as long as what is nominated is foreign income or gains. HMRC agree. The RDR Manual 32320 provides:

> **32320 Making a Nomination**
> *Insufficient nomination*
> Although an individual may choose to make an insufficient nomination (RDRM32360) they must have foreign income and/or foreign chargeable gains from the tax year such that, they can nominate something, even if only £1. This fulfils the mandatory requirement that a nomination **must** be made when making the claim.
> *Completing the self-assessment return*
> All claims and nominations are made on the individual's self assessment tax return. The minimum amount that can be nominated **must** be at least £1 of foreign income or gains for the claim to be valid. Where a claim to the remittance basis is made under s809B but no nomination of either

> foreign income or capital gains is made the claim is invalid.[21]

According to EN Amendments to the Remittance Basis Charge this was done to enhance confidentiality:

> 7. The legislation provides the option for those who can claim the remittance basis not to disclose anything about their unremitted income or gains as they can make a claim with a nominal £1 amount and do not have to specify what further foreign income or gains remain unremitted.

But it may not be in the interests of the taxpayer to under-nominate, and the confidentiality is illusory because HMRC are likely to make further enquiries.

The removal of the remittance basis for nominated income/gains might not yield the desired additional £30k tax where the individual has some tax reliefs (eg loss relief, interest relief, DTRs, etc).

Section 809H(4) ITA goes on to ensure that HMRC will receive their desired £30k tax:

> If the relevant tax increase would otherwise be less than £30,000, subsection (2) has effect as if—
> (a) in addition to the income and gains actually nominated under s.809C in the individual's claim under s.809B for the relevant tax year, an amount of income had been nominated so as to make the relevant tax increase[22] equal to £30,000, and

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21 Similarly March 2009 Qs & As provides:
"**Q7:** The question has arisen whether less than £1 (ie pence) can be nominated income. Given current interest rates there is concern that accounts specifically set up to generate nominated income may not generate £1 before 6 April 2009. The concern expressed is that because pence are rounded down on tax returns, it might be your view that there is no nominated income?
**A:** The minimum nomination of income or gains required to calculate the relevant tax increase is £1. This is the minimum figure to be declared on the relevant supplementary page of the Tax Return."
But where is the statutory authority for HMRC to disregard figures under £1?

22 Section 809H(5)(5A) ITA repeats the definition of "the relevant tax increase" from s.809C(5) (5A):
"'The relevant tax increase' is—
(a) the total amount of income tax and capital gains tax payable by the individual for the relevant tax year, minus
(b) the total amount of income tax and capital gains tax that would be payable by the

(b) the individual's income for that year were such that such a nomination could have been made (if that is not the case).

I refer to s.809H(4) as the "**£30k deficit charge**". The £30k deficit charge is a tax on deemed income (deemed nominated income) and not on any actual income of the taxpayer (if indeed the taxpayer has other income). Section 809H(6) ITA makes this clear (if necessary):

> Nothing in subs.(4) affects what is regarded, for the purposes of s.809I or 809J, as nominated under s.809C.

I use the term "**remittance basis claim charge**" to mean the two distinct (albeit related) charges:
(1) the nominated income/gains charge, under s.809H(2); and
(2) the deficit charge, under s.809H(4).
It might be more accurate to refer to remittance basis claim *charges* (in the plural). However for many purposes it does not matter that there may be two charges rather than one, (especially since in practice the second will not often arise) and it is convenient to have one label for them both.

### 9.11.5 *Interaction with Gift Aid*

Section 802H(5A) ITA provides:

> The references to income tax in subsection (5) do not include income tax under s.424 (gift aid).

The RDR Manual provides:

> **32450. Charitable Donations and Gift Aid**
> Chapter 2 of Part 8 ITA 2007 provides relief for gifts of money to charities by individuals, known as Gift Aid. Section 414(2)(a) treats the Gift Aid donation as if it had been made after deduction of basic rate income tax. Basically, the rules require that the donor must pay at least

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individual for the relevant tax year apart from subsection (2).
(5A) The references to income tax in subsection (5) do not include income tax under s.424 (gift aid)."
If there had been a chapter-wide definition the repetition would have been unnecessary.

as much UK income tax and capital gains tax in the tax year as the amount that is repayable to the charity.

Section 424 ITA 2007 ensures that, if the donor has not paid enough UK income tax and capital gains tax to 'frank' the gift aid donations in a tax year, a further amount of income tax is charged to make up the shortfall.

***The Remittance Basis Charge***

Tax paid as part of the Remittance Basis Charge can be used to frank Gift Aid donations, thereby reducing or extinguishing any tax 'shortfall' chargeable under section 424. The £30,000 remittance basis charge is 'income tax charged' or 'capital gains tax charged' on nominated income/gains.

Section 809C(5A) ITA 2007 and Section 809H(5A) ITA 2007 provide that for the purpose of computing the relevant tax increase any amount of income tax must be disregarded in calculating and income tax charged to make up any 'shortfall' in relation to gift aid donations under Section 424 ITA 2007.

The effect of this is that the appropriate amount of income is always nominated to produce exactly the required £30,000 Remittance Basis Charge. The £30,000 is an amount of tax charged on the nominated income/gains and as such counts as part of the income tax/capital gains tax taken into account in Section 424(2) ITA 2007 - Amount C.

Thus it is available to frank Gift Aid donations.

For this topic, see Kessler and Brown, *Taxation of Charities and Non-profit Organisations* (10th edition, 2011), para 16.41 (Donor pays insufficient tax).

### 9.11.6 *How much to nominate?*

It is important not to remit nominated funds to the UK. From that point of view it is convenient to under-nominate, ie nominate a nominal £1 only.

On the other hand, taxpayers who want to offset the £30k against foreign tax will want to nominate income or gains on which the foreign tax is at least equal to the £30k, or as close to the figure as possible; that requires a full nomination and some care in the choice of income/gains which are nominated.

### 9.11.7 *Remittance basis claim charge in cases of doubt over residence*

A person may be unsure whether or not they are UK resident in a year (residence if often unknowable) but know that they would be a long-term resident if actually UK resident in that year. That person may if appropriate make a remittance basis claim in that year, for the avoidance of doubt, and argue the residence position at leisure; if they are eventually held to be UK resident the £30k remittance basis claim charge is due, but if non-resident the sum is not due. Nothing is lost by making the claim.[23] Section 809B does not apply unless the individual meets the conditions of s.809B(1)(a) and (b) in the year.

Alternatively a person may know that they are UK resident in a year but not know if they are a long-term UK resident in that year (because they are unsure whether or not they were resident in one or more earlier years). That person should make a remittance basis claim but not nominate any income or gains. The claim is valid if they are not long-term UK resident. The claim is invalid if they are long-term UK resident, so the £30k remittance basis claim charge is not due (unless they proceed to make a new election and nomination).

On the other hand a remittance basis claim is effective (and the £30k charge payable) even if the individual has less than £2k unremitted income and gains, and so would qualify as a sub-£2k taxpayer. That would be an expensive box to tick in error!

### 9.11.8 *Minimising the £30k remittance basis charge*

Basic tax planning for spouses will be to arrange that income and gains accrue only to one of them, so that only one has to pay the remittance basis claim charge.

Basic planning for individuals who do not wish to pay the remittance basis claim charge every year is to time disposals and accruals so far as possible that foreign income and gains accrue before the 8th year of residence, and only once every few years subsequently (so a claim is only needed once every few years).

### 9.11.9 *Remittance basis claim charge: credit against foreign tax*

EN FB 2008 provides:

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23 Similar points arise if a person is unsure about their domicile in a year, but in practice that would be less common because domicile (unlike residence) is generally ascertainable.

> 17. As the RBC consists of income tax or CGT paid on the arising basis ... the tax should be recognised as tax (on income or capital gains, as the case may be) for the purposes of our double taxation agreements.

The proposal in the Draft Clauses published January 2008 was for a simple charge of a fixed amount. This would not have qualified as a credit against foreign tax because it was not a tax on income or gains. HMRC presumably agreed, as the provisions were then recast in order that:

(1) The provisions took the form (so far as possible) of a charge on income or gains but

(2) the provisions had the effect (so far as possible) of a fixed charge.[24]

It will be interesting to see if this sleight of hand satisfies American[25] and other foreign tax authorities. The question is of course one for foreign law, not UK law.

Article 24(1) of the UK/US DTA provides:

> In accordance with the provisions and subject to the limitations of the law of the United States (as it may be amended from time to time without changing the general principle hereof), the United States shall allow to a resident or citizen of the United States as a credit against the United States tax on income
>
> (a) the income tax paid or accrued to the United Kingdom by or on behalf of such citizen or resident ...

It is suggested that the *nominated income/gains charge* can in principle be set against foreign tax since it is an income tax or CGT. However the remittance basis *deficit* charge is not a charge on actual income, and cannot be set against foreign tax. HMRC agree. EN Amendments to the Remittance Basis Charge provides:

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24 See too 9.11.11 (Remittance basis claim charge in year of arrival and departure).

25 For HMRC's opening shot in this debate see BN 107 accessible *www.hmrc.gov.uk/budget2008/bn107.pdf*. It was expected that the United States Treasury and IRS would publish guidance. In fact HMRC say:
"HMRC said they had been in contact with the IRS on this matter and they had declined to say whether the £30,000 charge will be creditable for US federal tax purposes." Joint Expatriate Forum on Tax and NICs: 29 July 2010 Meeting Note *hmrc.gov.uk/consultations/expat-mins-290710.pdf*. In practice US taxpayers have been putting in claims (supported by the HMRC's published view).

> 16. The individual claiming the remittance basis might decide to nominate only £50,000 of bank interest under s.[809C(2)] and pay £20,000 of the £30,000 under s.[809H(2)] (assuming higher rate tax is due on all the £50,000). Section [809H(4)] would then apply with the effect that further income of £25,000 is treated as nominated to bring a further £10,000 of income tax into charge. However if the individual intended claiming credit for all or part of the £30,000 under a DTA then DTA relief will only be due on the income or gains actually nominated under s.[809C(2)] – £50,000 of income and £20,000 of income tax in this example. The income tax paid on income treated as nominated under s.[809H(4)] = £25,000 of income and £10,000 of income tax in this example, will not qualify for relief under DTAs as it is not tax on specific nominated income.

It follows that a careful choice of what income or gains to nominate is important, because (if foreign tax allows credit for the £30k UK tax) that can make up to £30k difference to the foreign tax liability.

9.11.10 *Individual treaty non-resident*

The RDR Manual provides:

> **RDRM32250 Dual residents - treaty non-resident** [July 2010]
> It is possible for individuals to be resident both in the UK and in another country or countries in a tax year. In such a case we look to the provisions of existing Double Taxation Agreements (DTAs) to determine in which country the individual is resident for treaty purposes. So a person may be resident in the UK under UK law, but regarded as 'treaty resident' elsewhere and consequently treated for tax purposes as 'not resident' in the UK.
> An individual who is, under the terms of a DTA, resident in the other country or territory but is also a long-term resident RDRM32200 in the UK (that is someone who is resident in the UK for more than seven out of the previous nine tax years) and claims the remittance basis is, if their un-remitted foreign income and gains is £2,000 or more, liable to the £30,000 remittance basis charge.

It is considered that DTA relief is in principle available against the nominated income/gains charge, but not against the remittance basis deficit charge. The effect of claiming DTA relief against nominated income or gains is to reduce the remittance basis claim charge on the nominated income or gains, but to increase the deficit charge by the same amount.

This certainly defeats the spirit of any DTA. It may also breach the DTA itself. But the intention of Parliament is clear, and the doctrine of parliamentary sovereignty allows Parliament to breach DTAs.[26] How our treaty partners will react to this will be interesting to see.

The RDR Manual continues:

> **32250 Dual residents - treaty non-resident** [July 2010]
>
> ...
>
> In determining the number of years in which an individual has been resident in the UK for the purposes of the long-term resident provisions, you count all years where the individual is resident in the UK under UK domestic law even if the individual was treaty resident in another territory in some or all of those years.

This is correct.[27] The RDR Manual continues with some tax planning advice:

> In most cases, an individual resident both in the UK and in another country and who under the Double Taxation Agreement with the other country is treated as resident in that other country (for the purpose of applying the provisions of the DTA) will be chargeable to tax in the other country on income and gains that originate in that other country and not in the UK. The treatment of any income and gains that originate in third countries (not the UK or the country of treaty residence) will depend upon the terms of the DTA between the UK and the country of residence. Where, exceptionally, an individual is chargeable to tax in the UK on such income or gains, they will need to consider whether a claim for the remittance basis of taxation is in their best interests or if, instead, they should pay tax on the arising basis and in the usual way, claim a credit for the tax charged in the other territory.

### 9.11.11 *Remittance basis claim charge in year of arrival and departure*[28]

The RDR Manual provides:

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26 See *Padmore v IRC (No.2)* [2000] STC (SCD) 356.

27 See 5.1.1 (Relationship between treaty-residence and domestic-law residence; dual residence).

28 For the distinct issue of the interaction of the split-year concessions and the definition of "long-term UK resident" see 9.11.1 ("Long-term UK resident").

> **32240 Interaction with Extra Statutory Concession (ESC) A11**
> ... Long-term residents who claim the remittance basis under ITA07/s809B are subject to the remittance basis charge of £30,000. This charge is payable in full if the remittance basis is claimed, even in years in which the individual arrives in or departs from the UK part the way through the year, and even if ESC A11 is applied.

In the absence of this guidance one would have expected ESC A11 and D2 to apply, so that if (for instance) an individual nominated gains accruing after their departure, they would be exempt under ESC D2. It is not constitutionally satisfactory that a relief formally granted by concession should be restricted by informal HMRC guidance: the correct course would have been to revise the text of the concession. But in practice nothing is likely to turn on that.

More fundamentally, what is the reason why the concessions do not apply in this case? If the remittance basis claim charge is a tax on the nominated income or gains, they logically should apply. The reason is that the charge is intended only to take the form of a tax on the nominated income or gains, and it is intended to have the effect of a fixed charge.

### 9.11.12 *Administration*

The RDR Manual provides:

> **32210 Long-term residents and the remittance basis charge - overview**
> ... The remittance basis charge is both payable and collected through the SA regime, and an SA tax return must be filed. The SA109 Residence, remittance basis etc is the supplementary return which should be completed and filed for this purpose.

So a long-term resident who wishes to claim the remittance basis will need to file an SA tax return in order to pay the £30,000 charge.

Of course the charge could not be collected through PAYE. For one thing, the charge might be a charge to CGT and even if it is income tax it need not be a charge on employment income. Also the claim on which the charge depends will be made in the tax return some time after PAYE is due.

HMRC Business Brief 17/09 provides:

The rules for nominating income and gains upon which the £30,000 is paid, and the rules for identifying what is taxed if those nominated income or gains are later remitted to the UK, can be complex. To help ensure individuals who pay the £30,000 get the right level of customer support [!] from HMRC, we have decided that most individuals who pay the £30,000, or have paid it in the past, will have their tax affairs dealt with in one HMRC office from 2009-10. This will be the CAR Residency office in Castle Meadow, Nottingham.
Customers who are sent a self assessment return by a different office should make the return to the office issuing that return. Once the return has been received by HMRC we will arrange for the individual's tax records to be transferred to the CAR Residency office in Nottingham and advise the individual and any agent, accordingly. Until such time as individuals or their agents receive such a notification they should continue to deal with their current tax office.

### 9.11.13 *Interaction with payments of IT on account*

The RDR Manual provides:

**32390 Payments on account - interaction with the remittance basis charge (RBC)** The remittance basis charge may consist of either income tax or capital gains tax, or a mixture of the two ...
To the extent that the remittance basis charge consists of income tax, the payment on account position for those paying the charge is the same as that for any other SA taxpayer. This means their payments on account are based their income tax liability for the previous year (TMA1970/s59A(1)).
The relevant SA109 "*Residence, remittance basis etc*" supplementary pages to the SA tax return must be completed to both claim the remittance basis and nominate income or gains and pay the remittance basis charge.
*Effect and treatment of income*
If paying part or all of the remittance basis charge in respect of nominated income, then income tax will be due. The amount which has been nominated from income and produced income tax will need to be taken into account and included in the overall calculation of payments on account for the following year.
If an insufficient nomination is made to produce the remittance basis charge of £30,000 (ITA07/s809H(4)) the additional amount treated as nominated will always produce income tax. This also has a bearing on the payments on account position, even though the additional nominated amount is from an unidentified and unspecified amount of income. The additional amount nominated from income will automatically produce income tax that will become part of the individual's payment on account calculation for the following year.
*Effect and treatment of capital gains*
Capital gains tax is never included in computing payments on account, so any of

the remittance basis charge that is constituted of capital gains tax will not form any part of the following year's payments on account.

*Example (Ricardo)*

R, a non-domiciled (ND) long-term resident has an income tax liability of £200,000 for tax year 2007-08. Subsequently he makes payments of £100,000 on 31 January 2009 and on 31 July 2009 on account of his liability for 2008-09.

His tax liability for 2008-09 is £250,000, which includes for the first time the £30,000 remittance basis charge. The remaining £220,000 is income tax on UK sources. R nominated only £21,000 of his foreign income which led to a charge of £8,400 income tax; he also nominated £120,000 foreign chargeable gains which led to a capital gains tax of charge £21,600. Together these amounts constitute his £30,000 remittance basis charge.

R's payments on account for 2009-10 will be calculated using the £220,000 income tax paid on UK income sources in 2008-09, plus the £8,400 income tax element of the remittance basis charge. This means that he will make payments on account of £114,200 on 31 January 2010 and on 31 July 2010 on account of liability for 2009-10. ...

**32400 Payments on account – nominations involving chargeable gains**

Capital gains tax is not included in computing payments on account, so any of the remittance basis charge (RBC) that is constituted of capital gains tax will not form any part of the following year's payments on account.

There is an additional box to complete on the SA109, if a nomination of capital gains is made in order to pay all or part of the RBC.

This box is called "Adjustments to payments on account" and must be completed if any nomination of capital gains is made. That is because capital gains tax is excluded from the computation of payments on account, and is simply payable as part of the balancing payment on 31 January following the tax year.

This box is not completed if a nomination of income only has been made, as any amount nominated from income will be taken into account in computing the overall payments on account liability for the following year.

The amount entered in the "Adjustment to payments on account" box on the SA109 is required in order for the payments on account to be calculated correctly for subsequent years:

- where a taxpayer is calculating their liability to tax, the amount for capital gains entered in the box to adjust payments on account, should be excluded in their calculation of payments on account
- if the tax calculation summary page is used the first payment on account for the following year will not include any part of the amount entered for capital gains in the adjustment to payments on account box.

*Example involving an amount of capital gains in the "Adjustment to payments on account" box:*

R, who pays tax at a is higher 40% rate decides to nominate both income and capital gains to pay the remittance basis charge.

He nominates as follows:

| | | |
|---|---|---|
| £21,000 of relevant foreign income | @40% | £8,400 |
| £120,000 of foreign chargeable gains | @18% | £21,600 |
| | | £30,000 |

The amount of £21,600 for capital gains will be entered in the "Adjustment to payments on account" box as this amount will be excluded in calculating payments on account for the following year. Only the £8,400 tax that is chargeable on nominated income is taken into account when calculating the amount due as payments on account.

If the entire amount nominated to pay the RBC comes from capital gains then it will not be included in the calculation for payments of account. In this case the full amount of nominated gains will be entered in the "Adjustment to payments on account" box.

**32410 Payments on account - first-year of paying RBC**

The remittance basis charge is only payable from tax years 2008-09 onwards by long-term residents making a claim to use the remittance basis.

For example, if a remittance basis claim is made in 2008-09 and the remittance basis charge is due, then the first year that any payments on account can be considered in relation to the remittance basis charge is 2009-10 unless there is a claim to reduce ...

The fact that their tax liability for 2008-09 will be increased for those paying the remittance basis charge has no effect on the payments on account position for 2008-09 (unless there is a claim to reduce them) but, to the extent that the remittance basis charge is income tax, it will be taken into account when calculating payments on account for 2009-10.

The remittance basis charge for 2008-09 is not due for payment until 31 January 2010 when it can be paid as part of any balancing payment for the year

The same principle applies to the payment on account position in relation to the remittance basis charge for any first year that a claim to the remittance basis is made, and the remittance basis charge is due. Payments on account will not generally be affected until after the first year in which they pay the remittance basis charge (TMA70/s59A(2)).

**32420 Payments on account: no remittance basis charge due in following year**

When the remittance basis of taxation is **not** claimed in a year following one where the remittance basis has been claimed and the remittance basis charge was paid, the amount of income used to pay part or all of the remittance basis charge may be excluded from the calculations of payment on account.

To allow this to happen, a claim to reduce payments on account may be made on form SA 303. Further information on the rules and the time-limits for making a claim to adjust payments on account can be found in the Self Assessment Manual under SAM1110.

**32430 Claim to reduce Payments on Account (PoA)**

The payment on account (PoA) position in relation to the remittance basis charge will be affected by any claims to reduce payments on account.

Where the RBC is paid in the previous year on nominated income, the amount feeds through to the individual's payments on account (PoA) for the next year, unless the individual makes a claim to reduce their PoAs on the grounds that their income tax liability for that year will be less than the sum of the two PoAs. For example this could be because they will not claim the remittance basis for the following year. If they subsequently do claim the remittance basis and pay the remittance basis charge in the following year and the income tax due for that year exceeds the sum of the PoAs made we will charge interest on the reduction in the PoA.

This is shown in the example below:

*Stage 1*

The return shows liability to income tax, which includes the RBC, partly or fully paid in respect of nominated income. The payments on account due on 31 January and 31 July are half of the relevant amount of income tax (TMA70/s59A).

For example, Marie-Clare's 2008-09 income tax liability is £55,000, of which £25,000 related to tax on UK source income, and the remainder is the £30,000 RBC (all in respect of nominated foreign income). Nothing is taxed at source. Her payments on account for 2009-10, payable on 31 January 2010 and 31 July 2010 will each be £27,500.

*Stage 2*

If the individual does not intend to use the remittance basis for the following year, and so they will not be subject to the remittance basis charge, they can claim to reduce the PoAs.

In the Marie-Clare example, if she does not think she will claim the remittance basis and so will not need to pay the remittance basis charge for 2009-10 she could reduce her payments on account for 2009-10 to £12,500 each, that is 50% of her 2008-09 income tax liability of £25,000 (if the remittance basis charge is excluded). She will of course still have to consider her other income sources and overall expected income tax liability for the year in making this decision.

*Stage 3*

If the individual subsequently decides to claim the remittance basis and to pay the £30,000 remittance basis charge and a claim to reduce payments on account has been made which resulted in insufficient PoAs being made, then interest will be charged from the due date for the payments on account until a claim to increase payments on account is made or payment is made for the year is paid to stop interest accruing (TMA70/s86).

In the Marie-Clare example, she has claimed to reduce her payments on account to omit the remittance basis charge, so she only makes payments on account of £25,000 (two lots of £12,500). When she files her 2009-10 self-assessment return her UK income has remained, as expected, at £25,000. However she now decides to claim the remittance basis and so she has to pay the remittance basis charge. As she has erroneously claimed to reduce her payments on account in the year, she will be charged interest on the payments that she should have made, that is, on £15,000 from 31 January 2010 and £15,000 from 31 July 2010 until the date these amounts are paid.

See Self-Assessment Manual – Legal Framework SALF303 for further information on claims to reduce payments on account.

*Example 1 (Eva)*

- E claimed the remittance basis and paid the remittance basis charge in 2008-09, and her income tax liability produces two payments on account for 2009-10 of £120,000 each.
- E has decided that she will not be claiming the remittance basis in 2009-10 so will not pay the remittance basis charge. E makes a claim to reduce the amount

due on account of her tax liability to £200,000 due to a drop in income and because she will not pay the remittance basis charge in 2009-10. When E files her 2009-10 return in September 2010 it shows that the tax due on income is £200,000, but these are provisional figures as E is awaiting some details from her foreign bankers in relation to some foreign transactions.

- The two £100,000 payments on account appear "correct" at this stage. In November 2010 E receives the information from her foreign bankers and decides to amend her return and to claim the remittance basis. She nominates some foreign income and has to pay the remittance basis charge of £30,000, all constituting income tax, bringing her total liability to £230,000.
- E will be charged interest on the £30,000 reduction in her payments on account on the grounds that E should not have reduced them.

*Example 2 (Vali)*

- V had no foreign income or gains arising in 2008-09, so he did not claim the remittance basis and so he did not need to pay a remittance basis charge in 2008-09.
- V's income tax liability for 2008-09 produces two payments on account of £200,000 for 2009-10. No claim is made to reduce the payments on accounts.
- When V begins to prepare his 2009-10 return he has a liability of £420,000 income tax on UK sources, so his £400,000 payments on account were correct, based on Vali's previous year's income tax liability.
- V has foreign income arising in 2009-10 and he decides to claim the remittance basis in his 2009-10 return. As a long-term but non-domiciled resident V has to pay the remittance basis charge of £30,000 bringing his total liability to £450,000. Interest will not be charged on the additional £50,000 tax due, as long as this is paid by the proper due date.[29]

## 9.11.14 *Position from 2012/13: the £50k charge*

The remittance consultation paper provides:

> 2.8 ... the Government proposes to introduce a higher charge of £50,000 for those non-domiciles who claim the remittance basis and have been UK resident in at least 12 of the 14 tax years prior to the year of the claim. It intends that this will take effect from 6 April 2012.
> 2.9 The £30,000 charge will be retained for those who have been resident in at least seven of the nine years prior to the year of claiming the remittance basis, but fewer than 12 years.
> 2.10 The £50,000 charge will work in exactly the same way as the current £30,000 charge, namely:
> • In each tax year the individual will have a choice whether to pay the charge or to be liable to UK tax on their worldwide income and capital

29 See too March 2009 Qs & As Q18.

gains. Any decision will depend on the individual's personal circumstances, such as the level of their overseas income and capital gains; 6
• Those who choose to pay the charge will make a claim to the remittance basis on an SA tax return after the end of the relevant tax year;
• Individuals will be able to opt in and out of the remittance basis from year to year. Choosing the arising basis in one year will not preclude claiming the remittance basis in a future year; and
• It will not be payable if the individual is under 18 or if they have unremitted overseas income and capital gains of less than £2,000 in the tax year.[30]

## 9.12 Nature of charge on remitted RFI

Section 809F(1) ITA provides:

> This section applies if s.809B, 809D or 809E applies to an individual for a tax year.

That is, the section applies to remittance basis taxpayers. Section 809F(3) ITA provides:

> The individual's relevant foreign income for that year is charged in accordance with s.832 of ITTOIA 2005.

So we turn to s.832(1) ITTOIA which provides somewhat repetitively:

> This section applies to an individual's relevant foreign income for a tax year ("the relevant foreign income") if s.809B, 809D or 809E of ITA 2007 (remittance basis) applies to the individual for that year.

We find the rule at last in s.832(2) ITTOIA:

> (2) For any tax year in which—
> (a) the individual is UK resident, and
> (b) any of the relevant foreign income is remitted to the UK,
> income tax is charged on the full amount of the relevant foreign income

30 HMT & HMRC, "Reform of the taxation of non-domiciled individuals: a consultation" (June 2011) accessible *www.hm-treasury.gov.uk/d/consult_condoc_non_domicile_individuals.pdf.*

so remitted in that year.

At first glance it may seem that IT is charged on remitted RFI and not on unremitted RFI. It is not that simple. The scheme of the rewritten legislation is that for every category of income there is:
(1) a charging provision; and
(2) a provision specifying the amount of income on which tax is charged.
For instance, in relation to dividends from non-resident companies, s.402 ITTOIA provides:

> **402 Charge to tax on dividends from non-UK resident companies**
> (1) Income tax is charged on dividends of a non-UK resident company.
> ...
> **403 Income charged**
> (1) Tax is charged under this Chapter on the...amount of the dividends arising in the tax year.
> (2) Subsection (1) is subject to ... Part 8 (foreign income: special rules).

The (subtle) point is that IT is *charged* on dividends under s.402 ITTOIA. Section 403 ITTOIA does not impose a charge. It merely quantifies *the amount on which income tax is charged.* Likewise s.832(2) ITTOIA does not impose a charge, it merely quantifies *the amount on which income tax is charged.*[31] The distinction does matter. For instance, references to "income chargeable to income tax" in principle include unremitted income taxable on the remittance basis.[32] However the context may show that the word "chargeable" is used in a narrower sense so as not to include unremitted income (un)taxed on the remittance basis.

## 9.13 Charge on remitted gains

Section 809F ITA provides:

> (1) This section applies if s.809B, 809D or 809E applies to an individual

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31 Hence the legislation states that tax is charged "in accordance with" s.832 not *under* s.832. See eg ss.13, 14, 16 ITA.

32 The distinction explains why foreign dividend income taxable under remittance basis in 2005/06 and 2006/07 was taxable at the dividend upper rate and not at the higher rate (though this is now of historic interest only); see the 6th edition of this work para 28.4.3.

> for a tax year...
> (4) If the individual is not domiciled in the UK in that year, the individual's foreign chargeable gains for that year are charged in accordance with s.12 of TCGA 1992.

So we turn to s.12(1) TCGA which provides (somewhat repetitively):

> This section applies to foreign chargeable gains accruing to an individual in a tax year ("the foreign chargeable gains") if—
> (a) s.809B, 809D or 809E of ITA 2007 (remittance basis) applies to the individual for that year, and
> (b) the individual is not domiciled in the UK in that year.

We find the rule at last in s.12(2)(3) TCGA:

> (2) Chargeable gains are treated as accruing to the individual in any tax year in which any of the foreign chargeable gains are remitted to the UK.
> (3) The amount of chargeable gains treated as accruing is equal to the full amount of the foreign chargeable gains so remitted in that year. ...

While non-ordinary residence is sufficient to qualify for the RFI remittance basis, foreign domicile is needed for CGT.

## 9.14 Remittance in year after income/gains arise

Suppose:
(1) Income or gains accrue to T (a remittance basis taxpayer) on or after 2008/09 and
(2) The sum is remitted in a subsequent year (in which T is still resident).
The income or gains are taxable in the year of remittance. There is no time limit so income or gains may be taxed many decades after they accrue.

### 9.14.1 *Transitional rule for pre-2008 income and gains*

Suppose:
(1) RFI accrues to T before 2008/09 and
(2) The RFI is remitted in 2008/09 or later (when T is still resident).
In the absence of a transitional rule, the income would not be taxable under s.832 ITTOIA because the condition in s.832(1) would not be met. Sections 809B, 809D or 809E did not apply before 2008. Para 83 Sch 7

FA 2008 fills that gap for RFI:

> (1) This paragraph applies to an individual's relevant foreign income for the tax year 2007–08 or any earlier tax year ("the relevant tax year") if—
> (a) the individual made a claim under s.831 of ITTOIA 2005 for the relevant tax year, or
> (b) s.65(5) of ICTA (or any earlier superseded enactment corresponding to that provision) applied in relation to the individual for the relevant tax year.
> (2) Section 832 of ITTOIA 2005 (as amended by this Part of this Schedule) applies in relation to the relevant foreign income as if s.809B of ITA 2007 (claim for remittance basis to apply) applied to the individual for the relevant tax year.

Thus pre-2008 RFI is taxed under s.832(2) if remitted from 2008/09 (as one would expect).

The same applies to gains. In the absence of a transitional rule, pre-2008 gains would not be taxable from 2008/09 because the condition in s.12(1)(a) TCGA would not be met. Para 84 Sch 7 FA 2008 fills that gap:

> (1) This paragraph applies if s.12 of TCGA 1992 (or any corresponding superseded enactment) applied in relation to a gain accruing to an individual in the tax year 2007-08 or any earlier tax year ("the relevant tax year").
> (2) Section 12 of TCGA 1992 (as amended by this Part of this Schedule) applies in relation to that gain as if s.809B of ITA 2007 (claim for remittance basis to apply) applied to the individual for the relevant tax year.

### 9.14.2 *Income arising before 2005/06 remitted before 2007/08: ITTOIA transitional rules*

Para 150 Sch 2 ITTOIA provided:

> A claim may be made under s.831 (claim for relevant foreign income to be charged on the remittance basis) for relevant foreign income to be charged in accordance with s.832 for the tax year 2005–06 or any later tax year, despite that income having arisen in a tax year before the tax year 2005–06; and ss. 832 to 834 apply accordingly.

ITTOIA EN Vol 3 para 347 explains:

> This paragraph ensures that Chapter 2 of Part 8 of this Act is not restricted in its operation to income that arose after the tax year 2004–05 (whenever the earlier income is remitted).

Para 150 was not aptly worded, but what it meant was this: if a s.831 claim is made in 2005/06, 2006/07 or 2007/08, pre-ITTOIA income (which was not taxed on receipt because a claim was made under the former s.65 ICTA) is taxed under s.832 ITTOIA if remitted in that year.

### 9.14.3 *Income arising before 2005/06 remitted from 2008/09*

FD Draft Clauses EN 2008 provided:

> 121. Para 47 deletes paras 150 and 151 of Schedule 2 (transitional provisions), which set out transitional arrangements for the application of the remittance basis to certain relevant foreign income arising before the tax year 2005-06. These are now considered obsolete in light of the amendments in this Schedule.[33]

## 9.15 Remittance after acquisition of UK domicile

Suppose:
(1) RFI/gains accrue to T (a remittance basis taxpayer).
(2) T acquires a UK domicile and for that reason ceases to be a remittance basis taxpayer. T remains UK resident.
(3) T subsequently remits the sum.
This is taxable under the ITA remittance basis.

### 9.15.1 *Transitional rules for pre-2008 RFI/gains*

The rule for the pre-2008 RFI remittance basis was that there was no IT charge on a remittance after acquisition of a UK domicile. It is considered that the same applied for the pre-2008 CGT remittance basis, though HMRC did not accept that.
Suppose:
(1) RFI/gains accrued to T before 2008/09.
(2) T became UK domiciled before 2008/09.

33 The equivalent passage in EN FB 2008 para 380 is less informative.

(3) The income/gains are remitted from 2008/09.

T is taxable on the remitted income under s.832(2) ITTOIA. The tax charge is retrospective in that pre-2008 RFI/gains outside the scope of tax has now fallen within the scope of tax.

What is the position if an individual acquires a UK domicile before 6/4/2008 and remitted the income or gains before then? It is suggested that there is no charge because of the cap on the amount remitted; see 10.23.5 (Cap on amount remitted).

## 9.16 Remittance in year when taxed on arising basis

Suppose:

(1) RFI accrues to T from 2008/09 in a year in which T is a remittance basis taxpayer.

(2) T subsequently remits the income in a year in which T is not a remittance basis taxpayer (because T's foreign income and gains exceed the £2k limit and T does not claim the remittance basis).

T is taxable on the remitted income under s.832(2) ITA.

### 9.16.1 *Transitional rules for pre-2008 RFI*

The rule for the pre-2008 RFI remittance basis was that there was no charge on a remittance in a year in which no claim was made for the RFI remittance basis. HMRC accepted that (at least for years when ITTOIA applied). The new rule applies to pre-2008 RFI remitted from 2008/09. The tax charge is retrospective in that pre-2008 RFI/gains outside the scope of tax has now fallen within the scope of tax.

If RFI was remitted before 2008/09, it is considered that there is no charge because of the cap on the amount remitted; see 10.23.5 (Cap on amount remitted).

## 9.17 RFI/gains arising when resident, remitted when non-resident

Suppose:

(1) RFI or gains accrue to T (a remittance basis taxpayer).

(2) T remits the sum to the UK in a year when non-resident.

RFI is not taxable in the year of remittance, because the conditions in s.832(2)(a) ITTOIA are not met. Gains are not taxable in the year of remittance because although the conditions of s.12 TCGA are satisfied (remitted gains are treated as accruing when remitted) the individual (being non-resident) is not subject to tax on chargeable gains.

The temporary non-residence rules need to be considered.

## 9.18 Remittance after death

Suppose:

(1) RFI or gains accrue to T (a remittance basis taxpayer).
(2) T dies, and the sum is received in the UK after the death.

If the RFI is received in the tax year after death, no tax charge arises because the condition in s.832(2) ITTOIA is not met. If gains are received in the tax year after death, no tax charge arises because (it is considered) s.12(2) TCGA assumes that the individual is alive in the year of remittance. The same applies if there is a remittance in the year of death because the sum cannot be received in the UK by T (who is dead) or by a relevant person (there are no relevant persons in relation to a dead person) so it cannot be remitted (within the definition of that term).

A different rule applies for employment income.

## 9.19 Remittance after source has ceased

Section 832(3) ITTOIA provides:

> Subsection (2) applies whether or not the source of the income exists when the income is remitted.

### 9.19.1 *Transitional rules for pre-2008 RFI*

The rule for the pre-2008 RFI remittance basis was that there was no charge on a remittance from a source in a year after the source has ceased. Suppose:

(1) RFI accrued to T before 2008/09.
(2) The source of the RFI ceased before 2008/09.
(3) The RFI is remitted from 2008/09.

Is T taxable on the remitted income under s.832(2) ITTOIA? Yes, the tax charge is retrospective in that pre-2008/09 income previously outside the scope of tax has now fallen within the scope of tax. It does not matter when the income arose or the source ceased: income arising in the 1950s could now come into charge, though all records relating to it would have been long discarded.

STEP rightly comment:

> It appears that any source ceased funds, whenever the source ceased will be caught by the new rules. The effect of this is to retrospectively change the nature of these funds and this is unfair. If this is to be the case then taxpayers who have used this technique may have placed the funds in capital accounts which will, as a consequence of the changes to the rules, now be classified as mixed accounts. Not only do the mixed account rules fail to take into account the change in nature of these funds which were capital on 5 April 2008 and income on 6 April 2008, but there does not seem to be any clear way to separate out these funds now as the mixed account rules only apply to remittances to the UK. Whilst STEP does not object to the change in these rules for the future, we do feel that it is unfair to impose additional tax and reporting burdens on taxpayers who used a technique in the past which HMRC recognised and accepted when they used it.[34]

What if the source ceased and T remitted the income before 2008/09? Even if the transitional rule does not provide relief, it is considered that there is no charge because of the cap on the amount remitted; see 10.23.5 (Cap on amount remitted).

HMRC accept that there is no charge on pre-2008 deemed gains.[35] The same reasoning must apply here so it is considered that pre-2008 source-ceased income, which was remitted to the UK prior to 6 April 2008, remains non-taxable.

## 9.20 RFI/gains arising when non-resident, remitted when resident

Suppose:

(1) A non-resident individual receives RFI or gains. The income or gains are not of course taxed as they arise.

(2) The individual becomes UK resident, and subsequently remits that sum when taxable under the remittance basis.

RFI remitted is not taxed on remittance as the condition in s.832(1) ITTOIA is not met. Gains remitted are not taxed on remittance because the condition in s.12(1) TCGA is not met.

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34 STEP Representations on the FB 2008.

35 See 10.24.5 (Transitional rules: pre-2008 gains).

FAQ Remittances (April 2008) correctly states:

> **Where a non-domiciled individual not resident in the UK, has purchased assets abroad out of income that has not been taxed in the UK, then moves to the UK and becomes resident, will the importation of those assets in the first year be taxed as a remittance?**
> No. As the untaxed income arose while the individual was not UK resident, there is no charge unless the proposed new s.832A ITA 2007 applies (temporary foreign residence).

## 9.21 RFI from Ireland

In the following discussion:
**"Irish income"** means RFI arising in Ireland.
**"Pre-2008 income"** means income arising before 6 April 2008.
The UK/Ireland DTA also needs to be considered but it is not discussed here. Similar points arise in relation to earnings: see 12.26 (Earnings from Ireland).

### 9.21.1 *Income from 2008/09*

The position for income from 2008/09 is straightforward. The ITA remittance basis treats Irish income in the same way as any other foreign income. The FA 2008 repealed the rule of the pre-2008 remittance basis which provided (unlawfully and probably ineffectively) that Irish income was taxed on an arising basis.

### 9.21.2 *Pre-2008 income remitted from 2008/09*

This change raised the problem of transition. Para 83 Sch 7 FA 2008 provides:

> (1) This paragraph applies to an individual's relevant foreign income for the tax year 2007-08 or any earlier tax year ("the relevant tax year") if—
> > (a) the individual made a claim under section 831 of ITTOIA 2005 for the relevant tax year, or
> > (b) section 65(5) of ICTA (or any earlier superseded enactment corresponding to that provision) applied in relation to the individual for the relevant tax year. ...
>
> (3) But nothing in section 832 of ITTOIA 2005 applies in relation to any

of the relevant foreign income that arose in the Republic of Ireland.

EN FB 2008 provides:

> 399. Sub-paragraph(3) provides that the new section 832 does not apply to relevant foreign income that arose in the Republic of Ireland. This ensures that no double charge can arise in relation to those tax years during which it was not possible to claim the remittance basis for such income. (This might be relevant for example where income arose in one of those years and was charged on an arising basis but was not remitted to the UK until on or after 6th April 2008.)

Para 83(3) disapplies the remittance basis charge for pre-2008 Irish income. In short, if:
(1) Irish income arose before 2008/09; and
(2) The income is remitted on or after 2008/09
there is no tax charge on remittance.

### 9.21.3 *Pre-2008 Irish income: tax position before 2008/09 and 2007/08*

As noted above, according to statute, Irish income was taxable on the arising basis: it did not qualify for the remittance basis. The discrimination against Ireland was contrary to EU law.[36] This book advised that those

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36 The point is more fully discussed in the 6th edition of this work para 9.51. It appears that the Irish Revenue agree. For the same point arose (in reverse) in Ireland (that is, under Irish law, UK source income was according to statute taxed on a remittance basis). But the Irish Revenue now agree that this was in breach of EU law. Irish Revenue eBrief No. 11/10 provides:

> "Under the provisions of Section 73 [Irish] Taxes Consolidation Act 1997, the remittance basis of assessment did not apply in respect of UK source income. However, Section 73 ceased to have effect in respect of UK income arising on or after 1 January 2008 (see Section 18 [Irish] Finance Act 2008). ...
> Under the provisions of Section 29(4) [Irish] Taxes Consolidation Act 1997, the remittance basis of assessment did not apply in respect of UK source chargeable gains. However, under the provisions of Section 42 [Irish] Finance (No.2) Act 2008, the remittance basis of assessment applies to chargeable gains arising in the UK as and from 20 November 2008.
> Section 18 [Irish] Finance Act 2008 and Section 42 [Irish] Finance (No.2) Act 2008 do not have retrospective effect. *However, arising from certain matters contained in a recent tax appeal case, Revenue are prepared to examine – on a case by case basis and subject to the statutory 4-year time limit for claiming repayment of tax –*

with pre-2008 Irish income should only agree to pay tax on the remittance basis. Where tax has been paid on an arising basis which would not have been paid on a remittance basis, a repayment claim should be made.[37] Under para 83(3) discussed above, pre-2008 Irish income which was not remitted before 2008/09 escapes UK tax altogether, since unremitted Irish income was not lawfully taxable when it arose and it is not (from 2008/09) taxable on remittance.

## 9.22 Remittance basis for trustees

### 9.22.1 *Income accruing before 2006/07*

Under the pre-2008 RFI remittance basis, a "person" who satisfies the relevant conditions could claim the remittance basis. The term "person" generally denotes individuals, trustees and companies.[38] The remittance basis therefore applied to trustees as well as to individuals.

Until 2006/07 a trustee qualified for the remittance basis (regardless of the beneficiaries or form of trust) if:

(1) the trustee was an individual domiciled outside the UK; or

(2) the trustee was a company incorporated outside the UK.[39]

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.

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*claims for repayment of tax where it is claimed that a repayment of tax would be due had the remittance basis of assessment, rather than the arising basis of assessment, applied for a relevant year of assessment in respect of an individual's UK source income and/or chargeable gains. ...*"

See *www.revenue.ie/en/practitioner/ebrief/2010/no-112010.html.*

37 For the limitation period see s.106 FA 2007.

38 Companies ceased to qualify for the remittance basis with the introduction of corporation tax in 1965: see 9.4 (History of the remittance basis).

39 Or (a rare case) if the trustee is resident but not ordinarily resident in the UK.

The domicile of a company is its place of incorporation. The charge to corporation tax does not apply to a company in its capacity as trustee: s.6 CTA 2009.

The application of the remittance basis to trust income of a UK resident foreign domiciled trustee was recognised in the former s.720(6)(b) ICTA, *Dawson v IRC* 62 TC 301 at 320 and the Trusts Consultative Document (1991) para 10.24.

### 9.22.2 *Income accruing in 2006/07*

Section 474(1) ITA provides:

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

Section 475 ITA goes on to ascribe to trustees a residence but not a domicile.[40] One possible solution is to look to the actual domicile of the trustees in their private capacities. But the trustee is deemed to be "distinct" from the persons who are actually the trustees so it is suggested that this is not the right approach. It is tentatively suggested, by analogy to company domicile, that the domicile should be taken to be the proper law of the trust. Another possibility is to say that trustees are not domiciled anywhere, but then all trustees qualify for the remittance basis, which would be absurd. The usual rule is that everyone has a domicile, and that rule should be applied here.

### 9.22.3 *Income accruing before 2008/09 remitted after 2008/09*

Since s.832 ITTOIA now only applies to individuals, trustees escape tax on income accruing before 2008/09 which is remitted after 5/4/2007. This is something of a windfall for trustees who qualified for the pre-2008 RFI remittance basis.

## 9.23 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

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40 See 4.4 (Trustee residence for income tax and CGT). One is looking at the domicile of the *trustees* and not the domicile of the "trust". Thus it does not matter that a trust does not have a domicile in the normal sense. (The Civil Jurisdiction and Judgments Act 1982 attributes a "domicile" to a trust, but the concept of domicile in that Act "has little in common, save in name, with the traditional concept": *Dicey and Morris, Conflict of Laws*, (13th ed., 2000) para 6-002.)

resident non-domiciled individuals.

HMRC required full disclosure of the taxpayer's worldwide assets. The taxpayer then offered to settle the tax liability on foreign sources for a fixed sum. A starting position was that one worked out the taxpayer's UK living expenses; deducted from that the amount of UK income; the balance then represented funds which would be required annually from overseas, on which tax was expected. The forward tax agreement related to foreign income and gains. UK source income remained taxable in the normal way. Malcolm Gunn explained:

> One may be able to negotiate the annual fixed payment downwards on the starting point figure. ... So in the final analysis, it is down to negotiating a deal which both the taxpayer and the Revenue feel they can live happily with.[41]

In the first edition of this book I said:

> It is likely that publication will stop the practice completely. Those who believe that tax should be governed by law will add: Quite right too.

Since then the courts have tried to stop these agreements by holding them to be *ultra vires*.[42] Where such agreements have been made in the past, a taxpayer may have a defence to an assessment if they can show they have suffered prejudice. It is an interesting question how these agreements will deal with the remittance basis claim charge.

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41 Transition from taxation by agreement to taxation by law raises additional problems discussed in Malcolm Gunn's article.

42 *Fayed v Advocate General* 77 TC 273. *Fayed*-style bargaining is however the basis of taxation of wealthy foreigners in many countries, including, I understand, Switzerland, France and Austria. Even in the UK after *Fayed* the temptation is ever present to move from the inconvenience of taxation by law to the convenient (but ultimately corrupt) method of taxation by negotiation.

CHAPTER TEN

# THE MEANING OF REMITTANCE

## 10.1 Meaning of remittance – Introduction

The ITA remittance basis is set out in ss.809K–809Z7 ITA. Section 809K(1) ITA provides:

> Sections 809L to 809Z6 apply for the purposes of—
> (a) this Chapter,
> (b) sections 22 and 26 of ITEPA 2003 (relevant foreign earnings charged on remittance basis),
> (c) section 41A of that Act (specific employment income from securities etc charged on remittance basis),
> (d) section 832 of ITTOIA 2005 (relevant foreign income charged on remittance basis), and
> (e) section 12 of TCGA 1992 (foreign chargeable gains charged on remittance basis).[1]

Thus the ITA remittance basis applies for most (but not quite all) tax purposes. In this chapter I shall not consider the exceptional cases where the ITA rules do not apply.

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1 Section 809K(2) ITA adds a (somewhat unnecessary) overview in accordance with the principles of Plain English Drafting:
"Those sections—
(a) explain what is meant by income or chargeable gains being 'remitted to the UK' (sections 809L to 809O),
(b) provide for the calculation of the amount remitted (section 809P),
(c) contain rules for attributing transfers from mixed funds to particular kinds of income and capital (sections 809Q to 809S),
(d) contain further provision in relation to certain foreign chargeable gains (section 809T and 809U), and
(e) treat income or chargeable gains as not remitted to the UK in certain cases (see sections 809V to 809Z6)."

### 10.1.1 *Remittance Conditions A to D*

Section 809L(1) ITA provides:

> An individual's income is, or chargeable gains are, "remitted to the UK" if—
> (a) conditions A and B are met,
> (b) condition C is met, or
> (c) condition D is met.

I refer to "**remittance conditions A to D**" to avoid confusion with the myriad other conditions in ITA.

It is considered that s.809L(1) is a comprehensive and not an inclusive definition of remittance, because of the complexity and breadth of the remittance conditions. That is, a sum is remitted if and only if one of these three sets of conditions are satisfied. In practice remittance conditions A and B are the most important.

I refer to a remittance within the meaning of s.809L(1) as **"a taxable remittance"**. A sum which can be received in the UK without a taxable remittance is referred to as **"clean capital"**.

### 10.1.2 *Why is the remittance basis difficult?*

The difficulty is inherent in the concept of a remittance basis. Although it is an exaggeration to say that "money has no earmark" it is often very difficult to trace or earmark money.[2] The fungibility between foreign income/gains and other assets makes it hard to determine whether any assets received in the UK should be regarded as the foreign income/gains. But this is what a remittance basis requires to be done.

Before 2008 the matter was largely left to the courts to sort out. It cannot be said that the courts were entirely successful.[3] In 2008 Parliament recast the rules in statutory form. It cannot be said that this is any more successful. The uncertainties are greater than before, complexity and

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

3 Thus Viscount Simonds referred to remittances as "this difficult branch of the law": *Thomson v Moyse* 39 TC 291 at p.328. Likewise Finlay J in *Kneen v Martin* 19 TC 33 at p.41: "This subject is always troublesome...".

record keeping are vastly increased,[4] and no less than before, careful planning is needed to avoid unfairness.

### 10.1.3 *Comparison with pre-2008 remittance basis*

The wording of the ITA remittance basis is so different that pre-2008 authorities on the remittance basis need careful review to see if they are still applicable under the ITA remittance basis, though some are still useful.

HMRC agree. The RDR Manual provides:

> **31210. Key differences between 'new' (post 5 April 2008) and 'old' regime (pre 6 April 2008)** [February 2011]
> ...The previous case law is now of limited relevance.

## 10.2 Relevant person – introduction

Before discussing the remittance conditions, it is necessary to consider the term "relevant person". All four remittance conditions use the term. "Relevant person" is defined in s.809M ITA. Section 809M(1) ITA provides:

> This section applies for the purpose of sections 809L, 809N and 809O.

In fact the definition applies throughout the remittance provisions.[5]

A relevant person strictly means the individual to whom income/gains accrue, as well as certain persons connected to them. But in the discussion below I generally refer to the individual himself as "the individual" and use the term "relevant person" to mean the others within the statutory definition.

Strictly one should not use the term "relevant person" in the abstract. A relevant person can exist only *in relation to an individual*. But where the context is clear it is permissible to refer to a relevant person in isolation (leaving the words "in relation to an individual" and the identity of that

4 The topic which took up 78 pages in the 2007/08 edition of this work needed three chapters and 300 pages in the current edition.

5 The term "relevant person" is also used in s.809Z2(2) where the drafter has to say expressly that the s.809M definition applies, and in transitional provisions.

individual to be inferred from the context).

Section 809M ITA sets out eight categories of relevant person. These can be split into three groups: close family, family companies and family trusts.

## 10.3 Relevant person – close family

The first four categories of relevant person are close family. Section 809M(2) ITA provides:

> A "relevant person" is—
> (a) the individual,
> (b) the individual's husband or wife,
> (c) the individual's civil partner,
> (d) a child or grandchild of a person falling within any of paras (a) to (c), if the child or grandchild has not reached the age of 18.

### 10.3.1 *Persons living together*

Section 809M(3) ITA provides:

> For that purpose—
> (a) a man and woman living together as husband and wife are treated as if they were husband and wife;
> (b) two people of the same sex living together as if they were civil partners of each other are treated as if they were civil partners of each other.

This provision treats cohabitees as married persons and so relevant persons. This was a relatively new development in tax, but it has now become standard in anti-avoidance provisions.

The New Tax Credits Claimant Compliance Manual provides:

> **15040 Couples who are Unmarried and Not Civil Partners** [April 2010]
> ... The legislation does not say what conditions must exist before we will conclude that a couple are LTAHAW [living together as husband and wife]. We have therefore adopted the approach used by the DWP. Using the same approach for same-sex couples means they are not treated any more or less favourably.
> Since 1977 the Department for Work and Pensions (DWP - formerly the Benefits Agency) has followed a standard approach to the question of whether a man and woman are living together based on a list of criteria to be considered both

individually and as a whole. Working Families' Tax Credit (WFTC) adopted the same criteria and this has continued for WTC and CTC. This approach ensures unmarried couples are not treated any more or less favourably than married couples.

Living together as husband and wife (LTAHAW) has its normal meaning in every day language, but the Courts and administrative practice have developed a number of criteria to help apply that meaning to every day situations. They are:-

- living in the same household - CCM15070-CCM15075
- stability of relationship - CCM15080
- financial support - CCM15090
- dependent children - CCM15100
- public acknowledgement - CCM15110

Remember that these are only indicators to help you form a sustainable view of whether a couple are living together for the purposes of the tax credit claim. They are not intended as a crude checklist and you should not apply a blanket "four out of five ticked" type test. The weight and worth of each indicator will vary from relationship to relationship and you should arrive at your conclusions on the balance of evidence, based on the facts (see CCM15060). However, you need to be aware of the changing nature of relationships - see CCM15045.

**15045 Modern-Day Relationships** [April 2010]

Since the LTAHAW criteria was devised in the 1970's, the United Kingdom has undergone major social and economic changes. These have had an impact on the nature of personal relationships.

In the 1970's a typical couple might not have lived together before marriage and, after marrying, they might have pooled the whole of their income with the man as the main breadwinner and the woman possibly working part-time and responsible for childcare and running the household.

By 2004, 70% of first domestic partnerships involved unmarried couples and it is now common for each party in a couple to work full-time, keep their own incomes and bank accounts and perhaps only pay money into a joint account for items of joint responsibility. Often because of demands on time both parties share childcare and domestic tasks.

It may therefore be more difficult to identify the criteria shown at CCM15040 but you should still explore all of these items.

**15060 Balance of Evidence** [September 2008]

It is not possible to lay down hard and fast rules about the weight and worth of the various criteria in establishing that a couple are living together. You will need to decide every case on its merits and on the balance of evidence. Sometimes the conclusion will be obvious, and at other times it will be a very fine judgement. Although you must consider each of the five criteria listed at CCM15040 you might not be able to gather evidence for each of them. For example the claimant might say they have no idea what others think of their relationship.

If you are having difficulties in making up your mind about what the evidence means, you may find it helpful to list the evidence on both sides of the argument. This should help you identify where the balance of evidence lies – though you should not base your decision on a crude numerical assessment, as some elements of the evidence may be far more critical than others.

If you still cannot decide, you may want to discuss the issues with your manager, or with another colleague in your team. If the issues are particularly difficult, you may, after consulting your manager, want to refer to your Claimant Compliance Group Manager.

Where there is no reply to your opening letter – see CCM15370.

**15070 Living in the Same Household** [April 2010]

The claimant may admit they live in the same household as the suspected partner but that does not automatically mean they are Living Together as Husband and Wife (LTAHAW) or Living Together as Civil Partners (LTACP).

There may be any number of reasons why a man and woman share accommodation. They include:

- a couple with disabilities or ill health may care for and support each other
- one of them may require care/support to live a normal life
- the claimant may provide accommodation for a friend, or relative or tenant
- the claimant may have been provided with accommodation by a friend, relative or landlord in that person's own home.
- a formerly married or unmarried couple may still live in the same house until they reach a financial agreement. During periods when property prices or rents are high, the property market is sluggish, or negative equity is common, former couples may be compelled by economic necessity to share the same premises for some time after the relationship has ended- see CCM15395

The relevant factors to consider when determining whether a couple are living in the same household may be:-

- how/why the couple came together
- is rent received or paid? If so the income will (unless it is exempt under the rent a room scheme) be treated as income in the hands of the recipient.
- what kind of accommodation they share
- if there is no formal rent agreement how are costs shared? How would exceptional expenditure be met? For example, if major unexpected repairs had to be carried out or home improvements made.
- any absences from the household - why and how often - see CCM15073
- any other reasons for them living in the same household.

Even if you establish a couple are living in the same house this does not necessarily mean they are LTAHAW or LTACP. Before you can amend the award you must therefore consider the other criteria detailed at CCM15080-CCM15110.

**15073 Absences From The Home** [April 2010]

Absences from the home, whether occasional or regular, do not necessarily mean that a couple is not LTAHAW or LTACP. For instance, the absence could be due to:-

- work (eg. oil rig worker or long distance lorry driver)
- hospital in-patient
- holiday
- visit to relatives
- higher education

- custody of less than 52 weeks
- armed forces

This list is not exhaustive, but gives some suggestions to the types of absence. The common feature of all of these reasons for absence is their temporary nature. There is no specific period of time after which an absence ceases to be temporary and you will need to draw conclusions based on the particular facts of each case. Factors to be considered include:

- the length of the absence
- how much longer it is expected to last
- to what extent the couple have maintained contact
- their future intentions

One situation you might encounter is where the partner works away for a few days at a time and either lives with friends or in hotels/bed and breakfast accommodation. They only return to the claimant's home for a couple of days at a time, the suggestion is this is purely to see the children and they stay at the claimant's home as they have nowhere else to stay in the area. As well as exploring the other criteria described in CCM15080-CCM15110 you will need to establish

- the reason why they have this arrangement
- how long has the arrangement lasted
- how much longer is it likely to last?
- what would happen if the partner lost their job?

**15075 Undisclosed Partner has No Other Address** [April 2010]

A claimant may accept that the suspected partner uses their address for mailing purposes. This could be for:

- tax and benefit purposes
- financial purposes (bank account, credit card, loan)
- for motor vehicle purposes (insurance, vehicle registration)

The claimant might suggest this is because the suspected partner has no fixed abode and simply drifts around a series of friends or because their mail is not secure at their own home.

You are entitled to ask for evidence of the suspected partner's other accommodation address and often an appeal tribunal will ask for this sort of information. However, you cannot demand that they provide such information nor can you say that if they do not provide evidence of an alternative address you will treat them as LTAHAW or LTACP and terminate their award.

The absence of such evidence is not conclusive proof that the claimant is living with the suspected partner. Where the claimant cannot provide such evidence you must still look at all of the other criteria and decide their various strengths and weaknesses. In addition, you should consider whether it is reasonable for the suspected partner to be using the claimant's address.

**15080.Stability of Relationship** [October 2005]

The length of time a couple have been together does not necessarily indicate how stable the relationship is. At one end of the scale you may come across couples who have known each other only a few weeks or days, but who have moved in together with the firm intention of staying together.[6] At the other end of the scale may be couples who have divorced after say 25 years of marriage and who are still both occupying the formal marital home until they can afford to live apart. Some couples may also have a history of repeated temporary splits and reconciliations.

Relevant factors may be: –

- on what basis they split household chores and responsibilities, such as cooking, cleaning and paying bills
- whether they are both involved in caring for any children who live in the household
- whether they tend to spend their leisure time together or separately
- whether they normally take joint holidays
- whether they plan any future activities or responsibilities jointly or separately
- whether they intend to get engaged or married
- whether the relationship has a volatile history ie. the couple is known to have had several splits and reconciliations.

An established pattern of domestic or financial activity will usually indicate an established relationship.

**15090 Financial Support** [April 2010]

How a couple organise their finances will vary from couple to couple. Relevant factors may be:

- the existence of joint accounts or investments. If the claimant claims that the joint account is being maintained because one of them is credit blacklisted, does the pattern of transactions suggest that the other person is withdrawing his/her wages for their own use? Or are there indications that the wages are available to meet general household expenditure?
- the extent to which money and other financial resources are pooled.
- who pays the household expenses?
- whether the suspected partner makes regular payments to the claimant, and if so, what they are for.
- whether the suspected partner would provide financial support if the claimant's income ceased.
- whether the claimant would support the suspected partner if their income ceased.
- whether a set amount of maintenance to be paid by the absent parent following a decision by the CSA or a binding agreement between the parties.

At any meeting you should attempt to establish the claimant's incomings and outgoings so that you can see whether they could exist on their own income. If you have already seen bank statements and household bills you should be ready to challenge suspect items. For example deposits into the bank account, direct

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6 The RDR Manual makes the same point:

**33030. Relevant person - definition** [July 2010]

... There is a no minimum period for cohabitation; it is a question of fact as to whether two individuals are living together as spouses or civil partners.

debits, patterns of withdrawal or any expenses for which you would have expected to see bills but none have been produced.

**15100 Dependent Children** [April 2010]

Joint responsibility for a child or children (who may belong to either or both of the couple) may be an indication that the couple is LTAHAW or LTACP, but it is not conclusive proof. Relevant factors may be:

- parentage of the child or children.
- whether, and how, the couple exercises joint responsibility, for example:
  - who visits the school or delivers/collects to and from the school
  - who would the school contact in an emergency
  - who arranges and takes the children to and from medical and dental appointments
  - who exercises control of or offers guidance to the children
  - who the Child Benefit Office has as the alternative payee
  - who provides financial support/pocket money/pays for treats
  - who buys the clothes and or toys.

An intention to adopt by the non-birth partner could be a particularly telling indication of the couple's long term view of the family unit. You should not, because of its sensitivity, seek out the information; but if it is spontaneously offered you should give it proper weight in arriving at your conclusions. Be wary of drawing conclusions about the current relationship based on say the fact that the children continue to be known by the surname of the ex-husband or ex-partner as this is common practice and is not evidence of a continuing relationship between the parents. Nor does the presence of photographs of the child's father or mother indicate the claimant is living with that person.

**15110 Public Acknowledgement** [October 2005]

An important consideration is how the outside world (including family, friends, neighbours, social workers, employers, schools, childcare providers, etc.), perceive the couple. Relevant factors may be:

- Whether both members use the same surname
- Whether schools/child care providers/employers/others regard them as a couple
- Whether they engage in social activities together
- Whether they are joint members of clubs/leisure centres/societies
- Whether they plan and organise their lives jointly.

CCM5500 lists the third parties you can legally approach for information during the course of your examination. You cannot obtain information from family members, friends, neighbours, social workers or schools, unless they also fall into one of the categories listed at CCM5500.

For example – A family member may also be an employer, or a neighbour may also provide registered child care. But it is perfectly acceptable for you to ask the claimant what their family/neighbours etc. would say if they were asked whether they regarded him/her as being a member of a couple.

**15120 Sexual Relationship** [January 2008]

DWP used to consider the couple's sexual relationship as one of the criteria for determining LTAHAW but this is no longer the case. The couple's sexual relationship is of little help in deciding whether they are living together as husband and wife or living together as civil partners. There may be no sexual relations in a marriage or civil partnership and sexual relationships of a casual nature, where neither partner has any lasting commitment to the other, are a common feature of contemporary life.

You must not ask any questions about a couple's sexual relationship. If the claimant introduces the subject, you should take note of any information volunteered but should bear in mind (and explain to the claimant) that it is unlikely to have any relevance to the question of whether they are living together as husband and wife.

Appeal tribunals sometimes ask claimants about their sexual relationships, however, it remains our policy that you must not ask such questions. If a tribunal asks you why you have not established the position you should say that our internal policy, in common with that in DWP, is not to ask about this side of the relationship.

In one particular appeal case the Social Security Commissioner said that where there has never been a sexual relationship between the parties, strong alternative grounds are needed to reach the conclusion that the relationship is akin to husband and wife. However, absence of a sexual relationship at anytime where there has been one in the past is not itself indicative that the couple are not LTAHAW.

Where the claimant's sole objection to your conclusion is that they have no sexual relationship with the suspected partner or they appeal against a decision on these grounds you should seek further advice from the Benefits and Credits Technical team in Preston.

**15150 Reasons for Failure To Report A Partner** [April 2010]

Claimants may offer a range of reasons or excuses for their failure to report the existence of a partner. These may include:

- S/he does not stay here all of the time - see CCM15073.
- S/he lives at another address but uses my address as a post box - see CCM15075.
- I thought s/he could stay 3 nights a week without it affecting my entitlement.
- S/he does not give me any money, or payments are not regular - see CCM15090.
- S/he is not the mother/father of my child (ren).
- S/he is a lodger - see CCM15070.
- S/he is just a friend.
- It is hard being a single parent.
- The Government does not pay people like me enough.
- The rules on income are not fair.
- We do not have a sexual relationship - see CCM15120.

The 3 nights rule is a popular misconception. No such legal loophole exists. If a suspected partner spends 3 nights with the claimant on a regular basis, s/he may be a member of an established couple. Also, the children's parentage is not, in isolation, reliable evidence.

You will need to explain to the claimant the criteria which we use to determine whether they are living together as husband and wife or living together as civil partners - see CCM15040. You will then need to establish the facts by considering all the evidence from all legally available sources, including the claimant.

**15160 Respecting Claimant's Privacy** [October 2005]

In all your contacts with claimants you must always be aware of Human Rights issues, and of the need to respect the claimant's privacy. It is particularly important that you adopt this approach in any discussions which may touch on their private life.

You should avoid any impression that you are examining the claimant's home or household for signs of any such relationship. You must not ask about the claimant's sleeping arrangements in an attempt to find out whether s/he shares a bedroom with another adult.

Claimants may however volunteer information of this kind when, for example, confirming the number of children who live there; describing how friends or relatives sometimes stay to help out with childcare or explaining that their ex-partners stays in the spare room whenever they come to visit the children. If the claimant simply says their partner stays overnight when they come to visit or care for the children you must not ask where they sleep.

You should not normally ask claimants about the number of bedrooms in their house but if the claimant has suggested that an adult who lives in the house is a paying lodger, it is reasonable to expect the lodger would have his/her room rather than sleeping on a sofa or floor.

In the circumstances it will be appropriate to ask how many bedrooms there are and what room(s) the lodger occupies, and to test the answer in the light of other information/evidence. The number of bedrooms and the ages/sexes of the other occupants of the house will be relevant. For example the claimant may live in a 3 bedroom house with 2 children, a boy of 12 and a girl of 16, and it will be reasonable to ask what arrangements have been made so that the lodger can occupy his/her own room.

It is important that any questions you need to ask should be directed at establishing the room the lodger occupies and their relationship with the claimant and not at establishing who the claimant sleeps with.

**15170 (This text has been withheld because of exemptions in the Freedom of Information Act 2000)** [June 2006]

**15180 (This text has been withheld because of exemptions in the Freedom of Information Act 2000)** [June 2006]

**15190 Claimant Has Been Involved in Different Relationships** [October 2005]

Where the claimant has been involved in relationships with different partners at different times during the year, you should treat the ending of one and beginning of another as a CoC on each occasion. However, where the claimant has split up and reconciled with the same partner, you should normally ignore the splits and treat the claimant and partner as a couple throughout the period.

If the claimant objects to this approach you should consider whether in spite of the temporary break in the relationship, the claimant and partner would still be considered a couple in accordance with other relevant criteria eg. nature of any financial support. If you cannot establish that the couple were effectively living together throughout the period, you should apply the CoC provisions to each break in the relationship.

**15195 Date on which Claimants Became A Couple** [October 2005]

The question of whether the claimant was in reality a member of a couple is not just relevant to the date at which the claim commenced. Becoming or ceasing to be a member of a couple is a notifiable change of circumstances so it is also relevant at all other times during the year.

You will sometimes have evidence that places the suspected partner at the claimant's address at one or more dates during the year for example a series of letters signed by the partner to his/her employer or tax office. However, you may not be able to point to anything which strongly indicates their presence at the beginning of the year or claim period.

When challenged about the existence of a partner, claimants may be reluctant to admit to their failure to declare the partner on the claim, claiming instead that s/he only moved in some time later.

You will need to use your judgement in these cases. As a general rule if you are confident the evidence you have is reasonable proof that the claimant was a member of a couple from the date the claim commenced, you should put that date forward to the claimant. If you feel there is some doubt around that date, or you would have difficulty in substantiating it, but you are convinced that the claimant was a member of a couple at some point during the year, you should propose to the claimant an appropriate date from which they should be treated as a member of a couple. You should be prepared to negotiate the date with the claimant bearing in mind the important factor of getting the claim on the right basis for the future. However, you must remember that your decision may have to be defended before an appeal tribunal so you must have evidence to support the proposal.

**15200 Information held by HMRC** [October 2005]

A case identified for enquiry on the grounds of a suspected undisclosed partner will usually have been selected because information held by us indicates another adult living at the claimant's address. The CCRO will have checked HMRC and other databases and other available information sources, before passing the case to you. You will therefore already have most of the evidence you will want to discuss with the claimant before you open the case.

The information is likely to include some or all of the following sources.

| **Type** | **Identifies** |
|---|---|
| Voter's List | Suspected partner listed? |
| HMC address database | What address does the HMRC hold for suspected partner? |
| Telephone Directory | What address/phone number is listed for suspected partner? |
| Yellow Pages/Other | Ditto for self employed suspected partner. |
| SA | Ditto for self employed suspected partner. |
| TRP Data Mart | Any joint bank accounts etc, listed? |
| COP/CODA | Any additional allowances? |
| Child Benefit | Partner shown on original claim/as alternative payee? |
| Previous Claims | Was partner shown on earlier WFTC/DPTC/WTC/CTC claims? |
| Equifax/Experian | Is suspected partner shown at claimant's address? |

| | |
|---|---|
| DWP | Intelligence suggesting a live-in partner? |
| CSA | Maintenance paid? Reference to partner in interview notes. |
| Housing or Council Tax Benefit | Details of occupants. CT reduction for single adult being Received? |
| Letters on File | Any indication (particularly recent) of suspected partner living at claimant's address? |

**15210. Information from Claimant** [April 2010]

Despite the information that will have been given to you by the CCRO there will also be information you can only obtain from the claimant or with the claimant's agreement, for example:

- Bank statements - are they joint? If not, do they contain evidence of joint incomings/outgoings/spending?
- Utilities and other bills - who are these sent to?
- Council tax bills - a single occupier is entitled to a reduction, which will be identified on the statement.
- Mortgage claims/statement - whose name appears on any documentation?
- Rent book - whose name appears in the book as landlord and tenant?
- Hire purchase agreements - whose name is on the documents?
- Services and rentals eg. TV, satellite, telephone agreements - whose name are they in?
- Marriage certificate - does it show a recent marriage to the suspected partner?

(This text has been withheld because of exemptions in the Freedom of Information Act 2000)

**15220 Short Term Relationships** [January 2006]

In some cases the claimant might admit they had a partner during the period under review but says they are no longer a couple. You will need to review the facts to establish whether they are in fact still a couple.

Where the claimant admits to a short term relationship which you accept has now ended you will need to decide whether the relationship amounted to them living together as husband and wife (LTAHAW) or living together as civil partners (LTACP). You will need to explore the criteria at CCM15040.

There are no hard and fast rules as to the length of time a couple are together before we consider it to be LTAHAW or LTACP. If they are LTAHAW or LTACP then we will treat them as a couple for tax credit purposes even if they are only together a short time. However, in reality a short term relationship (less than 3 months) is unlikely to meet the criteria at CCM15040. They may satisfy one of the criteria but not the others. In such cases you will have to use your judgement and you should consult your manager if necessary. Remember your decision may have to be defended before an appeal tribunal so you must have evidence to support the proposal.[7]

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7 Earlier versions of this guidance are (1) The Independent Taxation Manual (paragraphs now withdrawn) and (2) the ACG–WFTC/DPTC Applicant Compliance Guide para 9010 (not set out here as it adds nothing to the New Tax Credits Claimant Compliance Manual). The text is in the 9th ed of this work.

The Law Commission consultation paper "Intestacy and Family Provision" (October 2009) has some useful comments:

> 2.70 The requirement that the applicant should have been living "as" the spouse or civil partner of the deceased has been the subject of analysis by the courts. In *Re Watson*, it was said that the test is:
>
> > whether, in the opinion of a reasonable person with normal perceptions, it could be said that the two people in question were living together as husband and wife; but, when considering that question, one should not ignore the multifarious nature of marital relationships.[8]
>
> 2.71 Accordingly, it was not determinative in that case that Mr Watson and Miss Griffiths had not continued a sexual relationship during the period when they were living together, nor that they had informally agreed to share outgoings, nor that Miss Griffiths had rejected Mr Watson's marriage proposal. On the whole of the evidence the judge reached the conclusion that Miss Griffiths had been living "as the wife" of Mr Watson.
>
> 2.72 The couple must have been living in the same household, which means that it does not matter if the parties each have a separate home, provided that they have formed one joint household. It has been said that this seems:
>
> > To have elements of permanence, to involve a consideration of the frequency and intimacy of contact, to contain an element of mutual support, to require some consideration of the degree of voluntary restraint upon personal freedom which each party undertakes, and to involve an element of community of resources.[9]

The Law Commission also consider the salacious possibility that an individual may have more than one cohabitee:

> 4.108 ... where the deceased was a party to more than one cohabiting relationship at the date of death, it may be more difficult to determine

8 [Footnote original] [1999] 1 FLR 878, 883, by Lord Neuberger of Abbotsbury.

9 [Footnote original] *Churchill v Roach* [2002] EWHC 3230, [2004] 3 FCR 744, 761. See also *Kotke v Saffarini* [2005] EWCA Civ 221, [2005] 2 FLR 517, a case on similar wording in section 1(3)(b) of the Fatal Accidents Act 1976, where the Court of Appeal held at [59] that it was correct to distinguish between "wanting and intending to live in the same household, planning to do so, and actually doing so".

whether the deceased "was sufficiently involved in either household for one or both to amount to cohabitation at all".[10] However, cases may arise in which it can be shown that both partners are cohabitants within the definition adopted, for example where there are religious marriages which do not qualify as legal marriages.

### 10.3.2 *Prohibited Relationships*

The New Tax Credits Claimant Compliance Manual provides:

> **15025 Prohibited Relationships** [January 2006]
> The law prohibits certain relationships by relatives. For example a woman cannot marry or form a civil partnership with her grandfather or her uncle and a man cannot marry or form a civil partnership with his daughter or sister. A full list of prohibited relationships is contained at CCM15030.
> Where you establish that a claimant is living as a couple with a relative who appears on the list of prohibited relationships we do not consider this to be an LTAHAW or LTACP situation. The reason for this is that the couple cannot marry or become civil partners in law so we cannot say they are living together as husband and wife as they could never be husband and wife or living together as civil partners as they could never be civil partners. The claimant will therefore be treated as a single claimant.
> **15030 List of Prohibited Relationships - Marriage** [April 2010]
> Throughout the United Kingdom and Guernsey, Jersey and the Isle of Man, the law prohibits certain blood relatives, step relatives and relatives-in-law from getting married.
> A man cannot marry his:
> - mother
> - adopted mother/ former adoptive mother
> - daughter
> - adoptive daughter/ former adoptive daughter
> - grandmother
> - granddaughter
> - sister
> - aunt
> - niece
>
> A woman cannot marry her:
> - father
> - adopted father/ former adoptive father
> - son
> - adoptive son/ former adoptive son

10 [Footnote original] Cohabitation: the Financial Consequences of Relationship Breakdown (2007) Law Com No 307, para 3.68.

- grandfather
- grandson
- brother
- uncle
- nephew

Additionally, people cannot marry if:

- either of them is aged less than 16, or
- in a ‘step’ relationship, the younger person had, before reaching age 18:
- lived in the same household as the older person, and/or
  - been treated as a child of the older person’s family, or
- in an ‘in-law’ relationship:
  - either person involved is aged less than 21, and/or
  - any person originally involved in creating the ‘in-law’ relationship’ is still alive, for example we do not consider LTAHAW if a man lives in the same household as his daughter-in-law and the man’s son or wife is still alive.

If you are unsure whether the claimant is in a prohibited relationship you should seek further advice from the Benefits and Credits Technical Team in Preston.

**15032. List of Prohibited Relationships - Civil Partners** [April 2010]

The law in the United Kingdom prohibits certain blood relatives, step relatives and relatives by civil partnership from forming a civil partnership. The legislation in Scotland is slightly different from the legislation that applies in England, Wales and Northern Ireland.

In England, Wales and Northern Ireland someone cannot form a civil partnership with their:

- parent
- adopted parent/ former adoptive parent
- child
- adoptive child/ former adoptive child
- grandparent
- grandchild
- brother, sister, half-brother or half-sister
- parent’s brother, sister, half-brother or half-sister
- niece or nephew

Additionally, someone cannot form a civil partnership with the:

- Child of former civil partner
- Child of former spouse
- Former civil partner of grandparent
- Former civil partner of parent
- Former spouse of grandparent
- Former spouse of parent
- Grandchild of former civil partner
- Grandchild of former spouse

If:

- either of them is aged less than 21, or
- the younger person had, before reaching age 18:
- lived in the same household as the older person, and/or

- been treated as a child of the older person's family, or

Additionally, someone cannot form a civil partnership with the:

- Child of former civil partner
- Child of former spouse
- Former civil partner of parent
- Former spouse of parent

If:

- either person involved is aged less than 21, and/or
- any person originally involved in creating the relationship is still alive, for example we do not consider LTACP if a woman lives in the same household as her daughter-in-law and the woman's son or husband is still alive.

In Scotland someone cannot form a civil partnership with their:

- parent
- adopted parent/ former adoptive parent
- child
- adoptive child/ former adoptive child
- grandparent
- grandchild
- brother, sister, half-brother or half-sister
- parent's brother, sister, half-brother or half-sister
- niece or nephew

Additionally, someone cannot form a civil partnership with the:

- Child of former civil partner
- Child of former spouse
- Former civil partner of grandparent
- Former civil partner of parent
- Former spouse of grandparent
- Former spouse of parent
- Grandchild of former civil partner
- Grandchild of former spouse

## 10.4 Relevant persons - companies

The provisions discussed in this section have had a complicated evolution. I omit it here - reluctantly as the story has amusing aspects - as it is now of historic interest only.[11]

Under s.809M(2)(e) ITA the next category of relevant person is:

(e) [i] a close[12] company in which a person falling within any other

11 The reader may turn to the 9th edition of this work for a lesson in how not to legislate.

12 Section 809M(3)(c) ITA provides the standard definition:

"'close company' is to be read in accordance with Chapter 2 of Part 10 of CTA 2010 (see in particular section 439 of that Act)."

paragraph of this subsection is a participator, or

[ii] a company which is a 51% subsidiary[13] of such a close company.

Under s.809M(2)(f) ITA the next category of relevant person is:

(f) [i] a company

[1] in which a person falling within any other paragraph of this subsection is a participator, and

[2] which would be a close company if it were resident in the UK, or

[ii] a company which is a 51% subsidiary of such a company

This is intended to catch family companies but it is widely drawn. An individual would not usually know whether or not any company is a relevant person in relation to them, because they cannot tell whether it might have a participator who is a trustee of a RP trust. Companies may also be caught as bodies connected to trusts.[14]

### 10.4.1 *"Participator"*

The key term here is "participator". Section 809M(3)(ca) ITA provides:

"participator",

[i] in relation to a close company, means a person who is a participator in relation to the company for the purposes of section 455 of CTA 2010 (see sections 454 and 455(5) of that Act), and,

[ii] in relation to a company that would be a close company if it were resident in the UK, means a person who would be such a participator if it were a close company

This incorporates s.455(5) CTA 2010 which provides a wider than standard definition of "participator":

13 Section 809M(3)(cb) ITA provides the standard definition:

"'51% subsidiary' has the same meaning as in the Corporation Tax Acts (see Chapter 3 of Part 24 of CTA 2010)."

14 See 10.6 (Body connected with trust).

> If a company (C) controls[15] another company (D), a participator in C is to be treated for the purposes of this section as being also a participator in D.

For this definition, see 73.15 (Definition of participator).

## 10.5 Relevant persons – trusts

Under s.809M(2)(g) ITA the next category of relevant person is:

> (g) the trustees of a settlement of which a person falling within any other paragraph of this subsection is a beneficiary.

This is intended to catch family trusts but it is so widely drawn it covers many if not most trusts in existence.

I refer to a trust within s.809M(2)(g) as an "**RP trust**".

Section 809M(3)(e) ITA defines "beneficiary":

> "beneficiary", in relation to a settlement, means any person who receives, or may receive, any benefit under or by virtue of the settlement;

Thus every trust with an unrestricted power to add beneficiaries (which is a standard form) is an RP trust. But if the power to add is only exercisable with the consent of an individual the position is different.

If T is excluded but lends interest-free to the trust, it is considered that the trust does not become an RP trust in relation to T. T may receive a benefit (on repayment of the loan).[16] However that benefit arises under or by virtue of making the loan to the trustees, and under or by virtue of the loan agreement, but not under or by virtue of the settlement.[17]

A trust is not an RP trust in relation to T if its terms provide that children or grandchildren of T can benefit only after they have reached the age of

15 The ultra-wide definition of "control" applies: see 73.4 (Control in ultra-wide sense).

16 See 24.3.2 ("Settlor-interested" for IT purposes).

17 The same point arises in relation to pre-owned assets, where HMRC accept a similar argument: see 66.8 (POA intangible property charge).

18.[18]

Section 809M(3)(d) ITA provides:

> "settlement" and "settlor" have the same meaning as in Chapter 2 of Part 9.

This brings in the standard IT/CGT definition of "settlement".[19] The definition of "settlement" seems unnecessary, since this definition applies except so far as the contrary intention otherwise requires; but it does no harm.[20]

The definition of "settlor" is otiose as the word is not used in the definition of "relevant person".

Section 809M(3)(f) ITA provides:

> "trustee" has the same meaning as in section 993 (see, in particular, section 994(3)).

So we need to turn to s.994(3) ITA:

> For the purposes of section 993 "trustee", in the case of a settlement in relation to which there would be no trustees apart from this subsection, means any person—
> (a) in whom the property comprised in the settlement is for the time being vested, or
> (b) in whom the management of that property is for the time being vested.[21]

---

18 See *Vestey v IRC* 31 TC 1 which decided that a trust with a power to benefit the widow of the settlor was not settlor-interested. At the time that the income arose:
(1) The settlor's wife could not benefit (as she was not a widow).
(2) It was possible that in the future she could benefit (as she might survive the settlor and so become a widow). That did not matter because the legislation (which is comparable to s.809M) was held to apply only if *at the time that the widow received a benefit* she fell within the words "spouse of the settlor".

19 See 69.2.2 (Standard IT/CGT definition of settlement).

20 The definition is useful for the avoidance of doubt, since s.809M twice refers to s.993 ITA, where the settlement-arrangement definition applies. Thus the definition makes it clear that the settlement-arrangement definition of settlement is not applicable to s.809M.

21 For completeness: s.994(3) concludes: "Section 466(4) does not apply for the purposes of this subsection." That has no relevance here.

Section 809M(3)(f) (incorporating the s.994(3) definition of trustee) is misconceived. The s.994(3) definition of trustee makes sense in the context of s.993 ITA where settlement means settlement-arrangement (which may not have trustees). It does not make sense in the context of s.809M ITA where settlement means classic settlement, which must have trustees. But no significant harm arises from this mistake.

## 10.6 Body connected with trust

Under s.809M(2)(h) ITA the last category of relevant person is:

> (h) a body connected with such a settlement.

That is, a body connected with a settlement within 809M(2)(g), a settlement of which some other relevant person is a beneficiary.

### 10.6.1 *"Connected with a settlement"*

Section 809M(3)(g) ITA defines "connected with":

> a body is "connected with" a settlement if the body falls within section 993(3)(c), (d), (e) or (f) as regards the settlement.

This must not be confused with the more common tax concept of "connected person".

In order to follow it one needs to set out the four paragraphs of s.993(3)(c)(d)(e) and (f).

First, s.993(3)(c)(d) ITA provide:

> (3) A person, in the capacity as trustee of a settlement,[22] is connected with ...
> (c) any close company whose participators include the trustees of the settlement,

22 "Settlement" in s.993 means settlement-arrangement: see s.994(1) ITA. However for a body to qualify as a relevant person under s.809M(2)(h) there needs to be a settlement within the standard IT/CGT definition.

> (d) any non-UK resident company which, if it were UK resident, would be a close company whose participators include the trustees of the settlement

Section 809M(3) is not elegently drafted. It refers to a body connected with a settlement; whereas s.993 refers to bodies connected with trustees of a settlement; but the meaning must be the same.

At first sight it seems unnecessary for s.809M(3)(g) to refer to s.993(3)(c) or (d), because any company within (c) or (d) would be a relevant person in any event under s.809M(2)(e) or (f).[23] But this does make a difference as can be seen from the examples below. In any case, one needs to have them in mind in order to understand s.993(3)(e).

"Participator" in s.993(3)(c)(d) is not defined; it is considered that it bears the normal close company meaning.

Section 993(3)(e) ITA provides:

> (e) any body corporate controlled (within the meaning of section 995) by a company within para (c) or (d)

That takes us to s.995 which provides:

> (1) This section has effect for the purposes of the provisions of the Income Tax Acts which apply this section.
> (2) In relation to a body corporate ("company A"), "control" means the power of a person ("P") to secure—
> (a) by means of the holding of shares or the possession of voting power in relation to that or any other body corporate, or
> (b) as a result of any powers conferred by the articles of association or other document regulating that or any other body corporate,
> that the affairs of company A are conducted in accordance with P's wishes.
> (3) In relation to a partnership, "control" means the right to a share of more than half the assets, or of more than half the income, of the partnership.

Lastly, s.993(3)(f) ITA provides:

23 Because the trustees are participators.

(f) if the settlement is the principal settlement in relation to one or more sub-fund settlements, a person in the capacity as trustee of such a sub-fund settlement.

It seems unnecessary for s.809M(3)(g) to refer to s.993(3)(f). Possibly the drafter only intended to refer to s.993(3)(c)(d)(e) and the reference to (f) slipped in by mistake. But since sub-fund settlements are dead-letter tax law (never found in practice) the point does not matter.

### 10.6.2 *"Body"*

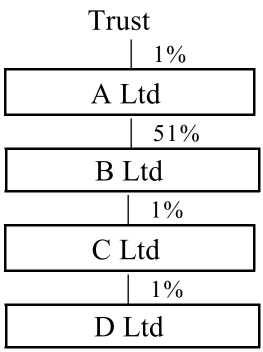
Section 809M(2)(h) refers to a "body" connected with a settlement. The term is wide and somewhat vague. However in order to fall within s.993(3)(c)(d) the body must be a company. In order to fall within s.993(3)(e) the body must be a body corporate. Presumably the word "body" was selected as the apt term to include the (somewhat theoretical) case of trustees of sub-funds under s.993(3)(f).

What if trustees control a partnership? A general or limited partnership is not a relevant person under s.809M(3) since although it is a body, it is not a company or body corporate. A LLP is a body corporate, but is deemed not to be one for IT and CGT purposes; s.993 clearly assumes that a partnership is not a body corporate.

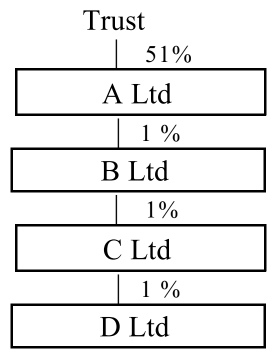
## 10.7 Companies as connected persons: examples

It may be helpful to give some examples of how the relevant person rules apply to trust/company structures. In the following examples:
**"An (e) company"** is one which is a relevant person under s.809M(2)(e).
**"An (f) company"** is one which is a relevant person under s.809M(2)(f).
**"An (h) company"** is one which is a relevant person under s.809M(2)(h).
**"A non (e) person"** is a person who falls within any other paragraph of 809M(2) ie not a person who falls outside 809M or who is *only* within para (e).
**"A non (f) person"** is a person who falls within any other paragraph of 809M(2) ie not a person who falls outside 809M or who is *only* within para (f).

*Example 1*




*Example 2*




Assume the trust is a relevant person (eg the individual is a beneficiary). Assume all the companies are UK resident or non-resident close companies.
A Ltd is an (h) company. It is also an (e) company if UK resident or an (f) company if non-resident. However since it is an (h) company that does not matter; it is a non (e) person and a non (f) person (as those expressions are defined).

*Example 1*
Assume first that the companies are all non-resident close companies.
B Ltd is an (f) company because a non (f) person - A Ltd - is a participator.
C Ltd is not a relevant person. It is not an (f) company as it does not meet the requirement in (f) that a person "falling within any *other* paragraph" of s.809M(2) is a participator.

The end result is the same if all the companies are UK resident close companies, though the statutory references are different:
B Ltd is an (e) company because a non (e) person - A Ltd - is a participator.
C Ltd is not a relevant person. It is not an (e) company as it does not meet the requirement in (e) that a person "falling within any *other* paragraph" of s.809M(2) is a participator.

Suppose however that B Ltd is UK resident and C Ltd is non-resident. In that case C Ltd is a relevant person:
B Ltd is an (e) company because a non (e) person - A Ltd - is a

participator.
C Ltd is an (f) company as a non (f) company - B Ltd - is a participator.

It follows that D Ltd is then an (e) company if UK resident, since as a non (e) company - B Ltd - is a participator.

*Example 2*

The difference in example 2 is that the trustees are participators in B Ltd[24] so B Ltd is an (h) company.

10.7.1 *Commentary*

Where any of these companies are relevant persons, so are all their 51% subsidiaries. It will be apparent that the definition of relevant person in relation to companies is far too wide and it is not realistic to think that the rules are being or ever could be applied in practice to large corporate groups of close companies.

## 10.8 Relevant person transitional rule for pre-2008/09 income and gains

Para 86(4) Sch 7 FA 2008 provides:

> Subject to sub-paras (2) and (3), in relation to an individual's income and chargeable gains for the tax year 2007-08 or any earlier tax year, section 809L has effect as if the references to a relevant person were to the individual.

This provision only operates for the purposes of s.809L, so it needs to be repeated for the purposes of s.809N ITA (which relates to remittance condition C)[25] and s.809O ITA (which relate to remittance condition D).[26] The RDR Manual provides:

> **31480 - Remittance Basis: Introduction to the Remittance Basis: Transitional Provisions: Relevant persons and foreign income and**

24 See 73.15.1 (Chain of wholly owned companies).
25 See 10.21.9 (Transitional rules: pre-2008 income/gains).
26 See 10.22.5 (Transitional rules: pre-2008 income/gains).

> **gains arising before 6 April 2008**
> *Background*
> The introduction of Chapter A1 Part 14 ITA 2007 has extended the meaning and scope of foreign income and gains that become taxable when remitted to the UK. One change is the introduction of the concept of 'relevant person'RDRM33030 at section 809L which, broadly, provides that a taxable remittance will occur when foreign income or gains are brought into or otherwise used in the UK by relevant persons other than the individual himself or herself.
> *Transition*
> The transitional rule provides that in establishing whether there has been a remittance of an individual's income and gains for 2007-08 or any earlier year Conditions A and B, Condition C and Condition D at ITA07/s809L (refer to RDRM33000) are applied as if references to 'relevant person' are to the individual.
> *Effect*
> This means that the income or gains remitted either as cash or property have to be brought to, received by or used in the UK for the benefit of the individual concerned before there can be a remittance.

The Manual then provides a factually implausible but fiscally straightforward example[27] and continues:

> Note: The exclusion of 'relevant persons' from s809L for pre 6 April 2008 income and gains does not apply in considering the other transitional rules in relation to the remittance of relevant foreign income (refer to RDRM31140 Relevant foreign income).

## 10.9 Relevant and other persons – compliance

Suppose:

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27 "Sanjay is a non-domiciled remittance basis user who transferred £10,000 of his foreign employment income from 2007-08 to his 15 year old grandchild's offshore bank account.
In 2008-09 the grandchild then remits £3,000 of this to the UK to buy himself a new computer. [How the 16 year old minor would operate the account and purchase the (surely overpriced) computer is not explained, but it does not matter.]
Under the rules at section 809L this would create a taxable remittance of £3,000 by Sanjay because his grandson is a relevant person. However the transitional rule means that there is no taxable remittance of this income because it is employment income from 2007-08."

(1) an individual gives income or gains to a relevant person ("R"); and
(2) R remits sums to the UK.

The individual in principle becomes liable to a tax charge. The residence of R does not matter.

However, R is under no duty to inform the individual that R has remitted sums to the UK. R is under no duty to inform HMRC, as any tax liability on the remittance is that of the individual, not of R. But the rules in theory require R to keep records for the lifetime of the individual.

Similar issues arise in relation to remittance condition C. Suppose:

(1) an individual gives income or gains to a non-relevant person ("G", a gift recipient); and
(2) qualifying property is enjoyed by a relevant person (or used in respect of a relevant debt).

The individual in principle becomes liable to a tax charge. The residence of G does not matter. G is under no duty to inform the individual or HMRC. But the rules in theory require G to keep records for the lifetime of the individual.

Similar issues arise in relation to remittance condition D, where any property of any third person ("P") is enjoyed by a relevant person (or used in respect of a relevant debt) and there is a connected operation (as defined). The individual in principle becomes liable to a tax charge. The residence of P does not matter. P is under no duty to inform the individual that P has remitted sums to the UK or to inform HMRC. But the rules in theory require P to keep records for the lifetime of the individual.

Of course in practice these rules will not (and indeed could not) be observed except in straightforward cases.

The individual has no indemnity against the relevant person, gift recipient or third party.

Under the pre-2008 remittance basis, if A (a remittance basis taxpayer) transferred A's foreign income to any other person ("B") and B receives that income abroad, there was in general no remittance of that income if B subsequently remits the income to the UK. In the 6th edition of this work I said:

> The law could hardly be otherwise, for A will not usually know what B does with his money after it has been transferred to B.

I was wrong about that! My comment assumed that workability was a necessary requirement of UK anti-avoidance provisions. Now it is sufficient if the law is workable in simple cases. Now if T gives income to a relevant person, who remits, T is taxable.

A relevant person who bears a grudge against an individual (eg a separated spouse) may be able to trigger a significant tax charge out of spite, by deliberately remitting income or gains they have received from the individual. They may alternatively blackmail the individual by threatening to remit unless paid not to do so.

What about a gift recipient (such as an estranged adult child)? There is no charge if they remit income or gains they have received from the individual. What if they apply property they have been given for the benefit of a relevant person, eg a minor child or grandchild of the individual? This arguably does not constitute a taxable remittance under condition B, because the sums are not derived property, but it is caught by remittance condition C.

Also see 10.38 (Proceeds of divorce settlement).

The RDR Manual provides:

> **35030 Conditions A and B - remittances derived from foreign income or gains**
> ... Where an individual gives untaxed foreign income or gains to another person then they should ensure the donee is aware that they must tell the donor if the property or anything subsequently derived from it is bought to the UK in circumstances such that there would be a remittance under ITA07/s809L.

There is no statutory obligation to do this but failure will make compliance difficult.

HMRC say in March 2009 Qs & As Q9:

> If
> [1] the record keeping requirements are felt to be too onerous and
> [2] the probability of remittance to the UK is high
> the donor may wish to consider making a gift of taxed income or gains.

This will not satisfy readers. If "the probability of remittance to the UK is high" then the donor may indeed prefer a gift of taxed income or gains,[28] quite regardless of record keeping requirements. Conversely, what advice

28 Or other clean capital.

would HMRC give if the record keeping was felt to be onerous but the probability of remittance was low? Or if the donee had insufficient taxed income or gains to make the gift?

## 10.10 Relevant persons - commentary: let's simplify relevant person rules

If an individual remits their own income to the UK, they are able to spend it here and there is some sense in taxing them. The same might be said for an individual's spouse and minor children. A case could be made to extend the class to other close family.

Para (d) – applying to minor grandchildren (though not to adults) – is a novel development in tax. The policy is inconsistent with other anti-avoidance provisions, and leads to some strange anomalies and nonsense.[29] The intention is perhaps to catch grandparents paying the school fees of their UK resident grandchildren – at least if the school is in the UK. But that is only a surmise, as the Government never published any explanation.

When a family trust or a family company remits its income to the UK, the individual (as beneficiary or shareholder) is not in any way advantaged unless and until the trustees decide to transfer the income to them or to a close family member. The main effect of the present rules is to impose a prohibitive tax charge on investment in the UK by the foreign domiciliary or relevant persons. In order to impose this comprehensively, the definition of relevant person is made extravagantly wide. What on earth is the thought process that has led to this outlandish situation? Needless to say, there was no discussion of these policy issues when the rules were announced. I infer that it is based on a doctrinaire conception that the remittance basis requires funds to be taxed if and when *the funds* come to the UK. The policy ought surely to be to charge tax when funds are available *for personal spending* in the UK, not simply because they are invested here.

For these reasons the definition of relevant person ought to be restricted to the individual, their spouse and minor children (and if necessary, though I would have thought not, their cohabitee).

29 See 10.26 (Payment of school fees).

## 10.11 Remittance condition A (link to UK)

Remittance conditions A and B go together: condition A requires a link to the UK, and condition B requires a link to the foreign income or gains. Both conditions need to be satisfied to have a remittance under s.809L(1)(a).

Section 809L(2) ITA provides:

> Condition A is that—
> (a) money or other property is brought to, or received or used in, the UK by or for the benefit of a relevant person, or
> (b) a service is provided in the UK to or for the benefit of a relevant person.

There are eight ways to satisfy remittance condition A. The first six are:

(1) Property is:
- (a) brought to the UK
  - (i) by a relevant person
  - (ii) for the benefit of a relevant person
- (b) received in the UK
  - (i) by a relevant person
  - (ii) for the benefit of a relevant person
- (c) used in the UK
  - (i) by a relevant person
  - (ii) for the benefit of a relevant person

I refer to these as the **"brought" limb,** the **"received" limb,** and the **"used" limb** of condition A. The last two ways to satisfy condition A are:

(2) A service is:
- (a) provided in the UK to a relevant person
- (b) provided in the UK for the benefit of a relevant person

I refer to property within (1) as "**property brought/received/used in the UK**". (One might refer to that as "condition A property" or "UK property" but on balance I think it is clearer to use the clumsy expression **"brought/received/used in the UK."** I leave the words by/for the benefit of a relevant person to be implied.)

### 10.11.1 *Enactment history*

The wording of remittance condition A is loosely derived from the pre-

2008 s.33(2) ITEPA, but the connection is tenuous. Section 33(2) ITEPA provided:

> *If general earnings are—*
> *(a) paid, used, or enjoyed in the UK, or*
> *(b) transmitted or brought to the UK in any manner or form,*
> *they are to be treated as remitted to the UK at the time when they are so paid, used or enjoyed or dealt with as mentioned in para (b).*[30]

In the current provision, the terminology brought/received/used has replaced paid/used/enjoyed/transmitted/brought.

The former words "in any manner or form" have been omitted; they are unnecessary as the concept of "derived property" in remittance condition B does the same work.

The words "for the benefit of" are new. The reference to a relevant person is new.

### 10.11.2 *"Property" and "Money"*

The language of the remittance basis provisions is not entirely consistent:
"Money or other property" is used 5 times.
"Property (including money)" is used once.
"Property (other than money)" is used once.
Sometimes the word "property" is used by itself. I think it is clear that the word "property" by itself includes money, that is, it is equivalent to "money or other property". In this chapter, I use the word "property" (by itself) to mean money or other property.

When the expression "money or other property" is used, we do not care about the meaning of the word "money" because if an asset is not "money" it will be "other property".

When the expression "money" is used by itself, or in the expression "Property other than money" we do care about the meaning of the word "money".

30 Pre-2008 s.12(2) TCGA was in the same terms. The wording was perhaps intended to extend the concept of "remittance" beyond that which applied for the pre-2008 RFI remittance basis. Though it is just as likely that the drafter only had in mind a plain English paraphrase of the antique language of the former s.65 ICTA 1988. There is no authority discussing these words. (The question was raised but left open in *Harmel v Wright* 49 TC 149.) The question will not now be decided.

Except in a few special contexts[31] the words "property" and "money" are not defined and carry their ordinary meaning.

### 10.11.3 *Property brought to the UK ("brought" limb of condition A)*

The first two ways to satisfy remittance condition A are:

> *(a) Property is brought to the UK by a relevant person*
> *(b) Property is brought to the UK for the benefit of a relevant person*

This limb requires one to identify who brings property to the UK. If a relevant person brings it, condition A is satisfied. If someone else brings it, para (a) is not satisfied.

For instance, suppose T wishes to lend a chattel to a non-relevant person, eg an adult child. If T instructs a courier to transport the chattel to the child, there is a taxable remittance. If the child arranges the transport, then para (a) does not apply. No other part of condition A applies, so there is no taxable remittance. It is strange that the administrative matter of who brings the asset to the UK should determine taxability but there it is.[32] This could be useful if a remittance basis taxpayer wished to lend to a museum, as it would not be necessary to meet the complex conditions of the public access rule.

Para (b) might apply if N holds property as nominee for T, and N brings the property to the UK.

### 10.11.4 *Property received in the UK ("received" limb of condition A)*

The next two ways to satisfy remittance condition A are:

> *(c) Property is received in the UK by a relevant person*
> *(d) Property is received in the UK for the benefit of a relevant person*

Para (d) might apply if N holds property as nominee for T, and N receives

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31 See 10.30.1 ("Property").

32 For gifts of cash, see 10.11.6 (Gift to non-relevant person).

the property in the UK.

We need the "brought" limb as well as "received". T can receive an asset in the UK without bringing it here (eg on the purchase of a UK situate chattel). Can T "bring" an asset to the UK without receiving it in the UK? Perhaps an example is if T acquires a chattel outside the UK, and packs it in T's hand luggage; or acquires a car outside the UK and drives it to the UK. T "brings" the chattel or car to the UK, but does not "receive" it here. (It is arguable that an asset can only be received once, so if it is received outside the UK it cannot later be received in the UK, but whether or not that is right, in the case of a chattel or car, there is no identifiable moment of "receipt" in the UK.) So both these limbs of condition A are needed.

This limb requires one to ask where property is received, the answer to which is by no means obvious.

### 10.11.5 *Banking machinery and property in transit*

What if a transfer of money to a foreign bank account involves credits in UK accounting records of the foreign bank? (This is understood to be the position for Channel Island and IOM banks.) No difficulty arises. The RDR Manual provides:

> **33560 Banking Issues** [July 2010]
> *Banking Transactions*
> Transfers between foreign centres often pass through the UK banking system, for example when a sterling payment is made abroad and the payment is cleared through London in the normal banking process.
> In such circumstances HMRC do not regard the passage of funds through the UK as being a taxable remittance.
> The machinery employed is irrelevant provided that, without express provision, the individual has:
> - no right to payment at any intermediate point; and
> - no control over the funds transferred by their foreign bank to secure payment at the agreed point.

This approach is extended in March 2009 Qs & As:

> **Q17:** Will HMRC apply the same principle, expressed in relation to mechanistic banking transfers which pass through the UK in the banking system, in a case where a courier passes through the UK in transit

> carrying property not covered by the temporary importation exemption?
> **A:** Yes. In principle, where the "passing through" is a mechanistic part of the courier service provision and, no relevant persons have any rights to use or access the property at any intermediate point; and no control over how property is transported to and from the agreed points. In such circumstances the passage of property which merely "touches" the UK would not be regarded as a sum remitted to the UK.

The EI Manual provides:

> **40302 Meaning of "remitted to the United Kingdom"** [December 2008]
> *Paid in the UK*
> [1] Earnings are remitted to the UK if they are paid to the employee in cash in this country or if the employee's bank account here is credited with them. Employees may arrange to have earnings paid into offshore bank accounts to avoid this rule.
> [2] Money that is transmitted from the employer's bank in the UK to the employee's offshore bank is not treated as remitted here. It has been in the banking system all of the time; the employee did not have access to it.

This is correct, though the statement at [2] that the money has "been in the banking system" is layman's language.[33]

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33 *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,

### 10.11.6 *Gift to non-relevant person*

In *Timpson's Executors v Yerbury*[34] (a pre-2008 remittance case)

(1) Mrs Timpson ("T") gave cheques representing her foreign income to her children.
(2) The children cashed the cheques which were credited to their bank accounts in the UK.

Thus, the foreign income was received in the UK, but it was not received by T. This was nevertheless held to be a taxable remittance by T. Romer LJ and (I think) Greene LJ decided *Timpson's Executors* on the basis that there is a taxable remittance if:

(1) money is received in the UK by a third party at T's direction, and
(2) immediately before receipt, the money (or funds representing it) belonged to T.[35]

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"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).

34 20 TC 155 followed at first instance in *Walsh v Randall* 23 TC 55.

35 "The Rule does not require that the sum should have been received by the person entitled to the income. In computing the tax, therefore, sums paid to third parties [in the UK] for the benefit or at the request of the party so entitled have to be taken into account..." (Romer LJ at p.181); "provided the income in respect of which the assessment is made is income to which the person assessed is entitled, it is, in my judgment, immaterial whether the sum 'received in the UK' is received by him or by some third party upon his instructions." (Greene LJ at p.186).

Lord Denning adopted this reasoning in an obiter comment in *Thomson v Moyse* 39 TC 291:

> "But [the taxpayer] need not receive [the foreign income] himself. It is sufficient if the sums are received in England by some third person *by his authority.* Thus, if Mr Moyse, instead of receiving the money himself, tells his New York banker to send a remittance to his butcher or baker or candlestick-maker in England, he is chargeable with tax on it for the simple reason that he was 'entitled' to the income which has been used to pay the debt; and he must pay tax on it *when it is received in England*, no matter by whom it is received, so long as it is received *by his authority* ..."

Lord Wright MR decided *Timpson's Executors* the case on a different basis, that: "if the sums in question were received in the UK as the income of Mrs. Timpson she was chargeable to tax as being the person entitled to it when it came into the UK, though in fact she never received it herself.... if it comes here as her income, ... the fact that on arrival it is applied, in accordance with her directions, in payment to others does

This is no longer the law under the ITA remittance basis. Remittance condition A requires that property is brought/received/used in the UK *by or for the benefit of a relevant person*. So if a remittance basis taxpayer writes a cheque on a foreign bank account, gives it to a donee (not a relevant person) who pays the cheque into their UK bank account, remittance condition A is not satisfied. The money is received in/brought to the UK by the donee (not by a relevant person).

Suppose (instead of a cheque) T makes a gift to the donee (not a relevant person) by electronic transfer from T's offshore account to the UK account of the donee. It is arguable that remittance condition A is not satisfied. It would be strange if there were a difference between payment by cheque and a direct electronic transfer. But in this case it might be said that T "brought" the money into the UK (even though T did not receive or use it in the UK).

The practice before 2008 was to make the gift abroad (by payment into a foreign bank account of the donee) and this will no doubt continue even though it is not on this analysis strictly necessary.

### 10.11.7 *Arm's length payment to non-relevant person*

Similar points apply to an arm's length payment to a non-relevant person. Suppose X provides services to T outside the UK, or sells a non-UK situate asset to T. If T makes a payment to the foreign bank account of X, remittance condition A is not satisfied. If T pays by giving X a cheque for the amount due, and X pays the cheque into their UK account, there is no taxable remittance. The money is received in/brought to the UK by X, not by T. It is not used in the UK by T.

If (instead of a cheque) T makes pays by electronic transfer from T's offshore account to the UK account X, it is arguable that remittance condition A is not satisfied.

A payment into the foreign account of X is safest, but in practice X may not wish to go to the trouble of opening a foreign bank account.

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not affect its chargeability to her;" 20 TC 155 at p.180. Clearly T did not receive the income, but Lord Wright said that she was entitled to it on arrival, when it came to the UK. This is not tenable for reasons given in the 6th edition of this work; but the point does not now matter.

### 10.11.8 *Property used in the UK ("used" limb of condition A)*

The next way to satisfy remittance condition A is:

> *(e) Property is used in the UK by a relevant person*

This requires one to ask whether property is used, where property is used, who is the user, and what exactly is the property which is used.

It is considered that "used" means enjoyed in specie, and property is used where it is situate. So if a sum is applied in the purchase of chattels which are brought to the UK and used by the individual, or any relevant person, the "used" limb of remittance condition A is satisfied.

It is difficult to see the role of the "used" limb of condition A. Normally if T uses property in the UK, T (or a relevant person) will have brought or received it in the UK, so the "brought" or "received" limbs will be satisfied. There could be a case where property is brought or received in the UK by a non-relevant person and used by T eg if T gives RFI to a brother who purchases a house which T occupies. In that case condition A is satisfied under the "used" limb alone. But in this case, condition B is not satisfied (the property is not property of a relevant person) so the question whether condition A is satisfied does not arise. This situation is covered instead by condition C.

If money is spent, it is "used" in the normal sense of the word. However it is not clear where spent money is used, so it is not clear how one decides whether it is used in the UK. It is suggested that the spending of money should be considered under the receipt limb, or the brought limb of condition A, or under the debt remittance rules, and so (say) paying a debt may be a remittance under the debt remittance rules but it does not satisfy condition A: the money is not used in the UK.

### 10.11.9 *Receipt of UK situate investment asset*

What is the position if T uses RFI to pay the purchase price of UK situate property which is not used *in specie*?[36] For example, if it used to purchase UK situate shares or land let as an investment?

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36 There are of course other reasons for avoiding UK situate investments: the income is subject to IT, gains subject to CGT, and IHT may also be a concern. Here I am only addressing the remittance issue.

Assume that the sum itself is not received in the UK (because payment for the asset is made outside the UK).

The “brought” limb of condition A is not satisfied: the shares or land are not brought to the UK, and neither is the RFI.

HMRC must rely on the “received” limb. The shares or land are certainly “received” by the relevant person, but are they received “in the UK”?

It is arguable that they are not, so while condition A is only satisfied if the relevant individual actually uses the assets, merely acquiring UK situate assets is not enough.[37]

Will HMRC agree? The EI Manual para 40302 [December 2008] provides:

> **40302 Meaning of "remitted to the United Kingdom"** [December 2008]
>
> *Assets*
>
> [1] 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.
>
> *Investments abroad*
>
> [2] The treatment of investments made abroad depends on the particular facts. In general, money invested abroad by an employee resident here should not be regarded as remitted to the UK. However, if the investment is subsequently sold in this country, or sold abroad and the proceeds brought into the UK, the amount originally invested should then be regarded as remitted here.

Para [2] does not answer the question, as the unlawyerlike expression “investments made abroad” might refer to the situs of the investment or the place where the investment is paid for. But para [1] referring expressly to chattels perhaps suggests that the position may be different for UK shares or other assets not enjoyed in specie.[38]

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37 If this were wrong then words “used in” in remittance condition C (and perhaps condition A) would be otiose since chattels used in the UK must be received in or brought to the UK.

38 SAI Manual provides:
“4380. **Remittance basis** [December 2009]
... In some cases... the securities themselves are treated as deriving from the accrued

If receipt of a UK situate asset is receipt of an asset in the UK, then there will usually be a remittance if a person lends to any UK resident (even if not a relevant person) since the lender receives a debt and a debt from a UK resident is usually UK situate.

A practical solution where possible is to use bearer shares and specialties and ensure that the document is kept outside the UK.

### 10.11.10 *Property used in the UK for the benefit of a relevant person*

The next way to satisfy remittance condition A is:

> *(f) Property is used in the UK for the benefit of a relevant person*

Funds can be said to be *applied* for the benefit of a person and it is suggested that "used for the benefit of a relevant person" has the same meaning.

### 10.11.11 *Situs of property for purpose of remittance condition A*

There are no statutory situs rules for income tax, so the rules of private international law apply. Thus money received in a UK branch of a foreign bank is remitted, but money received in a foreign branch of a UK bank is not remitted.[39] Money is remitted if received in:

(1) a UK account in the name of the taxpayer, and held by them beneficially; or
(2) a UK account held in the name of a third party who holds on trust for the taxpayer.

CGT has statutory situs rules. But it is considered that the effect of s.12(5) TCGA is to incorporate the ITA rules, so the CGT situs rules do not apply for the purpose of remittance condition A. My view is confirmed by s.809W(6) ITA which applies the CGT situs rules

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income profits. This means that a charge will arise on the taxpayer when they, or some other 'relevant person', either bring the securities to the UK (if they are held in bearer form) "

(The same point was made in EN FB 2008). Since this comment relates to bearer securities, which are in some ways chattels or like chattels, it does not shed any light on the issue discussed here.

39 See 70.17 (Bank account).

specifically for the purposes of s.809W(3) ITA. If my view were wrong, there would be a remittance under the CGT remittance basis whenever a UK resident foreign domiciliary:

(1) places sterling in a foreign bank account, as the account is regarded as UK situate for CGT;[40] or
(2) sells and leaves the purchase price outstanding, since the right to the purchase price is a UK situate asset under the CGT situs rules.

Suppose T sells and leaves the purchase price outstanding as a debt. T receives property - the right to the purchase price – but where is it situate? If the purchaser/debtor is UK resident, the debt is UK situate, unless one takes specific steps in the documentation to avoid that. If the purchaser/debtor is non-resident, the asset is not in principle UK situate. But if my view about the received limb is correct, it does not matter where the debt is situated.

### 10.11.12 *Non-UK company with UK asset – secondhand companies*

Suppose T acquires a non-UK company which holds a UK asset. If the UK asset is not enjoyed in specie by T or a relevant person, then Condition A is not satisfied. If the UK asset is (say) a house, which is occupied by T, then remittance condition A is satisfied. However, remittance condition B is not satisfied.

### 10.11.13 *Service provided in the UK*

The next way to satisfy remittance condition A is:

> *(e) a service is provided in the UK to a relevant person*

The rule requires one to identify the place where services are provided, or at least whether they are provided in the UK. While in some cases this is straightforward, in other cases there is no obvious answer.[41]

The connecting factors could be:

(1) where the work is done
(2) where the supplier is based

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40 See 71.12 (Bank account).

41 It is of course no solution to say that the question is just one of fact: see 17.2.10 (Unsatisfactory approaches).

(3) where is the property (if any) to which the services relate
(4) where the customer is
It is considered that the connecting factor should be where the work is done, when that is physical work with a simple physical location. This is consistent with the IT trading source rules.[42] In other cases it should be where the supplier is based.

In practice physical work will generally be done where the supplier is based, so factors (1) and (2) will normally point the same way. But that is not necessarily the case. If one instructs a French firm to provide building services in the UK the service is provided in the UK: if one instructs a UK firm to provide building services in France, the service is provided out of the UK.

Factor (3) cannot be decisive as foreign services relief assumes that a service which relates to property situate outside the UK may be a service provided in the UK.[43]

The RDR Manual is consistent with this view. It provides:

> **34040.Relevant services provided in the UK** [July 2010]
> ... A service is regarded as having been provided in the UK if the providers of that service are based in and give that service in the UK....

"Based in" the UK is my factor (2). I understand that the words *"and give that service in the UK"* is my factor (1), where the physical work is done. This is therefore an easy case where both factors point the same way.

The RDR Manual goes on to give this example:

> *Example 1 (Chandra)*
> C, a remittance basis user, engages an investment manager based in the UK to manage her portfolio of investments in foreign stocks and shares of overseas concerns. ...
> The service - the management of the portfolio - is provided in the UK to C...[44]

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42 See 13.12 (Services).

43 See 10.29 (Foreign services relief).

44 March 2009 Qs & As made the same point:
**Q23**: ... If a service provider engages with the Jersey resident trustees of a trust of which a UK resident but non-domiciled individual is a beneficiary and settlor and provides advice which is prepared and issued from the UK, but received and read in Jersey, it is not clear if this would be "a service provided in the UK."...

This is a case where there is no physical work within factor (1), so one falls back on factor (2), where the supplier is based.

Where one travels entirely within the UK, the services are provided in the UK and where one travels entirely outside the UK, the services are provided outside the UK. What is the position if the journey begins in the UK and ends outside, or begins outside the UK and ends within? Possible solutions are:

(1) the services are provided in the UK if any part of the journey is in the UK,
(2) the services are not provided in the UK if any part of the journey is not in the UK,
(3) apportion the journey into two parts.

None of these are satisfactory. (1) and (2) are unfair in favour of HMRC or the taxpayer, and not in accordance with the natural meaning of the words. (3) is wrong as there is only one service.

The best answer is that in this case factor (1) - where physical work is done - does not provide a solution, and one should rely on factor (2) - where the supplier is based.[45] HMRC may agree. The RDR Manual provides:

> **34040. Relevant services provided in the UK** [July 2010]
> *... Example 4 (Charlotte)*
> C, a remittance basis user, purchases a return air ticket using her foreign

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**A**: ... The general rule is that, for the purposes of this condition, a service is regarded as being provided in the jurisdiction where the providers of that service are based. Advice which is researched, prepared and issued from the UK would therefore fall within the definition of "provided in the UK" irrespective of where the client might receive it.

**Q24**: As part of providing advice to clients who have an international aspect to their affairs, a service provider may prepare advice in several different jurisdictions, which may then be issued from only one office, and therefore country, that being the office which has the main relationship with the client.

**A**: In the case where an offshore service provider provides advice which has been prepared in several different jurisdictions, the same approach will need to be taken to determine whether the test in section 809L is met, and, because the advisors in your scenario are based in the UK, their service will be provided in the UK.

45 Exactly the same considerations have led the OECD model to the same rule. Art 8(1) OECD model treaty provides: "Profits from the operation of ships or aircraft in international traffic shall be taxable only in the Contracting State in which the place of effective management of the enterprise is situated."

> income. The ticket is to travel from the UK to Belgium and return. *The ticket was purchased from a UK company* but payment was made into the company's offshore bank account.

The HMRC analysis is as follows:

> Because part of the travel service was provided in the UK (the journey begins and ends in the UK) there is a remittance to the UK [ie the service is provided in the UK].[46]

It is on this analysis significant that the HMRC example specified that the purchase was from a UK company.

In order to decide where a service is provided, it is necessary to identify the service or services which are provided. The VAT distinction between single (though composite) and multiple supplies is applicable here. The RDR Manual gives an example of a multiple supply:

> **34030. Remittance Basis charge - repayment by HMRC** [July 2010]
> ... *Example 5 (Sarah)*
> S, a remittance basis user, purchases an air ticket using her foreign income and gains to travel from Sweden to Holland, using a UK based booking agency. Payment is made into the agency's offshore bank account.
> There is a 'service provided in the UK', which is the agent's booking services, so the part of the cost of the service that relates to the agency's booking fee is a remittance (although not the cost of the flight between Sweden and Holland as no part of this service is provided in the UK).

This is correct if there are two supplies, a booking service and a transport service; but if there is only one supply then it would not be correct.

Basic planning is to use services outside the UK wherever possible, eg

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46 For completeness: there is another version of this example in RDRM 33130:
"*Example 3*
Charlotte, a remittance basis user, purchases an air ticket using her foreign income. The ticket is to travel from the UK to Belgium. The ticket was purchased from an overseas company and payment made into the company's offshore bank account.
Because part of the travel service was provided in the UK (the journey begins and ends in the UK) there is a remittance to the UK."
This is incoherent, since the question assumes there is a ticket from the UK to Belgium, but the answer assumes the journey ends in the UK.

foreign investment advice, foreign accountancy services, foreign travel agencies, and foreign schools.

The last way to satisfy remittance condition A is:

> *(f) a service is provided in the UK for the benefit of a relevant person*

Do the words "for the benefit of" add anything? Is there a case where a service is provided for the benefit of a person but not to that person? Perhaps an example is where a parent P contracts with a school to educate P's child C. The services are perhaps provided to P (who pays for them) but for the benefit of C.

## 10.12 Remittance condition B (link to foreign income/gains)

Section 809L(3) ITA provides:

> Condition B is that—
> (a) the property, service or consideration for the service, is (wholly or in part) the income or chargeable gains,
> (b) the property, service or consideration—
> (i) derives (wholly or in part, and directly or indirectly) from the income or chargeable gains, and
> (ii) in the case of property or consideration, is property of or consideration given by a relevant person ... [47]

There are eight ways to satisfy remittance condition B. The first six[48] are:

(1) The property received/used/brought to the UK:
  (a) is (wholly or in part) the income or gains,
  (b) is derived property and is property of a relevant person.

(2) The consideration for the service provided in the UK:
  (a) is (wholly or in part) the income or gains, or
  (b) is derived property and is property of a relevant person.

(3) The service:
  (a) is the income or gains or
  (b) derives from the income/gains.

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47 Section 809L(3) continues with paras (c) and (d) which relate to debt remittances, considered separately below.

48 The remaining two relate to the debt remittance rules, which are considered separately below.

### 10.12.1 *Property and consideration for service*

It is impossible to refer constantly both to property and to services so I refer to property and leave the reference to services to be read in, as the same points apply to both.

Remittance condition B is not satisfied unless the property brought/received/used in the UK either:

(1) is the foreign income or gains; or
(2) is derived from the foreign income or gains.[49]

If the property *is* the foreign income or gains, it does not have to meet the requirement that it is property of a relevant person. If the property is *derived from* the income/gains ("derived property"), it does have to meet that requirement.

Why the distinction? If T transfers income/gains to R, the funds cease to be the income/gains (instead in the hands of R the funds become derived property). That is, if the property *is* the foreign income or gains, the property must necessarily be property of the individual (T) himself (not any one else who is a relevant person in relation to T), so it is not necessary to impose the requirement expressly. That might be the reason; though if so the matter could have been more simply expressed.

Suppose:

(1) T gives foreign income to S (not a relevant person).
(2) S uses the money to buy property used by T.

Condition B is not satisfied: the purchased property is derived property but it is not the property of T or of any relevant person.[50]

The question whether the property either *is* the foreign income/gains or is *derived from* the income/gains also matters for the purposes of s.809P ITA (amount of income remitted).

We need to classify what the relevant person receives as (1) property or (2) a service or (3) neither. This is not always easy. Suppose T pays rent for use of a picture in the UK. Does T receive a service? It is thought not.[51] Does T receive property and if so what? T does not receive the picture, but receives a contractual right, which is arguably property. Or it may be that T makes a payment in respect of a relevant debt. A court is likely to hold that there is a taxable remittance under one or other of these

49 But where these conditions are not met, remittance condition C or D may apply.
50 But remittance condition C or D may then apply.
51 "Service" is widely defined for VAT, but that definition is not applicable here.

routes, though neither analysis is entirely trouble-free.

### 10.12.2 *Service derives from income/gains*

Next, condition B is met if:

> The service
> (a) is the income or gain; or
> (b) derives from the income or gains.

I am unable to make sense of this. How can a *service* be (or derive from) income or gains? I think the reference to "service" here is misconceived. Perhaps the drafter is considering services which constitute earnings or benefits in kind, or a disposal of an asset in consideration of services. In that case only para (b) is misconceived.

## 10.13 Property is the income or the gains

### 10.13.1 *What is the income?*

The question of whether the property brought/received/used in the UK is the income is straightforward if the income is pure income, such as dividends, interest or income distributions from trusts.

The question is less clear if the income consists of trading or rental income, since in this case the "income" is the result of a trading or property computation. The gross receipts of the trade or gross rents are not the income.

For example, suppose an individual borrows to purchase land and pays interest or other deductible expenses out of the rent. The income of the individual is the net profit (rent less expenses), it is not the gross rent. So the payment of the interest out of the gross rent is not a remittance of the rental income. The income is the profit (if any) which is left after payment of the interest.

### 10.13.2 *What is the gain?*

The question of whether the property is the gains is problematic. What is the jurisprudential nature of a gain? The former Inspectors Manual para 1567 published 9/95 provided:

> whilst the income content of any fund is a separate and distinguishable part of that fund, a capital gain is merely part of the whole proceeds of a disposal transaction that has no separate identifiable existence within those proceeds.

The Manual was correct to say that a gain has no separate identifiable existence. On one view, a gain does not exist even as "part of the whole proceeds". It is not a separate or separable item of property existing at all. A gain is merely the result of a computation. The proceeds of a disposal may be said to represent the gain, but they do not constitute the gain, just as gross trading receipts do not constitute the profits of a trade. On this analysis the proceeds of a disposal are not even derived from a gain, though the quantum of a gain depends on the quantum of the proceeds. But whatever the true jurisprudential nature of a gain may be, I think the drafter has assumed that the proceeds of a disposal for full consideration should be regarded as consisting of (1) gain and (2) everything else (representing base cost and other exemptions) so the proceeds do include the gain.[52]

## 10.14 Derived property

Remittance condition B (and C and D) refer to property which derives (wholly or in part, and directly or indirectly) from the income or gains. I refer to this as "**derived property**".

The words "directly or indirectly" show that the drafter did not want the word "derives" to be construed narrowly.

### 10.14.1 *Enactment history*

Under the pre-2008 CGT and employment income remittance bases, tax was charged on sums received in the UK *in respect of* the foreign income. Under the ITA remittance basis, the sum must be *derived from* the income or gains. Is there any difference? It is impossible to say, since "in respect of" and "derived from" are both vague and context-dependent expressions but "derived from" is probably narrower.

Perhaps the change was made to give effect to the statement in the former Inspectors Manual para 1564 published 9/95:

52 The position is more difficult for sales at an undervalue: see 10.24.4 (sale of asset).

> Income is received in the UK if funds provided in the UK are derived from income arising overseas.

Perhaps there was no reason for the change: the drafter started with a blank sheet and chanced upon the expression "derived from" or perhaps considered it more in accordance with Plain English principles.

### 10.14.2 *Investment and re-investment*

Suppose T uses RFI to purchase assets. The purchased assets are derived from the RFI. If the purchased assets are sold and the proceeds re-invested is new assets, those new assets are derived from the RFI. The tracing process can continue for the lifetime of T.

### 10.14.3 *T gives funds to R*

Suppose T gives income to R. The funds in the hands of R are not the income, but they are derived from the income. If R uses the income to purchase assets, the purchased assets are derived from the income, and (as above) that tracing process can continue indefinitely during the lifetime of T.

### 10.14.4 *T purchases asset for full consideration from R*

Suppose:
(1) T purchases an asset ("the purchased asset") from a relevant person ("R") for full consideration.
(2) T uses RFI to pay the purchase price.
It is considered that after the sale the purchase price in the hands of R is not the income and is not derived from the income. So if R remits the proceeds of sale, remittance condition B is not satisfied.[53]

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53 There would be a remittance of the RFI if T remits the purchased asset to the UK. If my view is wrong, there would be a double charge to tax where the purchased asset represented RFI of R, that is, where:
(1) R receives RFI (R's income) and uses it to purchase an asset (the purchased asset).
(2) T receives RFI (T's income) and uses it to purchase the asset.
Suppose T brings the purchased asset to the UK. T's income is remitted. But it would be surprising if R's income was also thereby remitted.

Likewise if T provides services to R for full consideration, and T uses RFI to pay the fee. The fee in the hands of R is not derived from the RFI.

This must be the case, because if T uses RFI to purchase an asset from a company, at arm's length, T will often have no way of knowing whether the company is a relevant person, and T can hardly be expected to ask the company what it has done with T's money. Whereas if T *gives* money to R, the request is not so unreasonable.

This view was accepted in another context in *Cohen v Petch* [1999] STC (SCD) 207. Here:

(1) T borrowed money from a building society and used it to purchase an asset from T's mother.
(2) The mother immediately gave or lent the proceeds of sale back to the son.
(3) The son lent the money to a company.

The Special Commissioner said at p.211:

> I cannot overlook the fact that once the money had been borrowed [by] the taxpayer from the society it was paid to his mother and became her funds. Subsequently, three days later, the sum of £46,600 was returned to the taxpayer by his mother either in the form of a loan or as a gift. The funds, whether or not they are traceable in specie, were no longer the money borrowed from the society. They were funds lent or given by Mrs Daphne Cohen to her son. There was no longer any link between the money which the taxpayer eventually lent to the company and the money which he borrowed from the society.

### 10.14.5 *T lends to R*

Suppose T receives RFI and lends it to an individual who is a relevant person ("R"). Are the funds in R's hands derived from the RFI? There are three possible solutions:

(1) R's borrowed money is always derived from T's RFI.
(2) R's borrowed money is never derived from T's RFI.
(3) R's borrowed money is sometimes derived from T's RFI.

In principle, R's funds are derived from R's promise to repay the loan which is full consideration for the money whether the loan is on commercial terms or interest free repayable on demand (the promise to repay an interest free loan is full consideration).[54] Solution (2) is in principle to be preferred. Since T has an asset (the benefit of the debt) which is derived from the RFI, it would be surprising if R's borrowed money was also derived from the same RFI. Suppose R repaid the debt (not out of the borrowed money but out of other funds). On solution (1) the borrowed money would continue to be derived from the RFI, which would be very odd to say the least.

Moreover the avoidance possibilities are dealt with by remittance condition D.

There may however be some circumstances in which one should regard the borrowed money as derived from the RFI. The court might then describe the loan as a mere "conduit" as Lord Templeman did in *Harmel v Wright* 49 TC 149 but the metaphor represents a conclusion rather than an argument for reaching that conclusion. The difficulty is to find a method of distinguishing between cases where one does and does not regard the borrowed money as derived from the RFI.

One circumstance in which that could be justified is if there were no intention to repay the loan.

Another might be where the borrower has insufficient funds to repay the loan (other than the borrowed money).

### 10.14.6 *T subscribes for shares in R Ltd*

Suppose T uses RFI to subscribe for shares in a company which is a relevant person ("R Ltd"). It is considered that the proceeds of the share subscription in R Ltd are derived indirectly from the income.

### 10.14.7 *T purchases shares in R Ltd (secondhand companies)*

Suppose T uses RFI to purchase the shares in R Ltd (a relevant person). R Ltd already owns assets. The assets of R Ltd are not derived property: they do not derive from the RFI.

54 Contrast 66.6 ("Provide"). The position would be different if the loan is a fixed-term loan at a low rate of interest as then R's promise to repay is not full consideration, but that case would be unusual.

### 10.14.8 *Receipt of cheque in UK*

Suppose T receives a cheque in the UK which if cashed would be foreign income. If the cheque is not transferable[55] the cheque is not derived property.[56] If the cheque is not sent abroad, but cashed here, there is still no remittance provided that the credit is made to an account abroad, not to a UK account.

### 10.14.9 *Borrowing on security of foreign income/gains*

It is helpful first to consider the position for unsecured loans. If T borrows without giving security the borrowed money is derived from the promise to repay. That is so even if T owns assets (say, RFI) and the lender would not lend had T not owned those assets. The fact that the lender only lends because of the RFI does not show that the borrowed money is derived from the RFI. No-one would doubt that.

Suppose T borrows on the security of RFI. Is the borrowed money derived from the RFI? It is considered that in this case the borrowed money is still derived from the promise to repay and not from the security. This is clearly so if T could have borrowed without giving the secuirty.

That is still the case even if T could not have borrowed without giving that specific security. There are three reasons for this view:

(1) The position is analogous to unsecured loans where no-one suggests that borrowed money is derived from the borrower's RFI even T could not have borrowed were it not for that RFI.

(2) A rule which says that borrowed money is derived from a security if and only if the borrower needed the security in order to borrow is not workable: the question whether the security is needed is often imponderable.

(3) The debt remittance rules[57] are designed to cover this aspect of remittances and that suggests that there would not be a remittance under general principles.

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55 Cheques drawn on UK banks have generally been non-transferable since the Cheques Act 1992.

56 This continues the pre-2008 law. The Inspectors Manual provided:

> "A cheque representing income assessable under Schedule D, Case IV or V, which is received in the UK by or on behalf of the taxpayer but is sent abroad and credited to the taxpayer's overseas bank account is not a 'sum received in the UK'."

57 See 10.18.2 (Use as security for debt).

For these reasons it is considered that borrowed money is derived from the promise to repay, not from assets used as security, even if T could not have borrowed without giving that security.

In *West v Trennery* 76 TC 713, trustees held shares and borrowed money on the security of the shares. One question was whether the borrowed money was derived property for the purposes of s.77 TCGA (now repealed). Section 77(8) TCGA at that time provided (somewhat tersely):[58]

> In this section "derived property", in relation to any property, means
> [a] income from that property or
> [b] any other property directly or indirectly representing
> [i] proceeds of, or
> [ii] of[59] income from,
> that property
> [c] or income therefrom.

So the question was whether the borrowed money directly or indirectly represented the proceeds of the shares. Lord Millett said:

> 16. The final question is whether the Revenue are correct in contending that the [borrowed] moneys ... constituted derived property within the meaning of s 77(8) in relation to the Einkorn shares. There can be only one answer to this: of course they do. The [borrowed] moneys ... directly represented the proceeds of a mortgage of the Einkorn shares ... If the trustees ... had invested the moneys in stocks and shares, these would have indirectly represented those proceeds. It will be observed that I have equated the proceeds of a mortgage of property with the proceeds of the property itself. But the subsection does not refer to "the proceeds of a sale of that property", but to "the proceeds of that property"; and this covers any proceeds, whether sale or mortgage or otherwise

58 In 2006 the definition was amended with retrospective effect, only to be repealed in 2008.

59 At first sight the word "of" appears to be a grammatical error, but it makes sense if one understands the words to mean:
*[i] proceeds of, or*
*[ii] [proceeds] of income from,*
*that property...*

> howsoever, by which value is extracted from one property and transferred to another.[60]

It is considered that this case is of no relevance, since the statutory words on which the decision rests are not present in the remittance basis provisions.

In practice HMRC appear to accept this view; see 10.18.2 (Use as security for debt).

### 10.14.10 *Income/gains used to pay debt*

Suppose:
(1) T borrows from L and receives "the borrowed money".
(2) T uses RFI to repay the debt to L so L receives "the repaid money".
In the absence of a statutory provision, the borrowed money would not be derived from the RFI. It is not derived from the RFI at the time of the borrowing. It does not become derived from the RFI later when the debt is repaid.[61] However, s.809R(3) ITA needs to be considered: see 11.3.5 (Income/gains used to repay debt).

It is considered that the repaid money in the hands of L is not derived from the RFI. It is derived from the debt, and (indirectly) from the money which L may have used to make the loan to T.

### 10.14.11 *Income from income/gains*

Suppose:
(1) T receives £1m ("original income").
(2) T invests the original income and receives £50k ("new income").
It is considered that the new income is not derived from the original income. One must stop tracing the original income at that point. Otherwise various odd results will follow:
(1) If T remits the £50k new income, T would pay tax on the £1m original income.[62]

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60 Likewise Lord Walker said:
> "In my opinion the £770,000 [borrowed money] started off as derived property..."

61 The position could be different if the two steps formed part of a scheme and were carried out in quick succession. Of course, under the debt remittance rules there would be a remittance of the RFI if the debt were a relevant debt.

62 See 10.23.2 (Remittance of derived property).

(2) Suppose:
 (a) T gives £1m original income to R (a relevant person).
 (b) R receives £50k new income.
 (c) R remits the £50k new income.

If the new income is derived from the original income, there will be double taxation:
 (i) R will pay tax on the new income (on an arising or remittance basis, depending on whether R is a remittance basis taxpayer; that makes no difference for the purposes of this example).
 (ii) T would pay tax on the remittance of the new income by R.

### 10.14.12 *Gift to third person*

The position becomes more complex if a second individual is involved. Suppose:

(1) T gives income/gains to A (an individual who may or may not be a relevant person).[63]
(2) A gives the fund to B (a relevant person).

It is suggested that the funds in the hands of B are derived property if steps (1) and (2) form an arrangement. If there is no connection of that kind between T's gift and the transfer to B, the funds in B's hands are not derived property. In particular, if B acquires the funds on the death of A, the funds are not derived property.[64]

If T gives income/gains to a trust and the trust appoints the fund to B, the same approach should be applied, but the two steps do form an arrangement because the trust is merely carrying out the intention of the settlor.

## 10.15 Debt remittance rules

I turn to the second part of remittance condition B. Section 809L(3) ITA provides:

> Condition B is that ...

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63 If A is not a relevant person, A will be a gift recipient, and remittance condition C needs consideration.

64 This view is supported a little by s.48(3C)(b) IHTA: see 53.16.3 (Purchased equitable interest).

(c) the income or chargeable gains are used outside the UK (directly or indirectly) in respect of a relevant debt, or
(d) anything deriving (wholly or in part, and directly or indirectly) from the income or chargeable gains is used as mentioned in para (c).

I refer to these rules as the "**debt remittance rules**".

In order to have a debt remittance under condition B, three conditions must be satisfied; in short:

(1) A *relevant debt* (broadly, relating to property brought/received/used in the UK).
(2) Foreign income/gains used *in respect of* the debt.
(3) The income/gains are used *outside the UK*; however if the income/gains are used in the UK, there will normally be a remittance under the usual remittance rules.

There is no remittance under the debt remittance rules:

(1) if a relevant debt is paid out of a sum which does not constitute foreign income/gains; or
(2) if foreign income/gains are used to satisfy a debt which is not a relevant debt.

Debt is not defined. It is suggested that it includes any liability to pay money. If an individual takes a lease, the payment of rent is the payment of a debt. If the land is UK situate, the debt is a relevant debt. A guarantee is not a debt but if the guarantee is called on, it becomes a debt.

## 10.16 Relevant debt

"Relevant debt" is a key term, which is found in remittance conditions B, C and D . Section 809L(7) ITA provides the definition.

There are six categories of relevant debt:

> In this section "relevant debt" means a debt that relates (wholly or in part, and directly or indirectly) to—
> (a) property falling within subsection (2)(a) [property brought/received/used in the UK].
> (b) a service falling within subsection (2)(b) [ service provided in UK]
> (c) qualifying property dealt with as mentioned in subsection (4)(a),
> (d) a service falling within subsection (4)(b),

(e) qualifying property dealt with as mentioned in subsection (5)(a), or
(f) a service falling within subsection (5)(b).

To understand this one must read back in the words in the six cross-references:
(a) and (b) relate to remittance condition A
(c) and (d) relate to remittance condition C
(e) and (f) relate to remittance condition D.
When one reads in the words, it is clear that para (f) is otiose: it only repeats para (d).

In para (e) "*Qualifying* property dealt with as mentioned in s.809L(5)(a)", the word "qualifying" is meaningless. The expression "qualifying property" is defined for remittance condition C but not for condition D.

The most important category is para (a). The discussion below concentrates on this category. There are two steps in deciding whether a debt is a relevant debt within para (a):

(1) One must identify the property (if any) to which the debt relates. I refer to that as **"the asset"**.
(2) One must ask if that property is "property falling within s.809L(2)(a)" ie the property is brought/received/used in the UK by a relevant person.

The residence of the lender is not relevant. A loan from a UK bank is not a relevant debt if the money borrowed is received and retained outside the UK but it is a relevant debt if the money borrowed is received in the UK. However the debt remittance rules only apply if income/gains are used *outside the UK* in respect of a relevant debt, which is not likely to happen where the loan is to a UK bank: repayment to a UK bank is in principle use of the funds in the UK.

## 10.17 Debt "relating" to property (debt-related asset)

"Relates" requires some nexus between the debt and the property; exactly what that nexus is has been left to the courts to sort out.

The words "directly or indirectly" do not add any clarity; indeed I am not sure that it is altogether coherent to speak in the abstract of direct and indirect relationships, for "relates" requires a relationship and an indirectly relationship is a type of relationship. But the word "indirectly" shows that the drafter did not want the word "relates" to be construed very narrowly.

In the following discussion I just use the word "relate" and leave "directly or indirectly" to be understood.

10.17.1 *Some straightforward examples*

Suppose T borrows and receives money. The debt relates to the money. If T receives the borrowed money in the UK, the debt is a relevant debt.

If T borrows and receives the borrowed money outside the UK, the debt still relates to the money but the money is not "property falling within s.809L(2)(a)" so the debt is not a relevant debt. However if T later brings the money to the UK, it becomes "property falling within s.809L(2)(a)" and the debt at that time becomes a relevant debt.

Under a typical loan facility, T will borrow but may not receive money: T may draw down the borrowing to pay for an asset, the money being paid directly to the vendor. In that case the debt relates to the asset. If at any time T brings/receives/uses the asset in the UK the debt is a relevant debt. So it makes no difference whether the loan is drawn down first or (which may be more usual) drawn down directly to pay for the asset.

The RDR Manual provides some examples which are consistent with the above. I here set out the relevant parts of the text, relegating the full text to footnotes.

Example 1 concerns borrowing to buy UK shares.

> *Example 1 (Katrina)*[65]
> K borrows money to buy shares in a UK company.

The HMRC analysis is as follows:

> This is a relevant debt as it relates to property (shares) in the UK which is for the benefit of a relevant person.

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65 The example in full (including its irrelevant detail) is as follows:

"**33160 Condition B - relevant debt**

In May 2006 Katrina, a remittance basis user, borrows money from an overseas bank to buy shares in a UK company. This is a relevant debt as it relates to property (shares) in the UK which is for the benefit of a relevant person (Katrina).

From 6 April 2008 any foreign income or gains that Katrina uses in respect of the loan, for example to service or to repay the loan, are taxable as a remittance."

More analytically, the debt is in the HMRC view a relevant debt on the following grounds:

(1) The debt relates to the shares. (This is correct).

(2) The shares are received in the UK by K. (This assumes a receipt of UK situate property is a receipt in the UK: see 10.11.9 (Receipt of UK situate investment asset)).

Example 2 concerns borrowing to buy UK residential accommodation:

> *Example 2 (Gary)*[66]
> G borrows money to buy an apartment in the UK which he occupies.

The HMRC analysis is as follows:

> The loan is a relevant debt because money is used in the UK, and it is respect of property (the apartment) which is used in the UK for the benefit of a relevant person (G).

More analytically, this is in the HMRC view a relevant debt on one or both of the following grounds:

(1) It relates to the flat which is used in the UK by G. (This is correct).

(2) It relates to money which is used in the UK by G. (Whether this is correct depends on the details of the purchase arrangement but it does not matter since the debt is a relevant debt under (1)).

Example 3 concerns borrowing to buy a UK chattel for a relevant person.

> *Example 3 (Robina)*[67]
> R borrows money to buy a car for M, a relevant person.

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66 The example in full (including its irrelevant detail) is as follows:
"On 6 April 2015, Gary, a remittance basis user, borrows money from an overseas bank to buy an apartment in Solihull.
The loan is a relevant debt because money is used in the UK, and it is respect of property (the apartment) which is used in the UK for the benefit of a relevant person (Gary)."

67 The example in full (including its irrelevant detail) is as follows:
"In October 2012 Robina, a remittance basis user, borrows money on a fixed-rate loan from an overseas bank to buy a car for Mark, a relevant person. Robina pays £x each month from 1 November 2012, making 24 monthly payments. She uses her foreign chargeable gains to make these repayments.
The loan is a relevant debt because it is respect of property (the car) which is used in the UK by a relevant person (Mark)."

The HMRC analysis is as follows:

> The loan is a relevant debt because it is respect of[68] property (the car) which is used in the UK by a relevant person (M).

More correctly, there is a relevant debt because:
(1) The debt relates to the car.
(2) The car is used in the UK by a relevant person, M. (Another reason is that the car must have been brought or received in the UK by R or M.)

Example 4 concerns borrowing to pay for two services, one provided in and the other out of the UK; I discuss this at 10.17.13 (Debt relating to UK property in part).

Example 5 concerns borrowing to purchase an asset given to a relevant person; I discuss this at 10.17.6 (Debt-related asset given to another person).

Example 6 (Francine) is a straightforward example of borrowing to pay for services in the UK which adds nothing and so is not set out here.

For example 7, see 10.17.12 (Borrowing by relevant person (not the individual)).

### 10.17.2 *Asset derived from debt-related asset*

Suppose:
(1) T borrows and uses the borrowed money to purchase a non-UK asset (“asset 1").
(2) T later sells asset 1 and uses the proceeds of sale to purchase a UK asset (“asset 2").

The debt relates to asset 1. It is considered that the debt does not necessarily relate to asset 2. The word “relates” requires more than just a historic tracing exercise. It is suggested that the debt relates to the UK asset if and only if steps (1) and (2) form part of an arrangement.

Similarly, suppose:
(1) T borrows.

68 The author of the example probably regarded “relates to” and “in respect of” as synonymous, which no doubt they are; but it is best to use the statutory wording and not a paraphrase.

(2) The borrowed funds (or proceeds representing them) are mixed with other funds.
(3) Some of the mixed funds are used to acquire a UK asset.

Unless steps (1) to (3) form part of an arrangement, the debt does not relate to the UK asset. If the debt does relate to the asset, some commonsense tracing rules must be devised; the ITA mixed fund regime does not apply.

Suppose T borrows invests the borrowed funds, and receives income from the borrowed funds. It is considered that the debt does not relate to the income. So if the income is remitted, it is in principle taxable, but the debt does not thereby become a relevant debt.

### 10.17.3 *Debt relating to asset later removed from UK or ceasing to exist*

Suppose:
(1) T borrowed to acquire an asset.
(2) T brings/receives the asset in the UK so the debt is a relevant debt.
(3) T later takes the asset outside the UK.

The debt still relates to the asset. It is suggested that the asset is still "property falling within s.809L(2)(a)" ie property brought/received/ used in the UK by T. So the debt is still a relevant debt. The contrary view gives some scope for planning/avoidance. Suppose T wanted to use property/chattels in the UK:
(1) T borrows funds.
(2) T uses the funds to purchase property in the UK and chattels which are in the UK or which are brought to the UK.
(3) Interest rolls up on the debt.
(4) Later when T no longer wants to use the property/chattels, the chattels are taken outside the UK, and the property is sold.
(5) The debt is then repaid.

If my view is wrong, the debt has ceased to be a relevant debt by the time it is repaid so there is no remittance, even though T may have enjoyed substantial benefits in the UK.

Refinancing might solve the tax problem.[69]

Suppose:
(1) T borrowed to acquire an asset.
(2) T brings/receives the asset in the UK so the debt is a relevant debt.

69 See 10.17.4 (Borrowed money used to repay debt: refinancing).

(3) The asset ceases to exist (eg it is a short lease which expires, or money which is spent).

It is considered that the debt remains a relevant debt. That is consistent with debt remittance rules for services, for if T borrows to pay for services provided in the UK, the debt is a relevant debt even after the services have ceased to be provided.

### 10.17.4 *Borrowed money used to repay debt: refinancing*

Suppose:

(1) T borrows and uses the borrowed money to acquire property brought/received/used in the UK. The debt (“debt 1") is a relevant debt.

(2) T borrows more (“debt 2") and uses the borrowed funds to repay debt 1.

It is suggested that debt 2 is a relevant debt if the steps form a scheme or arrangement.

On the other hand suppose there is no UK asset at the time of step 2 (the refinancing), eg:

(1) T borrows and
- (a) brings the borrowed money to the UK and later takes it out again; or
- (b) uses the borrowed money to acquire UK property which is later sold and the proceeds taken out of the UK or
- (c) spends the borrowed money in the UK.

In each case the debt (“debt 1") is a relevant debt.

(2) T borrows more (“debt 2") and uses the borrowed funds to repay debt 1.

It is suggested that debt 2 is not a relevant debt (unless the steps form part of a single arrangement).

Suppose:

(1) T borrows (“the first debt”) and receives fund A.

(2) T borrows again (“the second debt”) and uses the money borrowed on the second debt to repay the first debt. Thus T retains fund A.

It is suggested that the second debt relates indirectly to fund A if the two steps form a single arrangement, but not otherwise.

### 10.17.5 *Borrowed money lent on to another person*

The position becomes more complex if borrowed money is lent on to another person. Suppose:

(1) T borrows money from a bank.
(2) T lends the borrowed money to A.
(3) A uses the money to acquire a UK asset ("A's UK asset").

In this case:

(1) T has a debt: the burden of the debt to the bank ("T's debt"). One needs to ask if it is a relevant debt.
(2) A has a debt: the burden of the debt to T ("A's debt"). One needs to ask if it is a relevant debt.
(3) T has an asset: the benefit of A's debt to T: one needs to ask if it is UK situate.
(4) A has an asset: "A's UK asset".

A's debt is a relevant debt: it relates to A's UK asset.

Is T's debt a relevant debt? T's debt relates to the benefit of A's debt. If the benefit of A's debt is a UK situate asset, then T's debt is a relevant debt. Let us assume this is not the case.

T's debt is also a relevant debt if (1) it relates (indirectly) to A's UK asset and (2) A is a relevant person in relation to T. It is suggested that T's debt does not relate to A's UK asset. This is clearly the case if steps (1) and (2) do not form an arrangement. If there is no connection of that kind between T's debt and the UK asset, the debt does not relate to the asset. But even if there is an arrangement, T's debt does not relate to A's UK asset, since T has another asset which relates to the debt. There is no scope for tax avoidance in this conclusion, since the debt remittance rules apply to A.

If my view is wrong, what would the position be if:

(1) T borrows from a bank and lends to A.
(2) A lends the proceeds of the borrowing to B.
(3) B uses the money to acquire a UK asset.

How many assets would T's debt relate to, and how could T keep track of them all?

### 10.17.6 *Debt-related asset given to another person*

RDR Manual 33160 gives an example of borrowing to purchase an asset which is later given to a relevant person and brought to the UK:

*Example 5 (Ali)*[70]
A borrows to purchases a sculpture outside the UK.
A gives the sculpture to his wife W.
W brings the sculpture to the UK.

HMRC correctly analyse why the debt is a relevant debt:

> There is a debt (the loan from the bank) which relates to property (the sculpture) which is brought to the UK by a relevant person (W).

Suppose:
(1) T borrows money from a bank.
(2) T gives the borrowed money to R.
(3) R uses the money to acquire a UK asset ("R's UK asset").
Is T's debt a relevant debt? T's debt is a relevant debt if (1) it relates (indirectly) to R's UK asset and (2) R is a relevant person in relation to T. It is suggested that T's debt relates to R's UK asset if and only if steps (1)

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70 The example in full (including its irrelevant detail) is as follows:

"**33160 Condition B - relevant debt**
Ali, a remittance basis user, purchases a sculpture in Sweden in October 2012 (see earlier example). He takes out an interest-free [*sic*] loan with his US bank to fund this purchase, repayable within 1 year. In November 2012 he gives them to his wife as an anniversary gift.
She initially keeps it at her mother's home in Stockholm, but 6 months later in March 2013 Ali's wife decides to bring the sculpture to the UK to display in her UK garden. In October 2013 Ali arranges with the US bank that he will repay the loan by giving them an oil painting which is currently in his apartment in Miami, which he had purchased in May 2011, using his relevant foreign earnings, and some capital inherited from an uncle.
There is a debt (the loan from the US bank) which relates to property (the sculpture) which is brought to the UK by a relevant person (Ali's wife, in March 2013).
The painting which derives, in part, from A's relevant foreign earnings, is used outside the UK in respect of this relevant debt.
There is a taxable remittance in 2013-14, the tax year in which the painting is used to pay the relevant debt."

More analytically, remittance condition B is satisfied under s.809L(3)(d): the picture (which derives from RFE) is used in respect of the relevant debt. The example continues:

"The remittance occurs when the foreign income or gains are regarded as used in respect of the relevant debt (2013-14) not when the property is first used in the UK by a relevant person (2012-13). ...
NB – for the purposes of this example assume there is no chargeable gain on the transfer of the painting to the bank."

and (2) form an arrangement. If there is no connection of that kind between T's debt and the R's asset, the debt does not relate to the asset.[71]

10.17.7 *Borrowed money used to buy secondhand company*

Suppose T borrows and buys all the shares of a company which owns a UK asset ("the Co's asset"). The debt relates to the shares. At first sight it may seem likely that the debt also relates to the Co's asset. But note that if T uses foreign income to purchase the shares, the income is not remitted. That being the case, it would be anomalous if there were a remittance if T borrows to purchase the shares and then uses foreign income to pay the debt. So the debt should not be regarded as a relevant debt: the debt does not relate to the co's asset. One does not lightly pierce the corporate veil.

10.17.8 *Borrowed money used to buy partnership interest*

Suppose T borrows and buys an interest in a partnership which owns a UK asset. It is suggested that the debt does not relate to the UK asset.[72]

10.17.9 *Debt for unpaid interest*

Suppose one has two debts:
(1) A debt for capital borrowed (the principal debt).
(2) A debt for interest on the principal debt (the interest debt).
The fact that the principal debt is a relevant debt (assume it relates to property brought/received/used in the UK) does not make the interest debt a relevant debt. This follows from the repeal of the former s.809L(8) ITA in 2009. However see 10.18.1 (Payment of interest).

10.17.10 *Borrowing on security of UK asset*

Suppose T borrows and receives the borrowed money abroad but secures the debt on property brought/received/used in the UK. It is considered that the debt does not relate to the UK property (within the meaning of the section) so the debt is not a relevant debt. The context shows that the

71 Contrast 10.14.12 (Gift to third person).
72 See 10.37 (Partnerships).

colourless word "relate" is intended to apply to the proceeds of the debt, the borrowed money. Otherwise there would be a remittance when the debt is repaid, which is absurd.[73]

### 10.17.11 *Debt imposed by law*

Debts may be imposed by law. Court orders on divorces are not relevant debts (they do not relate to property brought received/used in the UK) and indeed the obligation may not be a "debt". So the debt remittance rules do not apply. Similarly, fines imposed by the courts do not in principle relate to property brought/received/used in the UK.

There might, however, be a remittance under ordinary principles when the court order is satisfied.

A tax liability relating to foreign income or gains is not a relevant debt, but it might be argued that a tax liability relating to UK income or gains, or remitted RFI and foreign gains, does relate to UK property.

### 10.17.12 *Borrowing by relevant person (not the individual)*

Suppose:

(1) R (a relevant person - not the individual) borrows to purchase an asset.

(2) R receives or uses the asset in the UK (so the debt is a relevant debt).

The debt is a relevant debt and if T uses their income/gains to repay it there is a taxable remittance.

It is suggested that this is the case even if R ceases to be a relevant person before T uses their income/gains to repay the debt, since even at that time the debt relates to the asset, and the asset is property falling within s.809L(2)(a); but the contrary is arguable.

The RDR Manual 33160 provides an example:

> Example 7 (Kumar)[74]

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73 The debt would not be a relevant debt if T first took the UK security outside the UK, which would be somewhat odd.

74 The example in full (including its irrelevant detail) is as follows:

> "**33160 Condition B - relevant debt**
>
> *Example 7*
>
> Kumar sets up and is a beneficiary of a non resident trust with £1,000,000 capital which the trustees invest in overseas property which produces income that would be

> K is settlor of a non resident settlor-interested trust.
> The trust borrows to buy an asset which K uses in the UK.

The HMRC analysis is as follows:

> There is a relevant debt (the loan) which is used to purchase an asset in the UK (property used by a relevant person).

More analytically, the debt is a relevant debt since:
(1) It relates to the UK asset.
(2) The asset is used in the UK by a relevant person (K).
Thus if the debt is repaid out of foreign trust income, K is chargeable under the s.624 remittance basis.

That applies even to pre-2008 debts. There is transitional relief if pre-2008 income/gains are used to repay the debt (wherever made).[75] However, transitional relief for pre-2008 debts[76] does not apply in this case.

### 10.17.13 *Debt relating to UK property in part*

If a debt relates partly to property brought/received/used in the UK, the entire debt is a relevant debt. The unfairness is avoided by the rules in s.809P: see 10.23.3 (Debt remittances). But HMRC do not agree. In RDR Manual the facts (stripping out irrelevancies)[77] are as follows:

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chargeable on Kumar if he remitted it to the UK.
The trust borrows £500,000 from an offshore lender to buy a UK asset which Kumar uses in the UK. The trust pays the interest on the loan with the income from the letting of the overseas property.
There is a relevant debt (the loan) which is used to purchase an asset in the UK (property used by a relevant person). The income used to service the loan is regarded as a taxable remittance, chargeable on Kumar."

75 See 10.8 (Relevant person transitional rule for pre-2008/09 income and gains).

76 See 10.43 (Transitional loan relief).

77 The example in full (including its irrelevant detail) is as follows:
"**33160 Condition B - relevant debt**
*Example 4*
In August 2011 Karen, a remittance basis user, uses an interest-free [*sic*] overdraft facility on her Jersey bank account to pay UK school fees for her 14 year old daughter Lauren. She also uses the remainder of the facility to pay for Lauren to attend a summer school in France organised by a French university. Karen repays the overdraft from her relevant foreign earnings between August and November

> *Example 4 (Karen)*
> K borrows:
> - to pay UK school fees for her 14 year old daughter.
> - to pay for a summer school in France for the daughter.
> K repays the overdraft from her relevant foreign earnings.

The HMRC analysis is:

> There is a debt (the overdraft) which relates in part to a service provided in the UK (the schooling) to a relevant person (the daughter) – this part is a relevant debt. However part of the overdraft facility is not a relevant debt because it does not relate to a service provided to the daughter in the UK, but to a service provided in France.

The author has overlooked the definition of relevant debt in s.809L(7) ITA:

> In this section "relevant debt" means a debt that relates *(wholly or in part,* and directly or indirectly) to—
> (a) property falling within subsection (2)(a),
> (b) a service falling within subsection (2)(b) ...

## 10.18 "Use in respect of" a relevant debt

Condition B is satisfied only if income/gains are used in respect of the relevant debt.

Use "in respect of" a debt requires some nexus between the use and the debt; exactly what that nexus is has been left to the courts to sort out.[78] The words "directly or indirectly" do not add any clarity. Indeed I am not sure that it is altogether coherent to speak in the abstract of use "directly or indirectly" in respect of a debt, for use indirectly in respect of a debt is use in respect of a debt. But the word "indirectly" shows that the drafter did not want the words "in respect of" to be construed narrowly.

In this section I sometimes refer simply to a debt rather than a relevant debt, ie I assume the debt is a relevant debt.

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2011. ...
The daughter therefore has taxable remittances of the relevant foreign earnings used to service and repay the part of the overdraft that is a relevant debt."

78 In *Cunard's Trustees v IRC* 27 TC 122 at p.135 Lord Greene MR described the phrase "in respect of" as "colourless words".

If foreign income/gains are used to pay a relevant debt, this is a taxable remittance under the debt remittance rules: money used to pay a debt is used in respect of a debt.

### 10.18.1 *Payment of interest*

Section 809L(9) ITA provides:

> The cases in which property (including income or chargeable gains) is used in respect of a debt include cases where the property is used to pay interest on the debt.

Suppose T has two debts:
(1) A debt for capital borrowed (the principal debt).
(2) A debt for interest on the principal debt (the interest debt).
We note above that it is possible that:
(1) the principal debt is a relevant debt (assume it relates to property brought/received/used in the UK) but
(2) the interest debt is not a relevant debt.[79]
However if T uses foreign income/gains to pay the interest debt, the funds are regarded as used in respect of the *principal* debt, and so are regarded as remitted under s.809L(3)(c). In other words, it does not matter whether or not the interest debt is a relevant debt, all that matters is whether the principal debt is a relevant debt.

### 10.18.2 *Use as security for debt*

Suppose foreign income/gains are charged as security for a debt. It appears at first sight that the funds are "used" and (if used) the funds are certainly used "in respect of" the debt. On this view charging funds as security for a debt constitutes a remittance. However the word "used" might connote "used up" ie consumed; in that sense (unless and until the security is enforced) the funds are not "used", and the charge does not constitute a remittance.

I have considered a compromise view, that the funds are "used" in circumstances where the loan would not be made without the security, and funds are not "used" if the circumstances are that the loan would be made

79 See 10.17.9 (Debt for unpaid interest).

anyway. On reflection I think that is not the better view. Among other objections, the question whether the loan would be made without the security is a hypothetical question which would often be imponderable.

The RDR Manual provides:

> **33170 Condition B - collateral[80] in respect of relevant debt** [July 2010]
> Foreign income and gains may be used as collateral for a loan which is brought to the UK or otherwise used for a purpose to which ITA2007/s809L(2) applies (that is, there is a relevant debt).
> Such foreign income and gains used as collateral are used 'in respect of' the relevant debt, so there may be a taxable remittance at this point.
> [1] The foreign income or gains used as collateral may be used directly, that is, the lender may receive a charge over cash assets in a bank account.
> [2] However it is more likely they will be offered indirectly, often in the form of an asset such as a property or bond note that is 'derived from' the foreign income or gains.[81]
> [3] This situation only arises where remittance basis users offer their foreign income or gains for use as collateral for a relevant debt, whether to a UK-based or an offshore lender.
> [4] In many cases UK property or non-taxable offshore property is offered as collateral in respect of a relevant debt; there is no remittance of this collateral within Condition B (ITA2007/s809L(3)(c)).
> To determine the amount of remittance where foreign income or gains are used as collateral in respect of a relevant debt refer to RDRM35050 Condition B - Collateral in respect of relevant debt.

So far the Manual appears to take the view that charging as security is use in respect of a debt, but the text now goes on to qualify that with an exception so large that the rule rarely applies:

> Foreign income and gains used to pay interest on the debt and to repay the borrowed capital are also 'used in respect of' a relevant debt, and will be taxable as a remittance. Thus there are potentially two possible sources of a taxable remittance charge in respect of the relevant debt –

80 [Author's footnote] A note on terminology. The author of this passage is using the word "collateral" as a synonym of "security" though that is (I think) American rather than English legal usage.

81 [Author's footnote]. I rather doubt that [2] is more likely than [1] but it does not matter.

the foreign income or gains used as collateral and the foreign income or gains used to repay the debt.

In the majority of commercial situations, neither party to the relevant debt transaction expects or intends that the collateral offered as security will be taken by the lender. Instead it is planned that the loan will be serviced and the capital repaid without recourse to the security charge. In such cases using foreign income or gains to regularly service or make capital repayments in respect of the relevant debt effectively 'masks' the collateral being used. In such cases the only taxable remittance will occur as and when the foreign income or gains are used to service or repay the loan. The payments, and thus the taxable remittances, will be spread over the loan period.

*Example 1: (John)*[82]

In 2012/13 J, a remittance basis user takes out a loan for £200,000 from a Guernsey bank. J uses the loan to purchase UK property so the loan is a relevant debt.

J offers as collateral for the loan an offshore bond. He purchased this bond in 2010 (a year in which he was also UK resident remittance basis user) using £200,000 of his untaxed RFI from that year.

J repays £18,000 of the loan (principle (*sic)* plus interest) in 2012/13, using his RFE.

J is using the offshore bond as collateral for the loan; the offshore bond derives directly from his foreign income so J is using his RFI in respect of the relevant debt. However J is also using his RFE to both service and repay the debt capital; this 'masks' the collateral and so J will only be regarded as remitting the £18,000 RFE in 2012/13.

Note – In the example above, the relevant debt could also be serviced and repaid using non-taxable income or capital sources; in which case there would be no taxable remittances of foreign income or gains. However the servicing/repaying of the loan effectively masks the collateral offered, so there is still no remittance of the collateral in this circumstance.

In some cases, usually involving avoidance or non-commercial arrangements, the relevant debt is not serviced or repaid by the borrower, or only a token amount is offered. In these circumstances the foreign income or gains offered as collateral are being utilised in respect of the relevant debt, that is, to delay or minimise service charges or repayments. As there is only one possible tax charge in respect of the relevant debt, that is the charge HMRC will take. The charge is taken

82 I omit a few irrelevancies in setting out the text of this example.

> up-front when the collateral is offered. Such arrangements are expected to be rare.
> This should not be mistaken with interest-only repayment terms, or commercial arrangements that offer payment breaks and so forth. Always check the terms and general availability of the loan arrangements on offer.
> If you think there is a remittance of foreign income or gains offered as collateral in respect of a relevant debt you should obtain copies of all the relevant arrangements, including all loan agreements and repayment schedules.

Thus in the HMRC view, security is not "used in relation to a debt" if the debt is "serviced and repaid" on commercial terms. This distinction is difficult to defend, and it is considered that the grant of security is not use in relation to the debt, until the security is enforced.

There may be some special feature in the arrangements which do constitute "use". Back to back loans may be an example. Suppose:

(1) T deposits foreign income/gains in a bank ("T's deposit").
(2) T borrows from the bank ("the relevant debt").
(3) No interest is paid on T's deposit and only a small rate of interest is paid on the borrowing.

It is reasonably arguable that the income/gains deposited is used in respect of the relevant debt. But even here, it is suggested that there is no use in respect of the relevant debt, as the funds are not used up or consumed. (On the other hand, if commercial interest rates are paid on the deposit and the borrowing, the deposited funds are clearly not used in respect of the debt.)

It follows that it is only rarely if ever necessary to consider the amount remitted on the grant of security, but the issue is considered at 10.23.4 (Use as security: amount remitted).

## 10.19 Becoming/ceasing to be a relevant person: conditions A & B

A person may be a relevant person at one time and not at another time. For instance, a child ceases to be a relevant person on becoming 18; a person becomes a relevant person on marriage or cohabitation and ceases to be a relevant person on divorce or separation. A company becomes a relevant person in relation to T if T becomes a participator in the company.

The statute gives no guidance to the application of conditions A and B in this situation. We need to find the answer as best we can in the words of the statute.

### 10.19.1 *Condition A*

Section 809L(2) ITA provides:

> Condition A is that—
> (a) money or other property is brought to, or received or used in, the UK by ... a relevant person...

For present purposes there are three ways of satisfying condition A: property must be (i) brought or (ii) received or (iii) used in the UK by a relevant person. Property is *brought* or *received* in the UK at a particular moment, and it is considered that the person must be a relevant person at that moment.

Suppose:

(1) T uses RFI to make a gift of an asset to S (not a relevant person). S brings or receives the asset in the UK. There is no charge at the time of the gift or of the receipt in the UK.

(2) Later, S becomes a spouse or cohabitee, and so becomes a relevant person. There is no charge at that time.

Likewise if:

(1) T uses RFI to make a gift of an asset to R (a relevant person). R does not remit the asset to the UK. There is no charge at this time.

(2) Later, R ceases to be a relevant person, and subsequently brings or receives the asset in the UK. There is no charge at that time.

HMRC agree. In RDR Manual 33150 example 5, the facts (stripping out irrelevancies)[83] are:

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83 The example in full (including its irrelevant detail) is as follows:

> "**33150 Condition B - remittances derived from income or gain**
> *Example 5*
> Caroline is a remittance basis user. In August 2013 she realises some foreign assets and so makes some foreign chargeable gains. She uses all the proceeds (and so uses all these gains) to purchase a motorcycle in Paris which she gives to her husband Joel. It is registered in his name. Joel keeps the bike at his French apartment. A few years' [*sic*] later Caroline and Joel divorce, and Joel moves from their home in Liverpool to Manchester.

> In 2013 W uses foreign chargeable gains to purchase a motorcycle in Paris.
> W gives the asset to her husband H. H keeps the bike at his French apartment. [So there is no remittance at this time].
> Subsequently, H and W divorce, and H moves from their home [ie H ceases to be a relevant person].
> In 2017 H brings his bike to the UK.

The relevant part of HMRC analysis is as follows:

> H and W were married and so H was a relevant person in 2013 when W gave him the motorcycle; he could not therefore have been a gift recipient (see Condition C – Gift recipients cannot be relevant persons).

More analytically, condition C is not satisfied.

> By 2017 they have divorced so H is not a relevant person when he brings in the motorcycle [to the UK] for S to use.

More analytically, condition A is not satisfied because H is not a relevant person when H brings the asset to the UK.

### 10.19.2 *Condition B*

Condition B provides (in part):

> Condition B is that—
> (b) the property, service or consideration [received in the UK]—
> (i) derives (wholly or in part, and directly or indirectly) from the income or chargeable gains, and
> (ii) in the case of property or consideration, is property of or consideration given by a relevant person ...

It is considered that the requirement in (b)(ii) is met only if the person is a relevant person at the time that condition A is met (ie at the time that the property is brought/received/used in the UK). HMRC agree. The RDR Manual 33120 provides an example (already discussed above in

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In September 2017 Joel and Caroline's 16 year old son, Joseph wants to learn how to ride a motorcycle, so Joel imports his bike from Paris to his Manchester home for Joseph to use."

connection with condition A). The facts (so far as relevant) are as set out above with one additional fact:

> The motorcycle is used in the UK by C who is a minor child of W (a relevant person).

The HMRC analysis is as follows:

> Here, property has been provided in the UK (the motorcycle) for the use of a relevant person (C) ...

More analytically, condition A is satisfied.

> ...and the property derives directly from W's foreign chargeable gains. However the motorcycle is the property of H, who is not a relevant person [at the time that the property is used by the relevant person], so there is no taxable remittance for W.

More analytically, condition B is not satisfied because H is not a relevant person when the asset is used by the relevant person, C.

To drive the point home, the RDR Manual 33150 gives another example making the same points on somewhat far-fetched facts. So far as relevant[84] the facts are:

> In 2011 W uses RFI to purchase prints retained outside the UK.
> W gives the prints to her daughter D who is age 16 and so a relevant person. D retains the prints outside the UK [so there is no remittance].
> D ceases to be a relevant person on becoming 18 but in that year (bucking statistics) D has a child GD (who is a relevant person in

84 The example in full (including its irrelevant detail) is as follows:

> "**33150 Condition B - remittances derived from income or gain**
>
> *Example 6*
>
> In 2011, while visiting New York, Ros, a UK resident remittance basis user, purchases several art prints by H Marecus, an international artist. Ros uses her relevant foreign income to make the purchase. She gives them to her daughter Rachael, who is at that time living and studying in the US, as a 16th birthday present in February 2011. Rachael returns to the UK in May 2011, but leaves the prints at her uncle's New York apartment.
>
> In June 2016 Rachael's 3 year old daughter Abigail decides to start singing lessons in Newcastle. The singing teacher's mother is a collector of Marecus prints, so the teacher agrees with Rachael to accept one of the prints in exchange for the lessons. Rachael arranges for her uncle to send the print from New York directly to the singing teacher's mother in California."

> relation to W).
> In 2016 D enters into an (implausible) agreement under which she transfers the prints to the mother of a singing teacher outside the UK in consideration of the teacher giving singing lessons to GD (age only 3) in the UK.

The HMRC analysis is as follows:

> A service has been provided in the UK (the singing lessons) for the benefit of a relevant person (GD) ...

More analytically, condition A is satisfied.

> ...and the consideration for the service (the print) derives from W's RFI. However the consideration is given by D, who is not a relevant person [at the time that condition A is satisfied] and so W has not made a taxable remittance of her relevant foreign income. Rachael is 21 years old and so is not a relevant person in June 2016 when she gives the prints in consideration for a service.

More analytically, condition B is not satisfied.

> Note – D was 16 years old and so is a relevant person in February 2011 when her mother gave her the prints (see also Condition C – Gift recipients cannot be relevant persons).

More analytically, condition C is not satisfied.

The rule of when one applies the relevant person test may work in favour of HMRC. Suppose:

(1) T uses RFI to make a gift of an asset to S (not a relevant person). There is no charge at this time.
(2) S becomes a relevant person, and subsequently remits the asset to the UK. There is a taxable remittance at that time.

HMRC agree. The RDR Manual provides an example where the facts (stripping out irrelevancies)[85] are:

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85 The example in full (including its irrelevant detail) is as follows:
"In June 2010 Sam, a remittance basis user, uses £8,000 of her relevant foreign income to make an overseas purchase of an antique clock from a dealer in Denmark. Sam immediately makes a gift of an antique clock to Chris and Jo, who at that time are living in Denmark. The clock is kept at Chris's family home in Copenhagen.

> **33240 Gift recipients cannot be relevant persons**
> *Example 2*
> In 2010 T uses RFI to purchase a clock outside the UK.
> T immediately gives the clock to S (not a relevant person) and it is kept outside the UK.
> S, not being a relevant person, is a gift recipient.
> In 2014, T marries S. S becomes a relevant person and ceases to be a gift recipient at this time.
> Subsequently, S brings the clock to the UK.

The HMRC analysis is as follows:

> As S is no longer a gift recipient Condition C is not relevant.
> However as S is now [in 2014] a relevant person there is a taxable remittance chargeable on T when S imports the clock, under Conditions A and B. This is because
> [1] property (the clock) has been brought to the UK by a relevant person (S) [ie condition A is satisfied] and
> [2] that property derives from T's RFI and the property is property of a relevant person (S) [ie condition B is satisfied]

So far we have considered property brought to or received in the UK. That can happen only at a particular moment. On the other hand, property can be *used* in the UK over a period of time. Suppose:

(1) Year 1: T uses RFI to make a gift of an asset to S (not a relevant person). S uses and continues to use the asset in the UK eg she buys a house which she occupies. There is no charge at the time of the gift or at the time of the use.
(2) Year 2: S becomes a spouse or cohabitee, and so becomes a relevant person. She continues to use the property.

---

Chris, not being a relevant person, is a gift recipient.
Two years later Jo and Chris split up, and in July 2014, Sam and Chris marry. Chris ceases to be a gift recipient at this time.
In October 2014 Chris brings the antique clock to the UK to the house that is shared with Sam."
The example as published is defective in that it must be assumed (though this is not stated) that Chris gave his interest in the clock to Jo (or perhaps the gift was to Jo and not to Jo and Chris).

Is there a charge in year 2 when S becomes a relevant person? It would be strange if there were a difference between this case and the case of receipt in the UK. It is tentatively suggested that the answer is, no.

### 10.19.3 *Third persons*

The position becomes more complicated when a third person is involved. Suppose:

(1) T gives RFI to T's spouse W.
(2) There is a divorce and W ceases to be a relevant person.
(3) W transfers the RFI to a trust under which a minor child of T is a beneficiary. The trustee is a relevant person in relation to T.
(4) The trustee transfers the funds to the minor child who receives them in the UK.

Condition B appears to be satisfied since at the time of the receipt in the UK the funds are the funds of a relevant person. But the trust funds may not be derived income.[86]

## 10.20 Debt becoming/ceasing to be a relevant debt

A debt which is not a relevant debt may become a relevant debt. Condition B is (in short) that income is used in respect of a relevant debt. It is considered that the debt must be a relevant debt at the time the income is used.

Suppose:

(1) Year 1: T borrows and receives the borrowed sum offshore.
(2) Year 1: T uses RFI to pay the interest (use in respect of the debt).

In year 1 condition B is not satisfied as the RFI is not used in respect of a relevant debt.

(3) Year 2: T remits the borrowed sum to the UK.

In year 2 the debt becomes a relevant debt, but it is considered that the RFI used to pay interest in year 1 does not become remitted at that time. But if RFI is used to pay more interest in year 2, that RFI satisfies condition B.

86 See 10.14.12 (Gift to third person).

## 10.21 Remittance condition C (gift recipients)

Section 809L(4) ITA provides:

> Condition C is that qualifying property of a gift recipient—
> (a) is brought to, or received or used in, the UK, and is enjoyed by a relevant person,
> (b) is consideration for a service that is enjoyed in the UK by a relevant person, or
> (c) is used outside the UK (directly or indirectly) in respect of a relevant debt.

### 10.21.1 *Enjoyment by a relevant person*

The requirements in (a) and (b) are similar but not the same as remittance condition A. The differences are as follows:

| **Condition C requirement** | **Condition A requirement** |
|---|---|
| Property brought/received/used in the UK | Property brought/received/used in the UK *by or for the benefit of a relevant person.* |
| Property *enjoyed* by a relevant person. | No equivalent in condition A (though the requirement that the property is brought/received/used by or for the benefit of a relevant person is similar.) |

The word "enjoyed" in condition C means more or less the same as the word "used" in condition A.[87] I do not think there is a difference though if there were, the vagueness of the words makes it impossible to say what it may be. The reason for the different word is probably that other parts of condition C are derived from the GWR wording, where the word "enjoyed" is used[88] so the word enjoyed is copied across to condition C.

### 10.21.2 *Enjoyment disregards*

Section 809N ITA provides definitions and other supplementary

87 As to which, see 10.11.8 (Property used in the UK ("used" limb of condition A)).
88 See 54.1 (GWR – Introduction).

provisions for condition C. Section 809N(1) ITA provides:

> This section applies for the purposes of determining whether or not income or chargeable gains of an individual are remitted to the UK by virtue of condition C in section 809L.

Section 809N(9) ITA provides three cases where enjoyment is disregarded. Since enjoyment is a requirement of remittance condition C, this disregard amounts to exemption from condition C:

> Enjoyment by a relevant person of property or a service is to be disregarded in any of these cases—
> (a) if the property or service is enjoyed virtually to the entire exclusion of all relevant persons;
> (b) if full consideration in money or money's worth is given by a relevant person for the enjoyment; or
> (c) the property or service is enjoyed by relevant persons in the same way, and on the same terms, as it may be enjoyed by the general public or by a section of the general public.

Para (a) and (b) are based on IHT GWR provisions.[89]

Para (c) concerns charitable or public gifts, but it is hard to see that it is needed.

Para (b) is the most important of the three exceptions: I refer to it as "**the full consideration exemption**".

Suppose:

(1) T gives pre-2008 RFI to T's spouse (not a relevant person and so a gift recipient) and the spouse uses the money to buy a house jointly with T; or
(2) T gives RFI to T's brother (a gift recipient) and the brother uses the money to buy a property jointly with T.
(3) The co-owners occupy the property jointly.

It is considered T does not "enjoy" the co-owner's half share, so condition C is not satisfied in respect of the gifted RFI.

Suppose:

(1) T gives RFI to T's adult son S (a gift recipient), and
(2) S uses the money to purchase a UK residence which is occupied by S,

89 For (a) see 54.1 (GWR – Introduction); for (b) see para 6 sch 20 FA 1986.

not by T.

(3) S has a minor child, GS, who also lives in the property.

It is considered that the property is not "enjoyed" by GS, who is merely a licensee of S. Any "enjoyment" by GS is incidental to the primary use by S, and should be ignored. It is different if S leaves the property and GS becomes the occupier (but since GS is by then likely to be 18, S ceases to be a relevant person). HMRC agree. RDR Manual provides:

> **33270 Remittance Basis: Identifying Remittances: Condition C - Gift Recipients: Remittances - enjoyment by a relevant person ignored**
> Each case will depend on its particular facts, but broadly, enjoyment by a relevant person is disregarded, and so there is no taxable remittance under Condition C (if there otherwise would be) where the property or service is enjoyed by the gift recipient virtually to the entire exclusion of all relevant person, that is,
> [1] the gift is genuine and
> [2] any enjoyment by a relevant person is incidental (ITA2007/s809N(9)).

After this somewhat loose paraphrase of the statutory provision, the Manual gives the example we are considering:

> For example a minor child may derive benefit from living in the UK with his parents in a house that was purchased using offshore funds gifted by his grandfather (a remittance basis user) to his father, for his father's own use. It is normal for a young child to live with his parents and therefore, in most cases, no advantage over minor children generally is obtained. In this type of circumstance HMRC would generally accept that the minor child's enjoyment of the house was merely incidental to that of his father.

10.21.3 *Gift recipient*

The key terms in remittance condition C are "gift recipient" and "qualifying property".

Section 809N(2) ITA provides:

> A "gift recipient" means a person, other than a relevant person, to whom the individual makes a gift of money or other property that—
> (a) is income or chargeable gains of the individual, or

> (b) derives (wholly or in part, and directly or indirectly) from income or chargeable gains of the individual.

Strictly one should not use the term "gift recipient" in the abstract. A gift recipient can exist only *in relation to an individual (the donor)*. But where the context is clear it is permissible simply to refer to a gift recipient.

A relevant person cannot be a gift recipient. So in practice gift recipients will be individuals who are not members of the individual's close family, such as parents, adult children, friends and relatives. (Trusts and companies will generally be relevant persons and where they are not, it is unlikely they would or properly could enter into a transaction caught by condition C.)

If T makes a gift to G, and G gives the property to H, H is not a gift recipient in relation to T.

If T makes a gift to a trust, and the trust appoints the property to B, B is not a gift recipient, as T has not made a gift to B.

### 10.21.4 *Meaning of "gift"*

Section 809N(5) ITA extends "gift" to include disposals at an undervalue:

> The individual "makes a gift of" property if the individual disposes of the property—
> (a) for no consideration, or
> (b) for consideration less than the full consideration in money or money's worth that would be given if the disposal were by way of a bargain made at arm's length;
> but, in a case falling in para (b), the individual is to be taken to make a gift of only so much of the property as exceeds the consideration actually given.

In the phrase "full consideration in money or money's worth *that would be given if the disposal were by way of a bargain made at arm's length*" do the italicised words add anything? It is thought not; these words are otiose but they do no harm.

Section 809N(6) ITA is intended to widen this:

> A reference to the individual making a gift of property includes a case where—

(a) the individual retains an interest in the property, or
(b) an interest, right or arrangement enables or entitles the individual to benefit from the property.

I am unable to make sense of this. The wording is loosely based on s.102A FA 1986 but the context there is different, and s.102A is itself obscure, so that does not shed any light on the matter. Perhaps it is meaningless.

Suppose T makes an interest-free loan to B. The transaction is for full consideration so it is not a gift within s.809N(5). A lender in principle has no interest in the money lent so s.809N(6)(a) does not apply. A loan does not entitle T to benefit from the money lent. B may use that money for himself. It is considered that the loan does not enable T to benefit from the money lent, so s.809N(6)(b) does not apply. B is not a gift recipient.

### 10.21.5 *Meaning of "qualifying property"*

Section 809N(7) ITA defines "qualifying property". There are three categories of qualifying property:

> "Qualifying property", in relation to a gift recipient, is—
> (a) the property that the individual gave to the gift recipient,
> (b) anything that derives (wholly or in part, and directly or indirectly) from that property, or

Para (a) and (b) are what one would expect, but the definition goes on to include something much wider:

> (c) any other property, but only if it is dealt with as mentioned in section 809L(4)(a), (b) or (c) by virtue of an operation which is effected—
> (i) with reference to the gift of the property to the gift recipient, or
> (ii) with a view to enabling or facilitating the gift of the property to the gift recipient to be made.

Section 809N(8) ITA is intended to widen this:

> In subsection (7)—
> (a) the reference in para (b) to anything deriving from property, and
> (b) the reference in para (c) to other property,

> includes a thing,[90] or property, that does not belong to the individual but which the individual is enabled or entitled to benefit from by virtue of any interest, right or arrangement.

This is misconceived. Qualifying property will not belong to the individual because it has been given to the gift recipient, so it is not necessary to say that property includes property not belonging to the recipient. Here, as in s.809N(6), the drafter's desire to achieve the widest possible generality, and avoid any possible gaps in the legislation, has led to incoherence.

### 10.21.6 *Time of remittance*

Section 809L(6) ITA provides a rule which applies for conditions C and D:

> In a case where subsection (4)(a) or (b) or (5)(a) or (b) applies to the importation or use of property, the income or chargeable gains are taken to be remitted at the time the property or service is first enjoyed by a relevant person by virtue of that importation or use.

### 10.21.7 *HMRC examples*

Remittance condition C catches remittances channelled through a gift recipient, which are not caught by conditions A and B.

The RDR Manual provides a straightforward example where the facts (stripping out irrelevancies)[91] are:

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90 The reference to a "*thing or* property" is meaningless. What non-property "thing" could there be?

91 The example in full (including its irrelevant detail) is as follows:

**33260 Gift recipients - qualifying property**

"*Example 1(a)*

In May 2015 Klimt, a remittance basis user, gives some of his foreign chargeable gains for that year to his sister Helena, a gift recipient.

In October 2016 Helena transfers half of this money to the UK and gives it to Klimt's wife.

The qualifying property here is the money that Klimt gifted to Helena. That qualifying property is used in the UK and is enjoyed by a relevant person (Klimt's wife). The use of the gift means there is a taxable remittance on Klimt.

> T gives money derived from chargeable gains to his sister G (a gift recipient).
> (a) G gives half of the money to T's wife W (a relevant person) in the UK.
> (b) G uses half of the money to buy a car which W uses in the UK.

Condition C is satisfied in case (a) and (b). Condition B would not be satisfied in case (b) because the car is not property of a relevant person. (Would Condition B be satisfied in case (a)? It depends on whether the money given to W can be said to derive from T's gains, which depends on the facts.[92] But since condition C is satisfied, that does not matter either way.)

The RDR Manual 35060 next provides a more challenging example. The facts (stripping out irrelevancies)[93] are:

> T gives RFI to his aunt G (a gift recipient) on terms that G will allow T's wife W to use a property in the UK owned by G, without charge. Several months later G grants a licence to W accordingly.

One analysis of these facts is that T and G have entered into a contract, under which G promises to allow W to use the land in consideration of T's payment (not properly called a "gift") of the RFI to G. In that case there

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> *Example 1(b)*
> In May 2015 Klimt, a remittance basis user, gives some of his foreign chargeable gains for that year to his sister Helena, a gift recipient.
> In October 2016 Helena uses half of this money to buy a car in the UK which she makes available to Klimt's wife to use.
> The qualifying property here is the car, which derives from the money that Klimt gifted to Helena. That qualifying property is used in the UK and is enjoyed by a relevant person (Klimt's wife). The use of the gift means there is a taxable remittance on Klimt."

92 See 10.14.12 (Gift to third person).

93 The example in full (including its irrelevant detail) is as follows:

> Linda's husband's family has owned a holiday house in Scotland for many years. In February 2012 Adam, a remittance basis user transfers some of his foreign income and gains to his aunt, Linda, the gift recipient, which she uses to book herself on an around-the-world cruise. Adam gives the money to Linda on the agreement that Linda will provide his wife Clare, a keen painter, with access to the Scottish property.
> Several months later Linda provides Clare with an agreement saying that she can use the Scottish house, for which Clare pays nothing.

is a straightforward remittance under remittance conditions A and B. It is however assumed (though unstated and factually somewhat implausible) that the arrangement is an informal, non-binding, non-contractual one. In that case condition B is not satisfied.

The HMRC analysis is as follows:

> The house cannot be said to "derive from" the income or gains.

More analytically, condition B is not satisfied. But condition C is satisfied:

> The house is "other property" [ie within s.809N(7)(c)] used in the UK and enjoyed by a relevant person (W). As the operation which brought the house within Condition C was done with reference to the gift or to enable or facilitate the gift it is qualifying property and Condition C is met.
> There is a remittance and tax is chargeable on T. The amount of the remittance is determined by s809P(11)(c).

Suppose the order of transactions was reversed:

> (1) G grants a licence to W to use a property in the UK.
> (2) Later, T gives RFI to G.

Condition C is not satisfied at stage (1) since G is not at that point a gift recipient. At stage (2) G becomes a gift recipient but condition C does not become satisfied. However condition D would need consideration.

The last HMRC example is slightly contrived, in order to illustrate the debt remittance rule in application to remittance condition C. The facts (stripping out irrelevancies)[94] are:

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94 The example in full (including its irrelevant detail) is as follows:

> "**33270 Condition C - remittances of relevant income or chargeable gains - relevant debt**
> Fraser, who is a remittance basis user, purchases some non-UK shares in January 2012, using his foreign income and gains. Fraser makes a gift of these shares to his brother, Victor, a fashion designer.
> In March 2012 Victor takes out a loan with an offshore bank to purchase a designer table and chairs. Victor brings these table and chairs to the London town house that he and his brother Fraser inherited jointly from their father, and where they both

T purchases non-UK shares using RFI.
T gives the shares to his brother G, a gift recipient.
G borrows to purchase furniture.
T uses the furniture in the UK.
G uses the shares to repay the loan.

The HMRC analysis is as follows:

> T has made a gift of property derived from his foreign income (the shares) to G, a gift recipient. The shares are thus qualifying property of a gift recipient.
> The loan taken out by G to purchase the furniture is a relevant debt because it relates to property (the furniture) brought to the UK for the benefit of a relevant person (T). T benefits because he uses the furniture.
> The qualifying property (the shares) of G (a gift recipient) is used outside the UK in respect of this relevant debt. There is a remittance under Condition C.

Suppose T gives RFI to T's adult son S (not a relevant person) and S uses it to buy the house in the UK in which T lives. This is not caught by remittance condition B. (The house is derived property, it derives from the RFI but it is not property of a relevant person.) So it can be caught by remittance condition C under s.809N(7)(a)(b).[95] The drafter was also concerned that:
(1) T makes a gift to G (say, an adult son);
(2) G makes a gift of other property to T.

This can be caught by s.809N(7)(c).

### *10.21.8 Becoming/ceasing to be a relevant person: condition C*

Section 809N ITA provides:

> (3) The question of whether or not a person is a relevant person is to be determined by reference to the time when a gift is made.

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now live. Fraser regularly entertains clients and friends at the house.
Victor uses some of the shares and bonds to pay off the loan.

95 See 10.25 (Purchase of family home).

> (4) But, if a person to whom a gift is made subsequently becomes a relevant person, the person ceases to be a gift recipient.

Thus if a gift is made to a relevant person, condition C cannot apply even if they cease to be a relevant person[96] and so become a gift recipient.

If a gift is made to a non-relevant person, condition C ceases to apply if they become a relevant person. That makes sense because in such a case, remittance conditions A and B may apply.

### 10.21.9 *Transitional rules: pre-2008 income/gains*

It will be recalled that Para 86(4) Sch 7 FA 2008 provides:

> Subject to sub-paras (2) and (3), in relation to an individual's income and chargeable gains for the tax year 2007-08 or any earlier tax year, section 809L has effect as if the references to a relevant person were to the individual.

I refer to this as **"the para 86(4) amendment"**. Amended as para 86(4) directs, condition C (set out in s.809L(4)) provides:

> (4) Condition C is that qualifying property of a gift recipient—
> (a) is brought to, or received or used in, the UK and is enjoyed by ~~a relevant person~~ *the individual*,
> (b) is consideration for a service that is enjoyed in the UK by ~~a relevant person~~ *the individual*, or
> (c) is used outside the UK(directly or indirectly) in respect of a relevant debt.

This is consistent with the transitional rule for remittance condition A and B. Since the para 86(4) amendment applies only for s.809L, para 87 Sch 7 FA 2008 has to make further amendments to s.809N:

> Section 809N of ITA 2007 (section 809L: gift recipients, qualifying property and enjoyment) has effect in relation to an individual's income and chargeable gains for the tax year 2007-08 or any earlier tax year as

96 See 10.19 (Becoming/ceasing to be a relevant person: conditions A & B); 10.22.3 (Becoming/ceasing to be a relevant person: condition D)

if—

(a) the reference in subsection (2) to a relevant person were to the individual,

(b) subsections (3) and (4) were omitted, and

(c) the references in subsection (9) to a relevant person, all relevant persons, or relevant persons were to the individual.

Amended as para 87 requires, s.809N(2) reads:

> (2) A "gift recipient" means a person, other than ~~a relevant person~~, the individual to whom the individual makes a gift of money or other property that—
>
> (a) is income or chargeable gains of the individual, or
>
> (b) derives (wholly or in part, and directly or indirectly) from income or chargeable gains of the individual.

The words "other than the individual" are meaningless because the individual cannot make a gift to himself. So s.809N(2) means:

> (2) A "gift recipient" means a person ... to whom the individual makes a gift of money or other property that—
>
> (a) is income or chargeable gains of the individual, or
>
> (b) derives (wholly or in part, and directly or indirectly) from income or chargeable gains of the individual.

Para 87 does not restrict the definition of "gift recipient": it *widens* it.

The para 87 deletions of 809N(3)(4) are straightforward amendments consequential on the para 87 amendment to s.809N(2).

The last para 87 amendment is also a straightforward consequential amendment. Amended as para 87 requires, s.809N(9) reads

> (9) Enjoyment by ~~a relevant person~~ the individual of property or a service is to be disregarded in any of these cases—
>
> (a) if the property or service is enjoyed virtually to the entire exclusion of ~~all relevant persons~~ the individual,
>
> (b) if full consideration in money or money's worth is given by ~~a relevant person~~ the individual for the enjoyment, or
>
> (c) the property or service is enjoyed by ~~relevant persons~~ the individual in the same way, and on the same terms, as it may be enjoyed by the general public or by a section of the general public.

The condition C rule for pre-2008 income/gains is not very different from that which applied under the pre-2008 law.

## 10.22 Remittance condition D (connected operation)

Section 809L(5) ITA provides:

> [1] Condition D is that property of a person other than a relevant person (apart from qualifying property of a gift recipient)—
> (a) is brought to, or received or used in, the UK, and is enjoyed by a relevant person,
> (b) is consideration for a service that is enjoyed in the UK by a relevant person, or
> (c) is used outside the UK (directly or indirectly) in respect of a relevant debt,
> [2] in circumstances where there is a connected operation.

We need some terminology to grapple with this, and in the following discussion:
**"The non-relevant person"** is "the person other than a relevant person."
**"The condition D enjoyment requirement**" is the requirement in s.809L(5)[1] (in short, that a relevant person enjoys the property of a non-relevant person in the UK).

The wording of the condition D enjoyment requirement is in large part the same as in remittance condition C.[97] The same enjoyment disregards apply.[98] The same timing rule applies. These aspects need not be considered again here.

The RDR Manual provides:

> **33430 Connected Operation - definition**
> The property that is brought to the UK, or used outside the UK as consideration for a service or in respect of a relevant debt must not be qualifying property of a gift recipient as this will fall within Condition C. However this restriction relates to the property not the individual, so the same person may be a gift recipient under Condition C and, in other transactions, "a person whose property is used" under Condition D.

97 See 10.21.1 (Enjoyment by a relevant person).
98 Section 809O(6) ITA exactly repeats s.809N(9); for a discussion, see 10.21.2 (Enjoyment disregards).

### 10.22.1 *"Qualifying disposition"*

The key terms in remittance condition D are "connected operation" and "qualifying disposition." Section 809O provides the definitions and other supplemental provisions for condition D.

Section 809O(1) ITA provides:

> This section applies for the purposes of determining whether or not income or chargeable gains of an individual are remitted to the UK by virtue of condition D in section 809L.

Section 809O(4) ITA defines "qualifying disposition":

> A "qualifying disposition" is a disposition that—
> (a) is made by a relevant person,
> (b) is made to, or for the benefit of, the person whose property is dealt with as mentioned in section 809L(5)(a), (b) or (c) [ie made to/for the benefit of the condition D person], and
> (c) is a disposition of money or other property that is, or derives (wholly or in part, and directly or indirectly) from, income or chargeable gains of the individual.

Section 809O(5) provides an exception:

> (5) But a disposition of property is not a qualifying disposition if the disposition is, or is part of, the giving of full consideration in money or money's worth for the dealing that falls within section 809L(5)(a), (b) or (c).

I do not see the need for that, since if there is full consideration for "the dealing that falls within section 809L(5)(a), (b) or (c)" (in short, for the enjoyment by the relevant person) then the full consideration exemption applies.[99] But it does no harm.

### 10.22.2 *Connected operation*

Section 809O(3) ITA defines "connected operation":

99 See 10.21.2 (Enjoyment disregards).

> A “connected operation”, in relation to property dealt with as mentioned in section 809L(5)(a), (b) or (c), means an operation which is effected—
> (a) with reference to a qualifying disposition, or
> (b) with a view to enabling or facilitating a qualifying disposition.

Thus in order to have a connected operation, four requirements must be met:

(1) There must be a qualifying disposition.
(2) There must be an operation (but that is so wide it scarcely counts as a requirement).
(3) There must be a specified link between the operation and the qualifying disposition. (The operation must be effected with reference to/with a view to enabling/facilitating the qualifying disposition.)
(4) There must be a specified link between the operation and the non-transferor’s condition D property. The operation must be “in relation to property dealt with as mentioned in s.809L(5)(a)(b)(c)” ie it must relate to the condition D property.

The RDR Manual comments on requirement (3):

> **33430 Connected Operation - definition**
> It is important to note the words “with reference to” and “with a view to enabling or facilitating a qualifying disposition”. The nature of the link between the connected operation and the qualifying disposition, or even which comes first, is not specified. This means that a taxpayer cannot avoid a charge to tax by setting up complex structures to disguise foreign income or gains, or to try and “break the link” between something enjoyed in the UK and that income or those gains.

An example would be if T and X enter into an informal non-binding arrangement[100] under which:

(1) X provides a benefit to T in the UK (so the condition D enjoyment requirement is met).
(2) Subsequently, T gives RFI to X (the qualifying disposition).

The connected operation is the provision of the benefit by X.

100 If the arrangement is by way of binding contract (which is likely unless T and X are close relatives or friends) then remittance conditions A and B are satisfied as T’s obligation to X will be a relevant debt.

### 10.22.3 *Becoming/ceasing to be a relevant person: condition D*

Section 809O(2) ITA provides:

> For the purposes of section 809L(5), the question of whether or not the person whose property is dealt with as mentioned in para (a), (b) or (c) of section 809L(5) is a relevant person is to be determined by reference to the time when the property is so dealt with.

### 10.22.4 *HMRC examples*

The RDR Manual provides a subtle example where the facts (stripping out irrelevancies)[101] are:

> T wishes to use UK land owned by X.
> T uses RFI to purchase a yacht outside the UK.
> T transfers the yacht to a company owned by X, at an undervalue.
> X, with reference to the transfer of the yacht, allows T to use the land rent free.

One analysis of these facts is that T and X have entered into a contract, under which X leases or licenses the land to T in consideration of T's transfer of the yacht to the company. In that case there is a remittance under remittance conditions A and B on the basis that B receives an asset in the UK (a lease or licence) which is derived from B's RFI. It is however assumed (though unstated and factually somewhat implausible) that the arrangement is an informal, non-binding, non-contractual one. In that case condition B is not satisfied.

The HMRC analysis is as follows:

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101 The example in full (including its irrelevant detail) is as follows:
"**35080 Condition D - remittances of foreign income or chargeable gains**
John personally owns a country estate in Cornwall, in an area of outstanding natural beauty. His friend Janet wishes to use the mansion for several important family functions.
Janet is a remittance basis user. She owns a foreign yacht which she bought using her foreign income and gains. On 2 March she disposes of the yacht to a nonresident company for £15,000. John has a controlling interest in that non-resident company.
In October, with reference to the transfer of the yacht, John allows Janet full and exclusive use of the estate, rent-free.

X is not a gift recipient (the yacht was given to his company, not to X). Condition C cannot therefore apply.

However condition D will apply:

[1] X is not a relevant person in relation to T.[102]
[2] There is a qualifying disposition because:
[a] There is a disposal of property (the yacht) which derived from T's income (ITA07/S809O(4)(c))
[b]The disposal was made by a relevant person (T) (ITA07/S809O(4)(a))
[c] The disposal was for the benefit of X (although the disposal was not made directly to X, he benefits from it through his ownership of the company) (ITA07/S809O(4)(b))
[3] X's property [the land] is enjoyed in the UK by a relevant person (T) (ITA07/S809L(5)(a) and ITA07/S809O(4)(b)).
In this example T's advantage is due to a connected operation[103] (ITA07/S809O(3)) and Condition D will be met. Some or all of the foreign income used by T to acquire the yacht will be remitted.

HMRC do not identify the operation, but I think it is X's licencing the land to T; this is indeed a connected operation.

Take the same facts but assume that X was a relevant person in relation to T. Condition D would not be satisfied and there would be no remittance.

Take the same facts in another order:

(1) T uses land owned by X rent-free for a period.
(2) After the end of that period, T transfers RFI to a company owned by X.

Condition D is not satisfied at stage (1) as there is no connected operation. There is no charge at stage (2): one could not say that X's property is enjoyed "in circumstances where there *is* [present tense] a connected operation." But if (as would normally be the case) there is a contract between X and T, there would be a remittance under conditions A and B.

102 The HMRC analysis adds that "the company is not a relevant person (as T is not a participator)" but it makes no difference whether or not the company is a relevant person (unless the company brings the yacht to the UK).
103 This wording is a loose paraphrase of the statutory language, but it does not matter.

## 10.22.5 *Transitional rules: pre-2008 income/gains*

It will be recalled that Para 86(4) Sch 7 FA 2008 provides:

> Subject to sub-paras (2) and (3), in relation to an individual's income and chargeable gains for the tax year 2007-08 or any earlier tax year, section 809L has effect as if the references to a relevant person were to the individual.

I refer to this as **"the para 86(4) amendment"**. Amended as para 86(4) directs, condition D (set out in s.809L(5)) provides:

> Condition D is that property of a person other than ~~a relevant person~~ *the individual* (apart from qualifying property of a gift recipient)—
> (a) is brought to, or received or used in, the UK, and is enjoyed by ~~a relevant person~~ *the individual*,
> (b) is consideration for a service that is enjoyed in the UK by ~~a relevant person~~ *the individual*, or
> (c) is used outside the UK (directly or indirectly) in respect of a relevant debt,
> in circumstances where there is a connected operation.

This is consistent with the transitional rule for remittance condition A and B. Since the para 86(4) amendment applies only for s.809L, para 88 Sch 7 FA 2008 has to make further amendments to s.809O:

> Section 809O of ITA 2007 (section 809L: dealings where there is a connected operation) has effect in relation to an individual's income and chargeable gains for the tax year 2007-08 or any earlier tax year as if—
> (a) subsection (2) were omitted, and
> (b) the references in subsections (4) and (6) to a relevant person, all relevant persons, or relevant persons were to the individual.

Amended as para 88 requires, s.809O provides:

> (4) A "qualifying disposition" is a disposition that—
> (a) is made by ~~a relevant person~~ *the individual*,
> (b) is made to, or for the benefit of, the person whose property is dealt with as mentioned in section 809L(5)(a), (b) or (c), and

> (c) is a disposition of money or other property that is, or derives (wholly or in part, and directly or indirectly) from, income or chargeable gains of the individual.

The last para 88 amendment is also a straightforward consequential amendment. Amended as para 88 requires, s.809N(6) reads

> (6) Enjoyment by ~~a relevant person~~ *the individual* of property or a service is to be disregarded in any of these cases—
> (a) if the property or service is enjoyed virtually to the entire exclusion of ~~all relevant persons~~ *the individual,*
> (b) if full consideration in money or money's worth is given by ~~a relevant person~~ *the individual* for the enjoyment, or
> (c) the property or service is enjoyed by ~~relevant persons~~ *the individual* in the same way, and on the same terms, as it may be enjoyed by the general public or by a section of the general public.

## 10.23 Amount remitted

Section 809P(1) ITA provides:

> The amount of income or chargeable gains remitted to the UK is to be determined as follows.

Five rules then follow.

### 10.23.1 *Remittance of actual income or gains*

Section 809P(2) ITA provides:

> If the property, service or consideration[104] is the income or chargeable gains, the amount remitted is equal to the amount of the income or chargeable gains.

That seems sensible, indeed self-evident.

104 The words "property, service or consideration" relate back to the wording of condition B: property means property brought/received/used in the UK, service means a service provided in the UK, and consideration means consideration for a service provided in the UK.

### 10.23.2 *Remittance of derived property*

Section 809P(3) ITA provides:

> If the property, service or consideration derives from the income or chargeable gains, the amount remitted is equal to the amount of income or chargeable gains from which the property, service or consideration derives.

The RDR Manual provides:

> **35030 Conditions A & B - remittances derived from foreign income/gains**
> ... Where, as in most cases, the property, service or consideration derives from a foreign currency, the taxable amount is the pounds sterling equivalent value of the foreign currency (see RDRM31190 Exchange rates) used to acquire or pay for the property or service etc. This means that where an item of depreciating value (such as a car) is brought to the UK the amount that is liable to tax is not the current value of the car but the amount of foreign income or gains from which the car derives (example 4). For the same reason, where an item of appreciating value (perhaps a work of art) is brought to the UK, the taxable amount is the amount of foreign income or gains from which the property derived, and not its current market value (example 5).
> The same principle applies where an investment is made in shares or other such financial instruments, and those shares are in, or are otherwise brought, to the UK. The chargeable amount is the amount of foreign income or gains from which the shares derived...

The RDR Manual provides an example where the facts (stripping out irrelevancies)[105] are as follows:

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105 The example in full (including its irrelevant detail) is as follows:
In example 1 above, Marianne, a remittance basis user, used £25,000 of her foreign chargeable gains to purchase a car. The car is regarded as derived from foreign income and gains.
Instead of bringing it straight to the UK, Marianne kept the car at her Italian villa for use on her visits to Italy. A few years later she then decides to bring the car to the UK for her and her daughter to use. At this time the approximate market resale value of the car is £14,000.

> **35030 Conditions A and B - remittances derived from foreign income or gains**
> *Example 4 (Marianne)*
> M, a remittance basis user, used £25,000 of her foreign chargeable gains to purchase a car. M kept the car outside the UK.
> A few years later M brings the car to the UK. The market resale value of the car is [implausibly] £14,000.

The HMRC analysis is as follows:

> The amount remitted is still £25,000, that being the amount equal to the chargeable gains from which the property – the car – derived.

The author has not addressed the interesting questions which arise if M sells the car abroad and remits the proceeds of sale or buys a new car.

Suppose:
(1) T invests £3m foreign income in an asset,
(2) T sells the asset at a loss and receives only £1m.
(3) T remits the £1m.
Under the pre-2008 remittance basis the amount remitted was £1m only. Is the amount remitted now £3m? The tax exceeds the amount remitted. I doubt if anyone will observe this in practice. Perhaps a purposive approach allows one to read in a requirement that the amount remitted cannot exceed the amount of the money remitted or (because of the loss) what is received in the UK is not derived from the gain.

Conversely suppose:
(1) T invests £3m foreign income in an asset,
(2) T sells the asset at a gain and receives £6m.[106]
(3) T remits £3m.
The amount remitted is only £1.5m, one half of the foreign income.

## 10.23.3 *Debt remittances*

Section 809P ITA provides:

106 For simplicity assume the gain on this disposal is not within the charge to CGT (eg the gain is not a chargeable gain or T was non-resident when the gain accrued).

> (4) If the income or chargeable gains are used as mentioned in section 809L(3)(c), [that is, used in respect of a relevant debt] the amount remitted is equal to the amount of income or chargeable gains used; but this is subject to subsection (10).
> (5) If anything deriving from the income or chargeable gains is used as mentioned in section 809L(3)(c), [that is, used in respect of a relevant debt] the amount remitted is equal to the amount of income or chargeable gains from which what is used derives; but this is subject to subsection (10).

This is the equivalent of s.809P(2)(3) for debt remittances, but here there is an apportionment rule. Section 809P(10) ITA provides:

> If the debt is only partly in respect of[107] the property or service, the amount remitted is (if it would otherwise be greater) limited to the amount the debt would be if it were wholly in respect of the property or service.

Suppose:
(1) T borrows £10m.
(2) T remits £1m of the borrowed sum to the UK.
The *entire* debt is a relevant debt. Suppose then T repays the entire borrowing out of income/gains. Only £1m is treated as remitted.

Suppose T only repaid £1m or £2m of the debt. There is still a remittance of £1m. This example illustrates a planning point: one should avoid debts which relate *partly* to property brought/received/used in the UK. Instead of the above, T should borrow so as to have two separate debts, one of £1m (remitted to the UK) and one of £9m (unremitted). Then the unremitted debt is *not* a relevant debt and can be repaid out of foreign income/gains.

The apportionment rule applies where a relevant debt is partly in respect of the property received in the UK. What if property is used partly in respect of a relevant debt?

The RDRM provides:

107 Section 809P(10) refers to a debt *in respect of* UK property but the definition of relevant debt is one which *relates to* UK property. It is considered that the expressions are synonymous.

**RDRM35040 Remittance Basis: Amounts remitted: Quantification: Conditions A and B - remittances in respect of relevant debt**

Where foreign income or gains are used outside of the UK in respect of a relevant debt RDRM33040 the chargeable amount is the amount of foreign income or gains so used (ITA07/s809P(4)) (example 1 and 2).

Similarly, if anything, for example an asset, which derived from foreign income or gains is used outside the UK to service a relevant debt then the amount of the remittance is the amount of the income or gains from which the asset used to service the debt was itself derived (ITA07/s809P(5)) (example 3 and 4).

Foreign income or gains may be used outside the UK to redeem or service a debt only part of which is a 'relevant debt' within the meaning of ITA07/s809L(7). In such cases, the amount that is taxable as an 'amount remitted' is, if it would otherwise be greater, limited to the amount that is attributable to that part of the debt which is a relevant debt (ITA07/s809P(10)) (example 5).

The taxable amount of foreign income or gain that is treated as having been remitted because of these provisions, taken together with any amounts that have been previously remitted (or treated as having been remitted), cannot be greater than the amount of the original foreign income and gains (ITA07/s809P(12)).

**Example 1**

In May 2011, Katrina, a remittance basis user, borrows £12,000 from an overseas bank to buy shares in a UK company. This is a relevant debt.

In tax year 2011-12 Katrina uses £4,600 of her relevant foreign income to pay the interest and to repay some of the amount borrowed. The chargeable amount is £4,600.

**Example 2**

On 6 April 2015, Gary, a remittance basis user, borrows money from an overseas bank to buy an apartment in Solihull. Payments are due on the first day of each month from May 2015 onwards. The first 12 payments are on an interest-only basis. Gary pays £1,000 interest each month to the overseas lender from his overseas account with the same bank, into which Gary ensures a sufficient amount of his relevant foreign earnings are paid directly to cover the repayments.

From 1 May 2016 the payments increase to a fixed amount of £2,500 each month as Gary starts to repay the capital amount of the loan as well as the interest. The payments continue to be met from the same account of relevant foreign earnings.

The loan is a relevant debt because it is respect of property (the apartment) which is used in the UK by a relevant person (Gary).

Gary has made taxable remittances in 2015-16 of £12,000, that being the relevant foreign earnings used to service the relevant debt. In 2016-17 Gary has made taxable remittances of £30,000, being the amount used to both service and repay the relevant debt.

**Example 3**

Ali, a remittance basis user, purchases some sculptures in Sweden in October 2012 for £80,000; he takes out an interest-free loan of £80,000 with his US bank to fund this purchase, repayable within 1 year.

In November 2012 he gives them to his wife as an anniversary gift. She initially keeps them at her mother's home in Stockholm, but 6 months later in March 2013 she decides to bring these sculptures to the UK to display in her UK garden.

In October 2013 Ali arranges with the US bank that he will repay the loan by giving them an oil painting which is currently in his apartment in Miami. Ali had purchased the painting in May 2011, using £50,000 of his relevant foreign earnings and £30,000 of capital inherited from an uncle. The relevant debt is serviced by the oil painting, which derives, in part, from Ali's relevant foreign earnings (refer to the earlier example). Ali has made a taxable remittance in 2013-14 of £50,000.

Note: For the purposes of this example assume there is no chargeable gain on the transfer of the painting to the bank.

**Example 4**

Francine, a remittance basis user, has a Spanish-style courtyard created at her house in Brighton. She takes out an unsecured loan of £40,000 from her French bank which she uses to pay the specialist Spanish contractor.

Francine has several French government bonds, which she purchased entirely from her relevant foreign income, and a German government bond which she acquired using her foreign chargeable gains. These bonds are each worth £10,000.

In September 2010 Francine gives the German bond to her bank as part repayment of the loan.

The relevant debt is serviced by the German bond which derives wholly from Francine's foreign chargeable gains, and is used outside the UK in respect of this relevant debt (refer to the earlier examples). Francine has made a taxable remittance in 2013-14 of £10,000.

**Example 5**

In August 2011 Karen, a remittance basis user, uses an interest-free £10,000 overdraft facility on her Jersey bank account to pay £8,000 of UK school fees for her 14 year old daughter Lauren. The remaining £2,000 of the facility is used to pay for Lauren to attend a summer school in France organised by a French university.

Karen repays the overdraft from her relevant foreign earnings between

August and November 2011.
Karen has made a taxable remittance in 2011-12 of £8,000 relevant foreign earnings, that being the part of the debt that is in respect of a service provided in the UK (refer to the earlier example) which is thus a 'relevant debt'.

10.23.4 *Use as security: amount remitted*

The RDR Manual provides:

> **35270 Remittances from mixed funds: Collateral[108] in respect of relevant debt**
> When foreign income and gains are used as collateral for a relevant debt they are used 'in respect of' the relevant debt, so there may be a taxable remittance at this point. See RDRM33170 Condition B - Collateral in respect of relevant debt.

In fact, the RDR Manual takes the view that circumstances where the grant of security is a taxable remittance will be "rare" and in the author's view, the grant of security is not taxable remittance at all, in the absence of some very special circumstances.[109] In the circumstances, it is not perhaps strictly necessary to consider the amount that is remitted on a grant of security, but the passage may still be of some interest as it shows a very loose view of when a property is partly used in respect of a relevant debt:

> The amount of the foreign income or gains that are used in respect of the debt will be restricted to the amount of the capital loaned, together with any accrued interest. See Chapter 5: Condition B – Collateral in respect of relevant debt.
> Often the collateral offered will be an asset which is itself a mixed fund. In these circumstances the mixed fund ordering rules at section 809Q(4) apply to the asset offered as security. In such a case, the taxable amount is made up of the same amounts of capital and foreign income and gains that were used to purchase the asset in the first place.
> The 'transfer' is the offering of the asset as collateral in respect of the relevant debt and any formal charge is registered to the lender (where

108 The author is using the word "collateral" as a synonym of "security" though that is (I think) American rather than English legal usage.
109 See 10.18.2 (Use as security for debt).

appropriate). The analysis is carried out on the date immediately before the collateral is so offered.

*Example 1 (John)*[110]

In 2014/15 J, a remittance basis user takes out a loan for £200,000 from a Guernsey bank. J uses the loan to purchase UK assets. The loan is a relevant debt.

J offers up, as security for this loan, a charge on his Guernsey farmhouse, which he purchased for £320,000 in 2010-11.

J has used his foreign income and gains as collateral, in respect of a relevant debt. If the use of the collateral creates a taxable remittance, the amount of the remittance is 'capped' at the amount of the debt, which is £200,000.

The farmhouse is derived from:

| | |
|---|---|
| Relevant Foreign Income | 2008-09 £60,000 |
| | 2009-10 £50,000 |
| Foreign chargeable gain | 2009-10 £120,000 |
| Clean capital | 2007-08 £40,000 |
| | 2008-09 £50,000 |

The mixed fund rules apply to determine the order of remittances. J will be regarded as remitting £50,000 RFI and £120,000 foreign chargeable gains from 2009-10, and £30,000 RFI from 2008-09.

*Example 2*

As per example 1, except that the farmhouse which J offers as collateral in respect of the relevant debt was purchased for £150,000 in 2010-11. It is now worth £250,000.

J has used his foreign income and gains as collateral, in respect of a relevant debt. If the use of the collateral creates a taxable remittance, the amount of the remittance is 'capped' at the amount of the debt, which is £200,000.

The farmhouse is derived from:

| | |
|---|---|
| Relevant Foreign Income | 2008-09 £60,000 |
| | 2009-11 £50,000 |
| Clean capital | 2007-08 £40,000 |

The mixed fund rules apply to determine the order of remittances; J will be regarded as remitting £110,000 RFI.

Any increase in the value of the farmhouse is ignored.

*Example 3 (Freda)*

F, a remittance basis user receives an interest-free loan[111] of £100,000.

110 I simplify and omit a few tiresome irrelevancies from this example.

111 The grant of an interest-free loan from a bank seems somewhat implausible.

> She uses the loan to purchase a plot of land in the UK, so the loan is a relevant debt. F gives, as collateral for the loan, a general right to the bank over her many current and savings accounts and investment portfolio held with them.
> Ignoring accrued interest, the 'cap' on the amount of collateral regarded as used in respect of the relevant debt is £100,000. The 'transfer' is the offering of the asset as collateral so an analysis of F's accounts over which the charge is granted would be needed to analyse the credits into each account immediately before the date of transfer, in order to determine the constituent parts of each account for s809Q(4) purposes.
> In these circumstances the terms and conditions surrounding the loan and the collateral offered should be examined carefully as this may prioritise the order of the accounts against which any 'collateral' charge will be taken; for example it may prioritise current or savings flexible accounts over high-interest period or notice accounts. The s809Q(4) analysis should reflect this priority.

### 10.23.5 *Cap on amount remitted*

Section 809P(12) ITA provides:

> If the amount remitted (taken together with any amount previously remitted) would otherwise exceed the amount of the income or chargeable gains, the amount remitted is limited to the amount which, when taken together with any amount previously remitted, is equal to the amount of the income or chargeable gains.

How could the amount remitted exceed the amount of the income or the gains? One case is a deemed gain on a disposal for less than full consideration.

Another case is if income is remitted (the remittance conditions are met) and then the remittance conditions are met again, in relation to the same income or gains. There are many ways that this could happen, but one case concerns re-remittances. Suppose:

(1) Year 1: T (an individual taxable on the remittance basis) receives foreign income. The income is remitted ("the first remittance") and so subject to tax.
(2) Year 2: The income is transferred out of the UK and remitted again ("the re-remittance").

FAQ Remittances (April 2008) provides a straightforward example:

> If an asset is purchased by a non-domiciled individual out of untaxed foreign income abroad after 6 April 2008 and then remitted to the UK, and tax is paid on that remittance under the new legislation, but that asset is subsequently taken out of the UK by the same person and then remitted again, is there a second tax charge on the second remittance?
> Once a taxable remittance has arisen, the amount taxed in the UK will not be taxed again if the asset is subsequently removed from the UK and then brought back.

Similarly, the RDR Manual provides:

> **35030 Remittance Basis: Amounts remitted: Quantification: Conditions A & B - remittances derived from foreign income/gains**
> ...When taken together with any amounts that have been previously remitted (or treated as having been remitted), the taxable amount of income or gain that is treated as having been remitted because of these provisions cannot be greater than the amount of the original foreign income and gains (ITA07/s809P(12)). Where property is brought to or used in the UK by or for the benefit of a relevant person the amount that is liable to tax is the amount of the underlying foreign income or gains from which the property derives (whether directly or indirectly). The taxable remittance will only occur once; this will usually be the time the asset is first brought to, received by or used in the UK by a relevant person.

This is obviously right. But the same would apply if the income were not taxed on the first remittance, eg a remittance before 2008 of source-ceased income or of property enjoyed in specie. The same would apply to cash. HMRC agree. December 2008 Qs & As provides:

> **Q9** If a taxpayer undertook a source ceasing exercise during the 2006-07 tax year and then remitted the proceeds before the 2008-09 tax year, if those funds were to then be taken back outside of the UK and re-imported, would this constitute a remittance. In other words, would the earlier source ceasing exercise be looked through despite its timing? It is understood that interest/profit from any new investment would be a remittance.
> **A** If the source ceased in 2006-07 and was remitted in 2007-08, then this did not count as a remittance and it will not count as a remittance if it is exported and subsequently re-imported.

HMRC do not cite a statutory authority to justify their answer: s.809P(12) ITA would do so, though there are others as well.[112]

### 10.23.6 *Condition C and D cases*

Section 809P ITA provides:

> (6) In a case falling within section 809L(4)(a) or (b), the amount remitted is equal to the amount of the relevant income or chargeable gains.
> (7) In a case falling within section 809L(4)(c), the amount remitted is equal to the amount of the relevant income or chargeable gains; but this is subject to subsection (10).
> (8) In a case falling within section 809L(5)(a) or (b), the amount remitted is equal to the amount of the income or chargeable gains referred to in section 809O(4)(c).
> (9) In a case falling within section 809L(5)(c), the amount remitted is equal to the amount of the income or chargeable gains referred to in section 809O(4)(c); but this is subject to subsection (10).
> ...
> (11) In subsections (6) and (7) "relevant income or chargeable gains" means—
> (a) if the qualifying property falls within section 809N(7)(a), the income or gains—
> (i) of which the qualifying property consists, or
> (ii) from which the qualifying property derives;
> (b) if the qualifying property falls within section 809N(7)(b), the income or gains—
> (i) of which the property given to the gift recipient consisted, or
> (ii) from which that property derived;
> (c) if the qualifying property falls within section 809N(7)(c), the income or gains—
> (i) of which the property given to the gift recipient consists, or
> (ii) from which that property derives.

The RDR Manual offers seven examples but the matter does not seem important enough to be setting out here.

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112 Para 86(2) Sch 7 FA 2008 would also provide relief here: see 10.42 (Transitional rules).

## 10.24 CGT disposal not for market value

### 10.24.1 *The CGT background*

In certain circumstances the consideration for a disposal is deemed to be market value consideration, not the actual consideration (if any).[113] In these cases a gain is deemed to accrue which is not a real gain (in the sense that the individual does not receive a sum which is or is derived from the gain). This is referred to as **"a deemed gain"**.

The most common case of a deemed gain is a gift: in economic reality a gift cannot give rise to a gain and normally gives rise to a loss. However, for CGT purposes a gift is treated as made for market value.

### 10.24.2 *Deemed gains and the remittance basis from 22 April 2009*

In the absence of express provision the deemed gain arising on the gift could not be remitted, because it does not exist (in the sense that the individual does not receive a sum from the disposal which is or is derived from the gain). Accordingly, s.809T ITA provides:

> (1) This section applies if—
> (a) foreign chargeable gains accrue to an individual on the disposal of an asset, and
> (b) the individual does not receive consideration[114] for the disposal of an amount at least equal to the market value[115] of the asset.
> (2) For the purposes of this Chapter, treat the asset as deriving from the chargeable gains.

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113 Section 17(1) TCGA sets out seven sets of circumstances when a disposal is treated as made for market value. (The section also deems certain acquisitions to be for market value, but we are not concerned with that here.)
In certain circumstances a gain is deemed to accrue to an individual even though there is no disposal, but s.809T does not apply to that.

114 "Consideration" here obviously means actual consideration, as opposed to market value which is (usually) deemed to be given by s.17(1) TCGA. (Though normally in the legislation the drafter states this expressly; eg s.165(7) TCGA.)

115 Para 171 Sch 7 FA 2008 defines "market value" for the purposes of Part 2 of Schedule 7 ("For the purposes of this Part of this Schedule, the market value of any asset is its market value for the purposes of TCGA 1992"). Accordingly market value here is not defined. But in practice difficulty will not usually arise.

It is not expressly stated that s.809T only applies on a disposal made by an individual, but this is implied. Eg on a disposal by non-resident close company, s.13 deemed gains may accrue to an individual who is a participator, and the individual does not receive the consideration for the disposal, but s.809T does not apply. Otherwise provisions such as s.14A(3)(a) TCGA would be unnecessary.

10.24.3 *Gift of asset*

Suppose:
(1) T (a remittance basis taxpayer) gives an asset (foreign situate) to a trust. A gain is deemed to accrue on the disposal as if the asset were sold for market value. (Assume the asset has risen in value and a gain accrues.)
(2) T (or a relevant person) receives the asset in the UK.

The deemed gain is remitted. This reverses the rule for the pre-2008 CGT remittance basis.

The RDR Manual gives an example:

> **31180. Foreign chargeable gains accruing on disposal made otherwise than for full consideration**
> Example 2 (Ahmeda)
> A transfers his property in Dubai to a trust receiving no consideration in return. The deemed gain computed using the market value of the property at date of transfer is £400,000. The trustees subsequently sell the property for £550,000. The trustees then make a capital payment of £300,000 to a UK close company in which A's spouse is a participator.
> £300,000 of Ahmeda's foreign chargeable gain has been remitted to the UK. This is because the property is treated as deriving from his gain (Section 809T ITA 2007) and the proceeds from the sale of the property therefore also derive from the gain. The company is a relevant person (Section 809M(2)(f) ITA 2007) and property (that is, money) which derives from Ahmeda's gain has therefore been received in the UK by or for the benefit of a relevant person (Section 809L ITA 2007).
> The gain which accrues to the trust on the actual sale of the property will be subject to normal rules.

10.24.4 *Sale of asset*

Suppose T sells an asset to a trust for £100. (Assume T is connected with the trustees.)

If the market value is equal to the purchase price (£100) then s.809T does not apply. It does not matter that the sale is to a connected person. The purchase price is or (better) is derived from the gain, but the asset itself is not (and is not derived from) the gain. So it does not matter if the asset is remitted.

Suppose T sells an asset and the purchase price is left outstanding as a loan. It is considered that T "receives" the consideration, for the benefit of the loan is the consideration.

Suppose a sale at an undervalue (the market value is more than the purchase price). In this case

(1) the asset is deemed to be derived from the gain; *and*
(2) the purchase price is (or is derived from) the gain.

This rule applies to all sales at less than market value, even if accidental.

This rule applies if the sale is less than market value even if it is 99% of the market value.

It is not necessary to have a disposal between connected persons, though in practice s.809T is not likely to apply to a disposal between unconnected persons.

Suppose:

(1) the asset is worth £200 and has a base cost of £50.
(2) the asset is sold for £100 giving rise to a deemed gain of £150.

If the £100 sale proceeds is received in the UK it is suggested that half – £75 – of the gain should be regarded as remitted. If the asset is also received in the UK by a connected person, then there is a remittance of the entire gain. However the cap on the amount remitted avoids double taxation.[116]

If the asset is sold for base cost, £50, it is suggested that the £50 is not derived from the deemed gain, so the £50 sale proceeds could be remitted tax free. But other views are possible.

### 10.24.5 *Transitional rules: pre-2008 gains*

Subject to immaterial exceptions, para 81 Sch 7 FA 2008 provides:

> The other amendments made by this Part of this Schedule have effect for

116 See 10.23.5 (Cap on amount remitted).

the tax year 2008-09 and subsequent tax years.

A deemed gain accrued to an individual on gifts made before 2008/9: it was just not remittable. At first sight this does not help. It is accepted that the ITA remittance basis rules govern pre-2008 income/gains. So after 2008/9 s.809T applies and the gain becomes remittable, though it qualifies for RP relief. It does not matter when (after 1965) the gain arose: gains from disposals made in the 1960s could now come into charge, though all records will have been long discarded. But HMRC do not take that view. FAQ: Residence and Domicile – NR Trusts provides:

> **Will a deemed chargeable gain that arose when I gifted foreign assets to the trustees of a non UK resident settlement before 6 April 2008 become taxable if the trustees remit the property to the UK on or after 6 April 2008?**
> No, a deemed chargeable gain accruing on the gift of property to a non resident trust before 6 April 2008 will not become chargeable if the trustees remit the property or anything derived from it to the UK on or after 6 April 2008.
> However where there was no real alienation of the income or gains by the individual, as for example in the case of *Harmel v Wright*, because the settlor retained effective control over them, then the position after 5 April has not changed. In such a case the income or gains could be taxed on the settlor.[117]

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117 The point is confirmed in the Public Bill Committee Debate 19 June 2008. Hansard col 834 and 840:
"**Mr. Hoban:** the new section 809R [now s.809T] set out in schedule 7 creates some uncertainty in the minds of advisers as to meaning. The optimistic, preferred best interpretation is that new section 809R does not apply in relation to gains that arose prior to 6 April 2008, It is understood that that is also the view of HMRC. Accordingly, the old legislation states that, provided that there was a genuine gift, there would be no tax liability on the gain that arose when the gift was made. while it has been helpful for HMRC to have made its view known, doubt and concern still remain.
The potential sums will often be significant, and it is likely that inadequate records will have been kept to establish the position since, at the time, the law was clear that there could never be a tax charge as a result of the gift,. Accordingly, taxpayers who made gifts of foreign assets offshore prior to 6 April 2008 will be concerned by the split in opinion; some suggest that new section 809R could exist retrospectively. Taxpayers who made absolute unfettered gifts of foreign assets offshore prior to 6 April 2008 had a legitimate expectation that the gain deemed to have been realised

It seems to me that *Harmel v Wright* 49 TC 149 has nothing to do with the case; though of course a trust could be disregarded under the sham doctrine.

The RDR Manual provides:

> **31180 Foreign chargeable gains accruing on disposal made otherwise than for full consideration**
> The new rule at Section 809T ITA 2007 applies to disposals by remittance basis users on or after 6 April 2008.

## 10.25 Purchase of family home

Suppose:
(1) T gives RFI to T's son S, not a relevant person.
(2) S buys the freehold interest of a house and uses the RFI to pay the purchase price.

The topic raises many remittance issues, discussed throughout this chapter, so it is convenient to draw them together.

### 10.25.1 *Rent-free occupation*

Suppose S allows T to occupy the house rent-free. It is considered that S "uses" the house (the word "use" is wide enough to cover this even though it would be more normal and better legal English to say S occupies or enjoys the use of the house). Accordingly remittance condition A is satisfied. The house is derived from the RFI, but condition B is not satisfied because the property is not property of a relevant person.

Remittance condition C is satisfied, since the property is qualifying property of a gift recipient, and is used and enjoyed by a relevant person. So the purchase price RFI is remitted.

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on the making of the gift would never come into charge. The new legislation should be clear, which is why amendment No. 375 seeks to insert:

> 'This section shall not have effect with respect to gains accruing to an individual on the disposal of an asset if the disposal took place prior to 6 April 2008.'

**Jane Kennedy (Financial Secretary to the Treasury):** On the very specific point about unfettered gifts of foreign assets offshore, HMRC made its view very clear in a frequently asked question some time ago. In simple terms, it is only when such gifts were made after 6 April 2008 that they would be taxed."

10.25.2 *Lease granted for full consideration*

Now suppose:

(1) T gives RFI to T's son S, who uses it to buy the freehold interest of a house.

(2) S grants a lease of the property to T for full consideration and T occupies the property. S retains the freehold reversion.

One must ask various questions here.

First, does T use the lease? The answer is that T does "use" the lease (see above). So remittance condition A is satisfied in relation to the lease. However the lease is not derived from the RFI. So condition B is not satisfied. Of course funds T uses to pay for the lease are regarded as remitted.

Next, does T use the reversion? If so condition A is satisfied in relation to the reversion. However that may be, the reversion is not property of a relevant person so condition B is not satisfied.

Conditions C and D are excluded (even if they could otherwise apply) since the full consideration exemption applies.

10.25.3 *Lease granted for less than full consideration*

Now suppose:

(1) T gives RFI to T's son S, not a relevant person, who uses it to buy the freehold interest of a house.

(2) S grants a lease of the property to T for no consideration or for less than full consideration, and T occupies the property. S retains the freehold reversion.

One must ask various questions here.

First, does T use the lease? The answer is that T does "use" the lease (see above) So remittance condition A is satisfied in relation to the lease. If the transactions are part of an arrangement, the lease is derived from the RFI. So condition B is satisfied (as the lease is property of a relevant person). What is the amount remitted? It is the amount from which the lease is derived. It is suggested that that is not the full amount used to pay for the property, but only a part reflecting the value of the lease.

Next, does T use the reversion? If so condition A is satisfied in relation to the reversion. However that may be, the reversion is not the property of a relevant person so condition B is not satisfied.

Turning to remittance condition C, does T enjoy the lease for the purposes of remittance condition C? T does. At first sight this does not matter as the lease is not qualifying property of a gift recipient (it is not property of a gift recipient). The lease may (depending on the facts) however be qualifying property within s.809N(7)(c). If so the amount remitted is all the RFI (not the value of the lease).

Next, does T use and enjoy the reversion? It is considered that T does, since the lease T enjoys is derived from the reversion, and the lease is the mechanism by which T enjoys the reversion. If that is right, then condition C is satisfied, since the reversion is qualifying property of a gift recipient.

#### 10.25.4 *Another analysis*

Another analysis is that the "property" is the physical house, not the legal interests in the property, but one should not disregard the most basic principles of the law of real property in construing a taxing statute, if any other approach is possible.

## 10.26 Payment of school fees

Suppose T wishes to pay the school fees of minor grandchildren. Assume the grandchildren are at school in the UK (otherwise there is no problem). A direct payment out of RFI is a remittance as conditions A and B are satisfied.

Suppose T gives funds to T's child (not a relevant person) and the child uses the funds to pay the fees. This is still a remittance as conditions A and B are still satisfied: the funds in the hands of the child are derived from the RFI.

Suppose there is an informal arrangement under which:

(1) T gives funds to T's child;

(2) the child will use *other* funds to pay the school fees.

This is caught by condition C because the funds used to pay the fees are "qualifying property" within s.809N(7)(c). That is, it is used to pay the school fees by virtue of an operation which is effected "with reference to the gift of the property to the gift recipient".

T must therefore make an unconditional gift to T's child ie a gift such that the payment of the school fees is not with reference to that gift; in that case (assuming the fees are not paid out of the gifted property) there is no remittance.

## 10.27 Remittance before income or gains arise

Section 809U ITA provides:

> **809U Deemed income or gains not to be regarded as remitted before time when they are treated as arising or accruing**
> Where—
> (a) income or foreign chargeable gains are treated as arising or accruing, and
> (b) by virtue of anything done in relation to anything regarded as deriving from the income or chargeable gains, the income or chargeable gains would otherwise be regarded as remitted to the UK before the time when they are treated as arising or accruing,
> treat the income or chargeable gains as remitted to the UK at that time.

EN Remittance Basis Amendments 482 to 493 states:

> Under the original wording such payments might in certain circumstances become chargeable before the tax year in which the income or gain is treated as arising. The amendment ensures that cannot happen.

This can apply so s.87 deemed gains[118] to s.731 deemed income, where a benefit is received in a year before the income accrues. It can also apply under the accrued income scheme.

## 10.28 Relief for payment of remittance basis charge

Section 809V ITA provides:

> (1) Money that is brought to the UK by way of one or more direct payments to the Commissioners [HMRC] is to be treated as not remitted to the UK—
> (a) if the payments are made in relation to a tax year to which

118 See 45.15 (Section 87 remittance basis).

section 809H applies, and

(b) if, or to the extent that, the payments do not exceed £30,000.

(2) Subsection (1) does not apply to a payment if, or to the extent that, it is repaid by the Commissioners.

The RDR Manual provides:

**34020. Remittance Basis charge - money paid directly to HMRC** [July 2010]
Money brought into the UK to pay the remittance basis charge (RBC) RDRM32210 is treated as not remitted to the UK if direct payment is made to HMRC (Section 809V(1) ITA 2007).
This exemption will only apply if the money is paid:

- in respect of the tax due for the year in which the remittance basis has been claimed, and
- the remittance basis charge is due for that tax year.

Only remittances that relate to the remittance basis charge are covered by the exemption. Remittances of foreign income or gains to pay any other liability to UK tax, including for example income tax or capital gains tax on remitted amounts, are themselves chargeable to UK tax as remitted income or gains of the tax year in which the tax is paid to HMRC (although also refer to remittances of nominated income) RDRM35140.
The remittance basis charge can be paid in one or more amounts. However, the amount that benefits from the exemption provided at Section 809V is limited to the amount of the charge, that is £30,000. The £30,000 can be paid in one lump sum or in several stages, and may form part of the payments on account paid on 31 January or 31 July, or may be paid as a balancing payment. The exemption applies as long as the payment is in relation to the tax year in which the remittance basis charge is due.
The exemption only applies where the remittance basis charge is paid directly from foreign income or gains held outside the UK, the payment must be made direct to HMRC. This can be done either by:

- cheque (drawn on a foreign bank account)
- electronic transfer of funds.

Taxpayers will need to keep sufficient records to show that payment of the £30,000 RBC was made directly to HMRC from an overseas account. A copy of a cheque (or cheques) drawn on the foreign bank account, or the relevant bank statement identifying the bank transfer are examples of acceptable evidence.
The £30,000 remittance basis charge may be paid directly from outside the UK to HMRC by a person other than the individual; the most common example will be a payment by an employer on behalf of an employee. In such cases the £30,000 paid to HMRC may form part of the taxpayer's income, for example if paid by his employer the £30,000 will form part of the employee's earnings. To the extent that these are regarded as foreign chargeable earnings this exemption will apply.
***Example 1*** (Olaf)

O uses the remittance basis in 2008/09 and 2009/10 and 2010/11; but in 2011/12 O chooses not to use the remittance basis.
In 2011/12 O makes payment of £30,000 direct to HMRC from his foreign income that arose during 2009/10. This payment is to pay the remittance basis charge of his sister Giselle, who is a long term resident of the UK and who has made a claim to the remittance basis in 2011/12.
The £30,000 remitted by O may be treated as not remitted to the UK under Section 809V ITA 2007 and so is not chargeable to tax provided that the payments made for a particular year do not exceed £30,000.
The position should be looked at critically if there is evidence of any reciprocity. In the case of doubt or difficulty submit to PTI Advisory Foreign Income and Remittance Basis Team.
***Example 2*** (Alex)
A is a long-term UK resident remittance basis user. He uses the remittance basis in 2008-09 and plans to use it in 2009-10 also. A therefore makes payments on account RDRM32390 of £100,000 on 31 January 2009 and on 31 July 2009 in respect of his 2009-10 liability.
In July 2009 he pays £40,000 of that payment on account from his 2008-09 foreign income. Payment is made by cheque drawn on an account at a bank in the Isle of Man that was sent direct to HMRC.
A's tax liability for 2009-10 is £200,000 including the remittance basis charge of £30,000, which has been wholly met from the payments on account that he has made. No further tax is due for this year.
Because £40,000 of the tax that A has paid on account was paid directly to HMRC from an overseas account, £30,000 of the £40,000 income remitted may be treated as not remitted to the UK and is not chargeable to tax, unless A has instructed otherwise. The remaining £10,000 will be taxed as a remittance in the normal way. As it was remitted in July 2009 it will be a taxable remittance for the tax year 2009-10, and should be declared as such.
In this example, all of the £40,000 was remitted in July. However the remittances might be split between the payment on account dates, for example £20,000 remitted on 31 January 2009 and a further £20,000 on 31 July 2009. In such cases, unless the taxpayer specifies otherwise, the £10,000 that is not subject to the exemption and so is a taxable remittance will be treated as having occurred at the later date, as this will usually be in the taxpayer's favour.
Refer to RDRM34030 for example of where the 'remittance basis charge' is repaid to A, or otherwise no longer applies.
**Note:** Taxpayers may choose to specify that a payment made is in respect of the remittance basis charge at time of payment. However they are not obliged to do so and it is not necessary as long as payments received can be clearly related to a tax year for which the remittance basis charge is due.
***Nominated Income or gains***
If taxpayers use nominated income or gains to pay the remittance basis charge of £30,000 it is treated as not remitted to the UK under section 809V. Because none of the individual's nominated income or gains is treated as having been remitted to the UK in that tax year you do not have to apply the 'ordering rules' at

ITAs809I and Section 809J. Refer to RDRM35100 Remittances of nominated income or gains.
lf the £30,000 is repaid by HMRC it is treated as remitted at that point (refer to RDRM34030) and section 809I will be triggered.
**34030. Remittance Basis charge - repayment by HMRC** [July 2010]
There may be some exceptional circumstances where the £30,000 remittance basis charge is paid to HMRC but then is later repaid, or is otherwise no longer due.
Any foreign income or gains remitted to pay the charge and initially covered by the exemption at Section 809V ITA 2007 will be regarded as a remittance when the charge is withdrawn and/or the repayment is made and so will be treated as liable to UK tax at that point (Section 809V(2) ITA 2007).
***Change of claim***
The £30,000 remittance basis charge is most likely to be repaid where an individual, having made a claim for the remittance basis and paid the charge for that year, subsequently decides not to claim the remittance basis for that year and makes an amendment to their Self Assessment return (TMA1970/Section 9ZA). In such circumstances Section 809H ITA 2007 will not apply for that tax year, so the exemption cannot apply either.
***Change of status***
The other situation where the £30,000 is likely to be repaid or not otherwise due is where it later transpires that an individual has claimed the remittance basis for a tax year but was not entitled to do so as they were UK domiciled and UK ordinarily resident in that year.
***Effect***
If the exemption under section 809V was claimed then the foreign income or gains used to pay the remittance basis charge will not have been subject to tax in the year in which they arose/accrued because the individual used the remittance basis in that year. Due to the exemption the income or gains will also not have been subject to tax when brought into the UK. In such situations there are two possibilities:
• the £30,000 payment was made from foreign income or gains from an earlier year in which the individual was entitled to claim the remittance basis and did so. The £30,000 is treated as a taxable remittance and will be taxable in the in which the remittance occurred
• the £30,000 payment was made from foreign income or gains from the present year or an earlier year in which the individual was not entitled to claim the remittance basis. In which case the income or gains will be taxed on the arising basis for the year in which the foreign income or gains actually arose. If the return cannot be amended you may need to deal with such assessments under the 'discovery provisions' at Section 29 TMA 1970.
***Example 1*** (Alex)
In the earlier example above, A's circumstances change and he decides not to claim to be taxed on the remittance basis for 2009-10. His liability for 2009-10 is £195,000.
When A made the payment on account of £40,000 in July 2009 he anticipated

> that £30,000 of it would be attributed to the remittance basis charge. In the event he did not claim to be taxed on the remittance basis. He does not have to pay the remittance basis charge.
> None of the payments on account can therefore be attributed to the remittance basis charge and the £40,000 that A paid from his 2008-09 foreign income (remember that A did use the remittance basis in 2008-09) in July 2009 is a taxable remittance.
> Any cases of difficulty should be referred to. CAR, PTI Advisory, Foreign Income and Remittance Basis Team.

## 10.29 Foreign services relief

Section 809W ITA provides a relief which I call "**foreign services relief**". Section 809W(1) provides:

> This section applies to income or chargeable gains if—
> (a) the income or gains would (but for subsection (2)) be regarded as remitted to the UK because conditions A and B in section 809L are met,
> (b) condition A in section 809L [remittance condition A] is met because a service is provided in the UK ("the relevant UK service"), and
> (c) condition B in section 809L [remittance condition B] is met because section 809L(3)(a) or (b) applies to the consideration for the relevant UK service ("the relevant consideration").

I refer to these conditions as "**services relief conditions A and B**" to distinguish them from the myriad other conditions in ITA.

Section 809W(2) ITA provides the relief:

> The income or chargeable gains are to be treated as not remitted to the UK if the following conditions are met but this is subject to subsection (5).

There is no relief in relation to remittance conditions C or D but in practice these will not often apply. More importantly, there is no relief if s.809L(3)(c) or (d) apply, which deal with debt remittances. Thus if T borrows, uses the borrowed money to pay for foreign services and repays the borrowing, there is a remittance under the debt remittance rules even though a direct payment for the services would be exempt. This is anomalous. The reason might be the difficulty of applying services condition B to a relevant debt case; if so it is not a good reason as services condition B is itself misconceived.

### 10.29.1 *Services relief condition A: Relating to property situated outside UK*

Section 809W(3) ITA provides:

> Condition A is that the relevant UK service relates wholly or mainly to property situated outside the UK.

One needs to identify:
(1) the service
(2) the property (if any) to which the service relates
(3) the situs of the property
(4) if the service relates to property in and outside the UK, whether the property is "mainly" outside the UK

Unless the service is provided in the UK there is no need for foreign property services relief.[119] In the following discussion it is assumed that the service is provided in the UK.

Situs is relatively straightforward. Section 809W(6) ITA incorporates the CGT situs rules.[120] The other requirements can be more difficult.

EN Clause 23 Sch 7 Remittance Basis Amendment 354 provides some obvious examples:

> 7. Condition A would cover for example, fees paid to a UK bank for managing an individual's overseas investment portfolio. It would cover legal or brokerage fees in respect of offshore assets, such as the legal fees on the sale of a foreign house....

This is considering fees paid by the individual, but the same applies to fees paid by a relevant person, such as a settlor-interested trust:

> 13. Among the sort of payments that Condition A might cover would be fees paid by non-UK resident trustees to UK advisers for advice on

119 See 10.11.13 (Service provided in the UK).

120 Section 809W(6) ITA provides: "sections 275 to 275C of TCGA 1992 (location of assets) apply for the purposes of subsection (3) as they apply for the purposes of TCGA 1992." See 71.1 (Situs of assets for CGT).

[1] managing the assets held in the trust or
[2] non-UK assets the trustees are considering purchasing.
Accountancy fees for preparing non-UK tax returns would also be covered providing the majority of the accountancy services relates to non UK property.

The RDR Manual provides:

**34060 - Remittance Basis: Exemptions: Relevant services provided in the UK - location of overseas property**
In applying these rules it is important to determine exactly what the service relates to, not just to whom it is provided.
For example, services may be said to be provided for non-resident trustees (a relevant person) RDRM33030 in respect of shares that the trust owns in a non-resident company (that would, if it were UK resident, be a 'close' company').[121] However if the service actually relates to that company's underlying UK assets then the service does not relate to property 'outside the UK'.
On the other hand, if the service is in connection with legal obligations between the trustees and the non-resident company in respect of, say the shares that are held, for example updating the share register in the local territory, then this is a service relating to property (the company/shares) wholly situated outside of the UK.
*Example 1 (Petra)*
P, a remittance basis user, is a participator in a Jersey company that would, if it were in the UK, be a close company. The company is a relevant person RDRM33030.[122] The company owns a portfolio of UK real estate. UK-based advisors produce an investment and tax report in respect of the company's UK activities; the advisors fees are paid overseas using P's foreign income.

The example is factually far-fetched since one would normally expect the company to pay for advice supplied to the company, and then there would

121 The author is confused, here and in the examples which follow, in that whether or not the company is a close company is not relevant; though in the kind of case under consideration the company is likely to be a trust holding company and so would be "close". (In this section I use the expression "close" company loosely, to include a non-resident close company, ie one which would be close if UK resident.)

122 The facts that the company is close, and a relevant person, are irrelevant; see above footnote.

in principle be no taxable remittance. Assuming (as the example requires) P did pay for advice supplied to P, then the HMRC analysis is as follows:

> The relevant UK service is the provision of advice in a tax report which relates to the Jersey company's UK activities. It is the UK activities which are the subject of the advice, not the overseas company so the exemption cannot apply. We look through to what the work relates to.

The HMRC analysis is wrong. The advice relates to property, not activities, but it is UK property and so HMRC are correct to conclude that the exemption does not apply. The moral for tax planning is that P should use foreign advisors.

> *Example 1(a)*
> The Jersey company in example 1 above also has a French property, which makes up only 10% of its business.
> UK-based advisors produce a separate marketing report in respect of this property. The advisors fees are paid overseas using P's foreign income.
> The service provided in the UK - in this case the preparation of the report - relates to a non-UK property. So the exemption at ITA07/s809W would apply, assuming the other conditions are also met.

This is straightforward.

> **RDRM34040 - Remittance Basis: Exemptions: Relevant services provided in the UK**
> ...
> *Example 6 (Micho)*
> M, a remittance basis user, employs UK-based agents to prepare his US tax return. He uses his foreign income to pay for this service, paying directly into the agent's offshore bank account. This is a service provided in the UK.
> Advice on the completion of a non-UK tax return would generally be within the exemption providing the majority of the advice relates to non-UK property; for example:
> 1. M's major source of income is UK salary and other UK employment benefits, and most of the work relates to this.
> This is service work relating to non-asset related income, eg employment income, so whether UK employment or not there is no property so the exemption at s809W cannot apply.

The HMRC analysis is wrong as an employment contract is property.[123] However the UK contract of employment is likely to be subject to UK law, and so UK situate, and so the conclusion that the services exemption does not apply is correct. The moral, again, is that M should use foreign advisors. The Manual continues:

> 2. Most of the work undertaken is in respect of his UK sources of income and gains, albeit these are small compared to his world wide income and gains.
> The service relates to investment income/gains from UK sources so it is outside the exemption.

The HMRC analysis is not strictly correct as the issue is CGT situs, not source, but in practice the two are normally the same.

> 3. Most of the work undertaken is in respect of advice relating to investment income/gains from non-UK sources.
> The service provided relates to investment income/gains from non-UK sources, so it is within the exemption if all other conditions are met.

Perhaps more importantly, fees for preparing UK tax returns will similarly be exempt if they relate mainly to non-UK assets.

### 10.29.2 *"Wholly or mainly"*

The RDR Manual provides:

> **34040. Relevant services provided in the UK** [July 2010]
> ... For the purposes of applying the exemption "wholly or mainly" means more than half. Wholly or mainly relates to the service provided, not the property, and is, in general, judged by reference to work done, normally time spent.
> However, if advisers value the measurement of work done using a variety of factors, such as, for example a basis of both time and fee rate (eg use of a team specialising in international property), it is appropriate that this should be reflected in the considerations of "wholly or mainly". Other factors may include the fee and time rate if specialist advice was

123 *O'Brien v Benson's Hosiery* 53 TC 254.

> required, split of assets between UK and foreign situs, and the place of research or administration.[124]

The RDR Manual provides an example:

> **34040. Relevant services provided in the UK** [July 2010]
> ... *Example 2 (Ritika)*
> R, a remittance basis user, engages an investment manager based in the UK to manage her investment portfolio which covers assets both in and outside the UK and which changes throughout the year. ... Whether Condition A is met depends on whether the service provided relates wholly or mainly to property situated outside the UK.
> If the advice relates to assets and investments held by R, and/or her obligations that ensue from these (eg completing valuation/ownership details to comply with requirements in the jurisdiction where the assets are based), and the advice relates to both UK-situs and offshore situs assets, it will depend on the split of the assets.
> For example, if she holds, say, 60% foreign assets, and the advice given relates to all of the assets held in the portfolio, then the 'wholly or mainly' test would be met.
> If the advisors are considering changes in R's portfolio or the acquisition of UK assets and their research is UK-centric, then the 'service' provided in the UK is likely to relate to UK property, regardless of what is eventually acquired.

The tax planning moral is that R should instruct the investment managers to invest in non-UK property, but in practice she will want to do that for other reasons anyway; or (probably better) appoint foreign managers and then R can forget about the requirements of the relief.

### 10.29.3 *Services relief condition B (payment to foreign bank account)*

Section 809W(4) sets out services relief condition B:

> Condition B is that the whole of the relevant consideration is given by way of one or more payments to one or more bank accounts held outside the UK by or on behalf of the person who provides the relevant UK service.

124 The same point is made in EN Clause 23 Sch 7 Remittance Basis Amendment 354.

No relief is available if any part of the fees are paid in any other manner, for instance by way of set-off.

The service provider will generally remit the payment to the UK immediately on receipt. That does not affect the customer's tax position. The customer will not know, and will not be entitled to know, what the supplier does with its own money.

### 10.29.4 *Services relief condition B: commentary*

I am unable to see the purpose of services relief condition B. It continues the rule in *Timpson's Executors v Yerbury* applicable under the pre-2008 remittance basis. Perhaps the policy was that nothing which was a remittance under the pre-2008 rules should cease to be a remittance under the ITA remittance rules. If so the policy was wholly misguided. The opportunity should have been taken to create an entirely new and coherent set of rules. As it is, suppliers of services relating to foreign property will need to open foreign bank accounts and the individual must ensure that they pay all the fees into that account; a pointless and inconvenient bureaucratic requirement, but there it is.

In practice it will often be easier to appoint foreign advisors so as not to have to bother about the relief.

### 10.29.5 *Identifying "the service"*

It is necessary to identify what is the service before identifying what is the property to which the service relates:

(1) There may be one service relating to UK and non UK property, in which case one applies the "wholly or mainly" test.

(2) There may be separate services, one (or more) relating to UK property, and one (or more) relating to foreign property, in which case the services relating to the foreign property only can qualify for exemption.

Of course either analysis may better suit the taxpayer or HMRC, depending on the result of the wholly or mainly test. The VAT distinction between single (though composite) and multiple supplies is applicable here.

The RDR Manual provides:

> **34040. Relevant services provided in the UK** [July 2010]
> ... If
> [1] the services (and thus the consideration due for that service) can be clearly and specifically identified as relating either to UK assets or to non-UK assets and
> [2] it is possible to separately identify this from the fees structure and invoicing,
> the work relating to UK assets will not be regarded as meeting the "wholly or mainly" test at Condition A in section 809W.[125] This does not necessarily require a separate advice letter, report or invoice ("split-invoice") to be issued, as long as the individual is clearly able to identify from the invoice to what his payments relate.

If that is right, a remittance basis taxpayer should not use a UK investment manager, say, as the commission on the purchase of UK situate securities would not be exempt, even if the securities as a whole are mainly non UK situate. A UK investment manager should be used only if no UK situate securities are purchased.

Where there are two or more separate supplies, some exempt, some not, it is necessary to identify the consideration given for each supply. The RDR Manual discusses apportionment:

> **34040. Relevant services provided in the UK** [July 2010]
> If there is a split contract for services relating to UK and non-UK assets you should accept the computations if the split bears a reasonable resemblance to the actuality of service provided.
> Any attempt to use artificial or otherwise unrealistic cost structures, for example to increase the costs attributed to non-UK property advice work against UK-property advice work should be strongly resisted.

### 10.29.6 *Exceptions: s.730 and s.87 benefits*

Section 809W(5) ITA provides:

> Subsection (2) does not apply if the relevant UK service relates (to any extent) to the provision in the UK of—
> (a) a benefit that is treated as deriving from the income by virtue of

125 [Author's footnote] It follows that the work relating to the foreign assets does meet the wholly or mainly test (even if the foreign assets are a minority of the whole).

section 735, or

(b) a relevant benefit within the meaning of section 87B of TCGA 1992 that is treated as deriving from the chargeable gains by virtue of that section.

I cannot see what the legislation is aiming at here. The following conditions must all be satisfied:

(1) A service is provided in the UK.
(2) The service relates to non-UK property.
(3) The service relates to the provision in the UK of a benefit within s.731 or a capital payment for CGT.

Points (2) and (3) appear to be contradictory, but if one could weave a course which satisfies both, why withhold foreign services relief? I would be grateful to any reader who could explain.

## 10.30 Exempt property

Section 809X(1) ITA provides:

> Exempt property which is brought to, or received or used in, the UK in circumstances in which section 809L(2)(a) applies is to be treated as not remitted to the UK.

There are five categories of exempt property. These relate to:

(1) public access
(2) personal use
(3) a de minimis exemption
(4) temporary importation
(5) the repair rule

In the FA 2008, exemptions (2) to (5) were limited to relevant foreign income. This was absurd, though it was a conscious decision. HMRC belatedly agreed. The FA 2009 extended the exemptions to apply to all types of income and gains, with retrospective effect.

The exemption does not extend to remittance condition C or D but they will not often apply.

### 10.30.1 *"Property"*

Section 809Z6 ITA provides some definitions. Section 809Z6(1) ITA provides:

> This section applies for the purposes of sections 809X to 809Z5.

Section 809Z6(2) ITA provides:

> "Property" does not include money.

This is an artificial definition of "property" in that the word in its natural sense does include money.

In the remittance basis provisions outside s.809X to 809Z5, the word "property" is used without a definition, and does include money.[126] This breaches the somewhat elementary principle of good drafting, that the same word should not be used with different meanings. The consequence is to cause confusion and make discussion more difficult, as greater care is needed in one's choice of terminology. In this chapter:
- the word "property" (by itself) does include money;
- where I want to refer to "property" in the artificial s.809Z6(2) sense, I use the expression "property (excluding money)".

### 10.30.2 *"Money"*

Section 809Z6(3) ITA defines money:

> In subsection (2) "money" includes—
> (a) a traveller's cheque,
> (b) a promissory note,
> (c) a bill of exchange, and
> (d) any other—
>   (i) instrument that is evidence of a debt, or
>   (ii) voucher, stamp or similar token or document which is capable of being exchanged for money, goods or services.

This is an artificial definition of "money" in that none of these five categories would be "money" in the ordinary meaning of the word.

The definition is over-complex, given the limited importance of the exempt property rules, but there it is.

126 See 10.11.2 "Property" and "Money".

The definition is expressed to apply only for the purposes of s.809Z6(2), through which it applies for the purposes of s.809X to 809Z5. It is also needed in s.809Y, where it is repeated verbatim. It also applies in para 86 Sch 7 FA 2008, where it is incorporated by reference. In the remittance basis provisions elsewhere the word *money* is used without any definition, and has its ordinary meaning. So once again, care is needed in ones choice of terminology. In this chapter:
- when the word *money* is used in the artificial 809Z6(3) sense, I refer to it as "money" with scare quotation marks.
- when the word *money* is used in its ordinary sense, I write it without the quotation marks.

### 10.30.3 *Property "being in the UK"*

Section 809Z6(4) ITA defines "being in the UK":

> References to property being in the UK are references to the property—
> (a) being in the UK after being brought to, or received in, the UK in circumstances in which section 809L(2)(a) applies, or
> (b) being used in the UK in circumstances in which section 809L(2)(a) applies.

Section 809L(2)(a) applies if "money or other property is brought to, or received or used in, the UK by or for the benefit of a relevant person."

## 10.31 Public access rule

### 10.31.1 *Introduction*

Suppose an individual has purchased works of art out of foreign income or gains. It may be possible to lend these works to UK institutions without a taxable remittance[127] but s.809Z ITA provides an additional exemption for works of art brought to the UK for public display. Perhaps it is intended for the case where the institution is a relevant person. The drafting incorporates by reference provisions relating to VAT and import duty (temporary imports and items brought into the UK permanently by

127 See 10.11.3 (Property brought to the UK ("brought" limb of condition A)).

museums and galleries).

Section 809X(3) ITA provides:

> Property is exempt property if it meets the public access rule (see sections 809Z and 809Z1).

Section 809Z(1) ITA provides:

> Property meets the public access rule if conditions A to D are met.

I refer to **"public access conditions A to D"** to avoid confusion with the myriad other conditions in ITA.

### *10.31.2 Public access condition A (works of art)*

Section 809Z(2) ITA provides:

> Condition A is that the property is—
> (a) a work of art,
> (b) a collectors' item, or
> (c) an antique,
> within the meaning of Council Directive 2006/112/EC (see, in particular, Annex IX to that Directive).

Annex IX of the directive provides:

WORKS OF ART, COLLECTORS' ITEMS AND ANTIQUES, AS REFERRED TO IN POINTS (2), (3) AND (4) OF ARTICLE 311(1)
PART A Works of art
(1) Pictures, collages and similar decorative plaques, paintings and drawings, executed entirely by hand by the artist, other than plans and drawings for architectural, engineering, industrial, commercial, topographical or similar purposes, hand-decorated manufactured articles, theatrical scenery, studio back cloths or the like of painted canvas (CN code 9701);
(2) original engravings, prints and lithographs, being impressions produced in limited numbers directly in black and white or in colour of one or of several plates executed entirely by hand by the artist, irrespective of the process or of the material employed, but not including any mechanical or photomechanical process (CN code 9702 00 00);
(3) original sculptures and statuary, in any material, provided that they are executed entirely by the artist; sculpture casts the production of which is limited to eight copies and supervised by the artist or his successors in title (CN code 9703 00 00); on an exceptional basis, in cases determined by the Member States, the limit of eight copies may be

exceeded for statuary casts produced before 1 January 1989;
(4) tapestries (CN code 5805 00 00) and wall textiles (CN code 6304 00 00) made by hand from original designs provided by artists, provided that there are not more than eight copies of each;
(5) individual pieces of ceramics executed entirely by the artist and signed by him;
(6) enamels on copper, executed entirely by hand, limited to eight numbered copies bearing the signature of the artist or the studio, excluding articles of jewellery and goldsmiths' and silversmiths' wares;
(7) photographs taken by the artist, printed by him or under his supervision, signed and numbered and limited to 30 copies, all sizes and mounts included.
PART B Collectors' items
(1) Postage or revenue stamps, postmarks, first-day covers, pre-stamped stationery and the like, used, or if unused not current and not intended to be current (CN code 9704 00 00);
(2) collections and collectors' pieces of zoological, botanical, mineralogical, anatomical, historical, archaeological, palaeontological, ethnographic or numismatic interest (CN code 9705 00 00).
PART C Antiques
Goods, other than works of art or collectors' items, which are more than 100 years old (CN code 9706 00 00).

### *10.31.3 Public access condition B (public access)*

Section 809Z(3) ITA provides:

> Condition B is that—
> (a) the property is available for public access at an approved establishment,
> (b) the property is to be available for public access at an approved establishment and, in connection with its being so available, is in transit to, or in storage at, public access rule premises, or
> (c) the property has been available for public access at an approved establishment and, in connection with its having been so available, is in transit from, or in storage at, public access rule premises.

The key terms here are "available for public access" and "approved establishment." Both are defined.

### *10.31.4 Available for public access*

Section 809Z(4) ITA provides:

> Property is "available for public access" at an approved establishment if

> the property is—
> (a) on public display at the establishment,
> (b) held by the establishment and made available to the public on request for viewing or for educational use, or
> (c) held by the establishment for public exhibition in connection with the sale of the property.

The RDR Manual provides:

> **34140 - Remittance Basis: Exemptions: Public access rule - Condition B - available for public access - definition**
> ... It is important to note that even though the third bullet [para (c)] allows property brought into the UK for public display in connection with its sale to satisfy the public access rule this does not negate any charge arising if the property is actually sold in the UK (refer to RDRM34080 Property ceasing to be exempt).

### *10.31.5 Approved establishment*

Section 809Z(5) ITA defines approved establishment. There are two types:

> An "approved establishment" is—
> (a) an approved museum, gallery or other institution within the meaning of Group 9 of Schedule 2 to the Value Added Tax (Imported Goods) Relief Order 1984, or

If one turns to the VAT (Imported Goods) Relief Order 1984 one might expect to find a definition of "approved museum, gallery or other institution." There is none, but article 2 does say that "approved" means approved by the secretary of state. In practice approval is granted by the National Import Reliefs Unit and its practice is set out in HMRC Notice 361 (Importing museum and gallery exhibits free of duty and VAT).

Section 809Z(5) ITA continues:

> An "approved establishment" is ...
> (b) any other person, premises or institution designated (or of a description designated) by the Commissioners.

The RDR Manual provides:

> **34130 - Remittance Basis: Exemptions: Public access rule - Condition B - approved establishment - definition**
> ...Any questions about what constitutes an 'approved establishment' or requests for approval as an 'approved establishment' (ITA07/s809Z(5)(b)) should be made to CAR: Offshore Personal Tax - Remittance Basis Technical Team.
> There is no set form which needs to be completed to request designation as an approved establishment, but all applications should be made in writing and provide sufficient detail about the relevant circumstances relating to making property available for public access, including particulars of the appropriate person, premises or institution wanting to be designated as an approved establishment and full contact details.

### 10.31.6 *Public access premises*

Lastly, s.809Z(6) ITA defines public access rule premises:

> "Public access rule premises" are—
> (a) premises in the UK at which the property is to be, or has been, available for public access, or
> (b) other commercial premises in the UK used by the approved establishment for the storage of property in advance of its being, or after its having been, available for public access at the approved establishment.

### 10.31.7 *Public access condition C (time limit)*

Section 809Z ITA provides:

> (7) Condition C is that, during the relevant period, the property meets condition B for no more than—
> (a) two years, or
> (b) such longer period as the Commissioners may specify.
> (8) "The relevant period" means the period—
> (a) beginning with the importation of the property, and
> (b) ending when it ceases to be in the UK after that importation.
> (9) "Importation" means the property being brought to, or received or used in, the UK in circumstances in which section 809L(2)(a) applies.

The definition of "importation" recognises that there may be an importation to the UK to which s.809L(2) does not apply, in which case time does not begin to run. The RDR Manual provides:

**34150 Public access rule - Condition C - two year period** [July 2010]
...
The relevant period starts with the importation of the property and ends when the property ceases to be in the UK after that importation.
For these purposes, property is treated as brought into the UK or imported if it is brought to the UK in circumstances such that it would be treated as a remittance to the UK within Condition A of s.809L ITA2007 (refer to RDRM33120 Condition A - property) if it were not for this public access rule (or any other rule exempting it) (s.809Z(9) ITA2007).
The two year period will not necessarily start with the importation of the property as the property may not have been available for public access when it was first imported into the UK. For example it may be brought in under the temporary importation rule prior to public access.
Again the two year period will not necessarily end when the property ceases to be in the UK as the property may cease to be available for public access before the property actually leaves the UK. For example it may instead qualify under the repair rule after a period of public access.
**Example 1** (Faizal)[128]
F is a remittance basis user. He is asked by a London museum, which is an approved establishment, if he will contribute a vase that he owns to an exhibition that the museum intends to stage. The vase is derived from F's relevant foreign income.
F arranges for the vase to be shipped to the UK from Switzerland. In May the vase is received by the museum and is put into storage for one month after which exhibition begins. The exhibition lasts until the following year in October, at the end of which the vase is returned to Switzerland. The vase has been in the UK for 18 months in total. The vase is exempt property so F has not made a chargeable remittance.
**Example 2**
The circumstances are the same as Example 1 but this time, at the end of the exhibition, the vase is not returned to Switzerland. Instead, F asks for the vase to be sent to a restorer in Newcastle to be cleaned. The restorer keeps the vase in his business premises for a further eight months [!] and then in the following June F arranges for it to be sent back to Switzerland.
The vase has been in the UK for 26 months. The vase, purchased using F's relevant foreign income is exempt property under the public access rule for the 18 months from its arrival in the UK in May to the October in the following year.

128 I omit a few irrelevancies in setting out the text of this example.

Between October and the following June it is within temporary importation rule (as it is with the repairer) and so remains exempt property. As the 2 year time 'repair' limit at Condition C has not been exceeded the vase remains exempt property throughout and F has not made a taxable remittance.
Any requests under the terms of s.809Z(7)(b) ITA 2007 to extend the period during which property may remain in the UK under the terms of the public access rule should be made to CAR: PTI Advisory, Foreign Income and Remittance Basis Team

### 10.31.8 *Public access condition D (VAT relief)*

Section 809Z(10) ITA provides:

> Condition D is that the property attracts a relevant VAT relief (see section 809Z1).

So we turn to s.809Z1(1) ITA:

> Property "attracts a relevant VAT relief" if any of conditions 1 to 4 are met.

I refer to **"VAT relief conditions 1 to 4**."

### 10.31.9 *VAT relief conditions 1 and 2*

Section 809Z1 ITA provides:

> (2) Condition 1 is that article 5(1) of the Value Added Tax (Imported Goods) Relief Order 1984 applies in relation to the importation of the property by virtue of Group 9 of Schedule 2 to that Order (importation of works of art or collectors' pieces by museums etc).
> (3) Condition 2 is that article 5(1) would so apply if the following requirements were disregarded—
> (a) the requirement that the importation be from a third country,[129] and

129 RDRM34160 notes that "In this context 'third country' means a place outside the Member States of the European Union. The second and fourth conditions are required to ensure that, where the conditions are met, the remittance basis exemption scheme applies to property imported from within the European Union, works of art

(b) the requirement that the purpose of the importation be a purpose other than sale.

So we need to turn to article 5(1) VAT (Imported Goods) Relief Order 1984:

> Subject to the provisions of this Order, no tax shall be payable on the importation of goods of a description specified in any item in Schedule 2 to this Order.

Our journey takes us on to group 9 of schedule 2:

> **Group 9 Works of Art and Collectors' Pieces**
> Item No.1: Works of art and collectors' pieces imported by approved museums, galleries or other institutions [for a purpose other than sale][130].
> Note
> Item 1 applies only where the goods are—
> (a) of an educational, scientific or cultural character; and
> (b) imported free of charge or, if for a consideration, are not supplied to the importer in the course or furtherance of any business.

10.31.10 *VAT relief conditions 3 and 4*

Section 809Z1 ITA provides:

> (4) Condition 3 is that article 576(3)(a) of Commission Regulation (EEC) No 2454/93 (relief from import duties for works of art etc imported for the purposes of exhibition, with a view to possible sale) applies in relation to the importation of the property.
> (5) Condition 4 is that article 576(3)(a) would so apply if the requirement that the importation be from a third country were disregarded.

So we need to turn to article 576(3) which provides:

> 3. Total relief from import duties shall be granted for the following:
> (a) works of art, collectors' items and antiques as defined in "Annex I"

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already in the UK and goods imported for sale which would not otherwise be covered by the existing VAT scheme."

130 The words in brackets are effectively undone by s.809Z1(3)(b) ITA.

> of Directive 77/388/EEC, imported for the purposes of exhibition, with a view to possible sale ...[131]

This is of (virtually) no interest as it only applies to exhibition with a view to sale; a sale in the UK gives rise to a charge; and one would not normally exhibit a work of art in the UK with a view to its sale elsewhere.

### 10.31.11 *Date of importation*

Section 809Z1(6) ITA provides:

> Where the property does not meet condition B in section 809Z at the time of its importation it is to be assumed for the purposes of this section that the property was imported on the day during the relevant period when the property first meets that condition.

The RDR Manual provides:

> **RDRM34160 - Remittance Basis: Exemptions: Public access rule - Condition D - relevant VAT relief**
> ...Where Condition B of ITA07/s809Z - the public access condition - is not met when the property is imported into the UK it is to be assumed, in considering whether the property attracts a relevant VAT relief, that the property was imported at the point that the property is made available for public access, thereby deeming the relevant VAT relief provisions to apply.

### 10.31.12 *Commentary*

Readers (of whom there will not be many) who have studied this section to this point can need no commentary of mine to reach the conclusion that this relief should have been much more simply expressed; contrast the IHT works of art exemption - see 53.18 (works of art). I would be grateful to any reader who could explain in particular what is the reason for public access condition D, which seems quite pointless.

131 This article was inserted into the 1993 regulation by Commission Regulation (EC) No 993/2001 of 4 May 2001.

## 10.32 Personal use rule

Section 809X(4) ITA provides:

> Clothing, footwear, jewellery and watches ~~that derive from relevant foreign income~~[132] are exempt property if they meet the personal use rule (see section 809Z2).

Section 809Z2 ITA provides:

> (1) Clothing, footwear, jewellery or watches meet the personal use rule if they—
> (a) are property of a relevant person, and
> (b) are for the personal use of a relevant individual.
> (2) In this section—
> (a) "relevant person" has the meaning given by section 809M, and
> (b) "relevant individual" means an individual who is a relevant person by virtue of section 809M(2)(a), (b), (c) or (d) (the individual with income or gains, or a husband, wife, civil partner, child or grandchild).

The words "*by virtue of section 809M(2)(a), (b), (c) or (d) (the individual with income or gains, or a husband, wife, civil partner, child or grandchild)*" are otiose because an individual who is a relevant person is necessarily a relevant person by virtue of those provisions; but no harm is done.

## 10.33 Repair rule

Section 809X(5)(a) ITA provides:

> Property ~~of any description~~ ~~that derives from relevant foreign income~~[133] is exempt property if— ...
> (a) the property meets the repair rule (see s.809Z3).

132 The words "that derive from RFI" were deleted with retrospective effect by the FA 2009.

133 The words "that derive from RFI" were deleted with retrospective effect by the FA 2009.

Section 809Z3 ITA provides:

> (1) Property meets the repair rule for the whole of the relevant period if, during the whole of that period, the property meets the repair conditions.
> (2) Property meets the repair rule for a part of the relevant period if—
> (a) during the whole of that part of that period, the property meets the repair conditions, and
> (b) during the whole of the other part of that period, or the whole of each other part of that period, the property meets the repair conditions or the public access rule.
> (3) Property meets the repair conditions if the property—
> (a) is under repair or restoration,
> (b) is in transit from a place outside the UK to repair rule premises, in transit between such premises, or in storage at such premises, in advance of repair or restoration, or
> (c) is in storage at such premises, in transit between such premises, or in transit from such premises to a place outside the UK, following repair or restoration.
> (4) "Repair rule premises" means—
> (a) premises in the UK that are to be used, or have been used, for the repair or restoration referred to in subsection (3)(b) or (c), or
> (b) other commercial premises in the UK used by the restorer for the storage of property in advance of, or following, repair or restoration of property by the restorer.
> (5) "Restorer" means the person who is to carry out, or has carried out, the repair or restoration referred to in subsection (3)(b) or (c).
> (6) Property meets the repair conditions, or the public access rule, during the whole of a period, or the whole of part of a period, if the property meets those conditions or that rule—
> (a) on the whole of, or on part of, the first day of that period or part period,
> (b) on the whole of, or on part of, the last day of that period or part period, and
> (c) on the whole of each other day of that period or part period.
> (7) "The relevant period" has the same meaning as in section 809Z.

The relief applies only to the property being repaired. There is no relief for the service of repair. A remittance basis taxpayer would be mad to bring an asset to the UK in order to make use of UK repair or restoration services. Even if the importation of the asset did not give rise to a remittance the payment for the repair would give rise to a remittance. All yacht and similar restoration work, for instance, from remittance basis taxpayers is lost to the UK. But there it is.

## 10.34 Temporary importation rule

Section 809X(5)(b) ITA provides:

> Property ~~of any description that derives from relevant foreign income~~[134] is exempt property if— ...
> (b) the property meets the temporary importation rule (see s.809Z4)

Section 809Z4 ITA provides:

> (1) Property meets the temporary importation rule if the total number of countable days is 275 or fewer.
> (2) A "countable day" is a day on which, or on part of which, the property is in the UK by virtue of being brought to, or received or used in, the UK in circumstances in which section 809L(2)(a) applies (whether the current case, or a past case, when the property was so brought, received or used).

One needs to keep a lifetime record for every asset.

> (3) A day is not a countable day if, on that day or any part of that day—
> (a) the property meets the personal use rule,
> (b) the property meets the repair rule, or
> (c) the notional remitted amount[135] in relation to the property is less than £1,000.

The interaction of the temporary importation rule and the public access rule is more complicated:

> (4) A day on which, or on part of which, the property meets the public access rule (the "relevant day") is not a countable day if any of conditions A to C is met.
> (5) Condition A is that the property meets the public access rule during

134 The words "of any description" (which were otiose and misleading) and the words "that derive from RFI" were deleted with retrospective effect by the FA 2009.
135 This term is defined in s.809Z5 ITA: see 10.35 (De minimis rule).

the whole of the period of importation in which the relevant day falls.
(6) Condition B is that—
(a) the property does not meet the public access rule during the whole of the period of importation in which the relevant day falls, and
(b) that period of importation—
(i) begins with a period of no public access, and
(ii) ends with a period of public access which immediately follows that period of no public access.
(7) Condition C is that—
(a) the property does not meet the public access rule during the whole of the period of importation in which the relevant day falls, and
(b) during the parts, or each of the parts of the period of importation during which the property does not meet the public access rule it meets the repair conditions.[136]

Section 809Z4(9) defines period of importation in terms that echo the language of s.809Z1:

(9) "Period of importation" means a period that—
(a) begins when property is brought to, or received or used in, the UK in circumstances in which section 809L(2)(a) applies, and
(b) ends when the property ceases to be in the UK after having been so brought, received or used.
(10) "Period of no public access" means a period which is not a period of public access and "period of public access" means a period during the whole of which property meets the public access rule.

The RDR Manual provides an example:

**34220 Temporary importation rule - countable days**
... Example (Jez)
On 15 January 2010 J, a remittance basis user, brings a rare oil painting into the UK to hang on the wall of his castle. J had purchased the painting two months earlier using his foreign employment income.
On 1 July 2010 he allows the painting to be put on public display at the National Gallery, London. The painting remains on display for six months, until 31 December 2010, after which it is immediately shipped to J's office in Dubai on 1 January 2011.

136 Section 809Z4(8) ITA defines the repair conditions by reference: "Section 809Z3(6) applies for the purposes of this section."

The conditions for meeting the public access rule for the period 1 July 2010 to 31 December 2010 have been satisfied.
Bringing the painting into the UK would ordinarily be a taxable remittance under section 809L but we need to consider the exemption rules. During the period 15 January to 30 June 2009 the painting was not available for public access. This period is immediately followed by a period of public access from 1 July 31 December 2009.
The 15 January to 30 June 2009 period falls to be considered under the temporary importation rule (167 days).
For the period 1 July 2009 to 31 December 2009 the property is exempt property under the public access rule and therefore this period does not count towards the 275 day limit

## 10.35 De minimis rule

Section 809X(5)(c) ITA provides:

> Property ~~of any description that derives from relevant foreign income~~[137] is exempt property if ...
> (c) the notional remitted amount (see s.809Z5) is less than £1,000,

Section 809Z5(1) ITA defines "notional remitted amount":

> The "notional remitted amount", in relation to property, is the amount ~~of income~~[138] that would be taken to be remitted to the UK in relation to the property (if section 809X did not apply in relation to the property).

Each item of property qualifies for the £1,000 limit. HMRC agree. The RDR Manual provides:

> **34180 Exempt Property - Notional remitted amount less than £1,000**
> ... Example (Jacob)
> J, a remittance basis user, uses his foreign income to purchase a mobile phone for £250 a fountain pen for £485, and a new suitcase for £630. He brings all the items back to the UK.

137 The words "that derive from RFI" were deleted with retrospective effect by the FA 2009.

138 The words "of income" (which mistakenly disapplied the section in relation to CGT) were deleted with retrospective effect by the FA 2009.

> The mobile phone, pen and suitcase all derive from J's foreign income so would be taxable as remittances when brought into the UK under ITA07/s809L. However each item's notional remitted amount (£250, £485 and £630 respectively) is under the £1,000 limit, so section 809Z5 provides that the phone, the pen and the suitcase are regarded as exempt property. J has not therefore made a chargeable remittance.
> In J's case the total cost of all the property brought to the UK exceeds £1,000. However the exemption limit applies to each item of property, [unless it forms part of a set.]

In the 7th edition of this book I noted that s.809Z5(2)(3) continued with an unnecessary rule relating to sets of property. HMRC presumably agreed, since this was repealed with effect from 22 April 2009 (though the Manual has not yet been updated).

## 10.36 Exempt property clawback charge

### 10.36.1 *Sale in UK*

> (3) The first case is where the whole or part of the exempt property is sold or otherwise converted into money[139] whilst it is in the UK.

An exchange for a non-money asset is not a sale.
This rule applies (illogically) even if the proceeds are received abroad. It is proposed to relax this rule from 2012/13. The remittance consultation paper provides:

> **Taxation of assets sold in the UK**
> 2.81 Under the current remittance basis rules, assets purchased overseas using foreign income or capital gains are normally liable to tax when they are brought to the UK. Limited exemptions exist for certain assets purchased out of overseas income or capital gains. These are known as exempt assets. These exemptions apply where an asset is:
> • a work of art or antique brought to the UK to be displayed in public;
> • an item of personal clothing, footwear or jewellery;
> • an item brought to the UK temporarily (up to 275 days in total) or for

139 Section 809Y(5) provides a definition of "money" which is the same as in s.809Z6. (If the definition had been expressed to apply to the whole ITA remittance code the repetition would have been unnecessary.) For this definition see 10.30.2 ("Money").

repair; or

• worth less than £1,000.

2.82 However, these exemptions are not available where the asset in question is sold in the UK and, as a result, if it is sold the individual will be liable to UK tax on the initial cost of the asset in question.

2.83 This means that individuals can be faced with a tax charge when they bring such assets to the UK, even in cases where they have only been remitted for the purposes of being sold. The Government recognises that this situation has the potential to make the UK less attractive as a place for the sale of assets by non-domiciled individuals.

2.84 This particularly affects assets, such as works of art, where the current rules strongly discourage non-domiciles from bringing the asset to the UK for sale. This undermines some areas of the UK's economy, including the art market and auction houses, to the advantage of the UK's competitors. It also creates complexity in the rules on remitted assets and imposes a tax charge on income that may not actually be enjoyed in the UK. 2.85 The Government therefore proposes to build on the existing exemptions and introduce a new provision which would remove the tax charge on remitting an exempt asset to the UK where it is subsequently sold in the UK. This exemption would cover situations where an exempt asset which is brought to the UK temporarily is sold and the purchaser retains the asset in the UK.

2.86 However, there is a need to prevent individuals using the proposed exemption as an opportunity to bring their overseas income and capital gains into the UK tax-free by using the proceeds of a sale of their assets for their personal use. Therefore, the exemption would include a provision that, in order to be exempt from a tax charge, all of the proceeds from any sale must be taken out of the UK within two weeks of the money being received by the individual. The Government would welcome views on whether this is a suitable period of time.

2.87 This proposed exemption would apply to all exempt assets and would not be restricted to any particular class of asset or sector of the economy. This would be in line with the underlying principle that non-domiciles using the remittance basis should only be liable to UK tax on overseas income and capital gains to the extent that they are enjoyed in the UK.[140]

140 HMT & HMRC, "Reform of the taxation of non-domiciled individuals: a consultation" (June 2011) accessible *www.hm-treasury.gov.uk/d/consult_condoc_non_domicile_individuals.pdf.*

This presumably reflects some effective lobbying by the auctioneer industry.

10.36.2 *Exemption requirements cease to apply*

Section 809Y ITA provides:

> (1) Property that ceases to be exempt property is to be treated as having been remitted to the UK at the time it ceases to be exempt property.
> (2) Property ceases to be exempt property in either of the following cases....
> (4) The second case is where the property—
> (a) is exempt property only because it meets one or more of the relevant rules,[141]
> (b) ceases to meet that rule, or all of those rules, whilst it is in the UK, and
> (c) does not meet any other relevant rule.

## 10.37 Partnerships

This section discusses two related questions:

(1) *Remittance of funds transferred to partnership.* Suppose:
(a) P (a remittance basis taxpayer) receives foreign income/gains.
(b) P contributes the funds to a partnership of which P is a partner, as partnership capital.
(c) The partnership brings the funds to the UK.

(2) *Remittance of partnership income/gains*. Suppose:
(a) A partnership (whose partners include P, a remittance basis taxpayer) receives foreign income/gains.
(b) The partnership does not distribute the funds to the partners, but brings the funds to the UK.

In these cases, is there a taxable remittance? There are two possible views:

141 Section 809Y(5) ITA provides:
"relevant rule" means-
(a) the public access rule,
(b) the personal use rule,
(c) the repair rule, and
(d) the temporary importation rule.

(1) One regards P as owning an asset (a partnership share) which is derived from the foreign income/gains. In that case:
   (a) Funds contributed to the partnership are remitted if P receives the partnership share in the UK.
   (b) Partnership income/gains are not remitted.

(2) One regards the individual as owning a share of the partnership assets. In that case:
   (a) Funds contributed to the partnership are remitted if the partnership brings the funds to the UK.
   (b) Partnership income/gains are remitted if the partnership brings the funds to the UK.

One might describe the first view as being that partnerships are not transparent for remittance basis purposes, and the second view as one that partnerships are transparent.

### 10.37.1 *The background partnership law*

In order to address this one needs to understand the nature of a partner's interest in a partnership (also known as a partnership share).

Partners jointly own the partnership assets. However a partner individually is not entitled to exercise proprietary rights over partnership assets, and a partner's interest in partnership assets is described as a future interest.[142] The RDR Manual correctly states:

> **33530. Partnerships** [July 2010]
> *Investment into partnerships*
> When a partner makes a capital contribution to a partnership they acquire an asset under partnership law, namely an 'interest' or 'share' in the partnership which gives them rights to share in future profits and distributions (of their capital and any surplus) on dissolution of the partnership.

The same applies to a LLP.

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142 *Lindley & Banks on Partnership* (19th ed 2010) para 19-03 onwards; Law Com, *Partnership Law*, Report no 283, para 9.66 (The nature of a partner's interest).

10.37.2 *Non-transparent nature of partnership for remittance basis purposes*

On this basis the RDR Manual adopts the non-transparent view:

> **33530. Partnerships** [July 2010]
> ... *Offshore partnerships trading or investing in the UK*
> A partnership is not a relevant person. Individuals who are partners together in a partnership are not relevant persons by virtue of their role as a partner (although they may, of course, be relevant persons under other provisions).
> Offshore partnerships, whether trading or investment partnerships, may bring partnership funds into the UK to meet trading or investment expenses in the usual course of partnership business. As the funds are brought in by the partnership they are not brought in by a relevant person. In most cases there will be no benefit to a relevant person from the money or other property brought into the UK by the partnership, nor will a service usually be provided in the UK to or for the benefit of a relevant person, so Condition A of ITA07/s[809L][143] is not met. Thus there will be no taxable remittance.

In short, in the Manual's view, partnerships are not transparent for remittance basis purposes. Insofar as the tax analysis follows partnership law, this is clearly correct. At first glance, one might have thought that s.848 ITTOIA imposed transparency, regardless of what partnership law may have to say.[144] But that view is not really workable. A partner (for instance in a large investment partnership) may not know (and may not be entitled to know) what happens to partnership property, and cannot work it out from the accounts. Serious tracing difficulties arise. So either this is not the true effect of s.848 or the context shows that the deeming of s.848 does not apply here.

This is consistent with the view that a partnership is transparent in the sense that income of the partnership is income of the partners, for the issues are different: there is no reason why the general principle of income tax transparency should require the same answer to both.

The RDR Manual adds four qualifications (which should not be controversial):

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143 The original erroneously reads: 709L. This is a somewhat inaccurate paraphrase of remittance condition A, but the meaning is clear.

144 See 36.3 (Transparency of partnership for IT).

> **33530. Partnerships** [July 2010]
> ... [1] In cases where there does appear to be a benefit to an individual partner (or to another relevant person) from money or other property brought into UK by the partnership, or from a service provided in the UK for which the partnership gives consideration then you should examine the transaction and the partnership documents very carefully to identify the source of the partnership funds.
> [2] The provision of the property or service by the partnership may be a remittance of that individual's 'share' in partnership profit. To the extent that the individual's share in partnership profit falls to be regarded as relevant foreign income (see below) there may be a remittance.

Para [1] is considering whether a contribution to the partnership is remitted and para [2] is considering whether the partnership income is remitted. Clearly, if the partnership asset is used by the individual, remittance condition A is in principle satisfied.

> [3] You may also need to examine whether there is a true partnership, or whether in fact it is the individual's foreign income or gains that have been remitted.

Whether there is a partnership is a question of partnership law, which should not in practice cause difficulties if documentation and implementation are correct.

> [4] Alternatively there may be a connected operation to which Condition D of ITA07/s809L(5) applies.

The Manual wisely does not seek to explain how condition D might be satisfied.

10.37.3 *Contribution of foreign income/gains to UK partnership*

The RDR Manual 33530 provides:

> **33530. Partnerships** [July 2010]
> ... It follows [from the statement of the partnership law position] that a remittance basis user who uses his foreign income or gains to make a capital contribution to a UK partnership acquires a UK asset; namely a share in the UK partnership, in exchange for his 'equity' subscription in

> the partnership. Thus the foreign income or gains that he uses to contribute to the partnership will be a taxable remittance within ITA07/s809L.
> This is so even if the individual places his investment into the partnership's overseas account, and the UK partnership is only investing or trading overseas and not in the UK.

The text does not say what it means by "UK partnership" - presumably it means one an interest in which is UK situate, on common law principles: that is, an unincorporated partnership which is managed and controlled in the UK or a LLP with a UK register.[145]

An unspoken assumption here is that receipt of a UK situate asset (applying IHT/international law situs rules) is a taxable remittance, ie is a receipt of an asset in the UK. That is arguable.[146]

### 10.37.4 *Remittance of partnership profits*

Where partnership income is RFI[147] the same point arises. There is no remittance if the partnership receives its income in the UK. A partner who is a remittance basis taxpayer can only remit income to the UK after it is distributed to them from the partnership.

### 10.37.5 *Company held by partnership*

Suppose a partnership holds a company. The partners are participators in the company. The company must be a close company (or a non-resident close company), since the partners are connected persons. Accordingly the company is a relevant person in relation to each of the partners. So property brought/received/used in the UK by the company is remitted - even though there would be no remittance if the same property was brought/received/used in the UK by the partnership which holds the company! This is the case regardless of the size of the partnership. The proposed relief for UK investment may mitigate this problem for the future.

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145 See 70.28 (Situs of partnership share).
146 See 10.11.9 (Receipt of UK situate investment asset)
147 See 36.4 (Partnership income: remittance basis).

## 10.38 Proceeds of divorce settlement

### 10.38.1 *Is a transfer on divorce made for "consideration"?*

The starting point is to understand the family law background.

A transfer in connection with divorce may be made:

(1) Pursuant to a court order
   (a) following a contested hearing; or
   (b) approving a settlement agreed by the parties.
(2) Without a court order but under an agreement between the parties (the transferee agreeing to seek no (or a reduced) court order in return for the transfer).

Assume (as will normally be the case) that the transfer is made bona fide, at arm's length and with no gratuitous intent. Are transfers of these kinds made for consideration?

One might have thought that the answer was no. One argument is:

(1) there is only "consideration" where there is a contract[148] and
(2) (a) a court order is not a contract; and
   (b) an agreement between the parties is not a valid contract.[149]

This line of reasoning now seems less convincing, both because the word consideration is wide enough to apply in the absence of a contract, and because nuptual agreements can in some cases constitute enforceable contracts.[150] But more fundamentally, the quid pro quo which is the essence of consideration is lacking.

Accordingly in *G v G*[151] the High Court held that a transfer pursuant to a Court Order at a contested hearing (type (1)) was not made for consideration, so that CGT hold-over relief was available.

However in *Hill v Haines* [2008] Ch 412 the Court of Appeal held that a transfer pursuant to a Court Order at a contested hearing (type (1)) *was* made for consideration, for the purposes of s.339 Insolvency Act 1986.

Where does this leave *G v G* and CGT hold-over relief? Either it is

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148 *C&E Commissioners v Apple and Pear Development Council* [1985] STC 383; *IRC v Plummer* 54 TC 1 at p 57; *Unilever v Smith* [2002] STC 113.

149 See *Aspden v Hildesley* 55 TC 609.

150 See Law Commission consultation paper no. 198, *Marital Property Agreements* (Jan 2011) accessible *www.lawcom.gov.uk*.

151 *G v G* [2002] EWHC 1339 [2003] Fam Law 14 [2002] 2 FLR 1143 at [43] accessible *www.kessler.co.uk*.

overruled or else there are (at least) two concepts of consideration, in which case a transfer might be for consideration in one sense but not for consideration in the CGT sense. In that case one could never ask whether a transfer is made for consideration in the general, but only whether it is made for consideration in some specified sense of the ambiguous word.

Each view has some support in *Hill v Haines* (though they cannot both be right). Morritt C said:

> [30] ... the fact that a transfer ordered by the court does not give rise to a payment of consideration so as to reduce the value of hold-over relief *for capital gains tax* [does not dictate] a conclusion that a property adjustment order must be regarded as made for no consideration.

In other words, "consideration" in the CGT code has a different meaning. But Rix LJ preferred the view that *G v G* was wrong.[152] Since Rix also agreed with Morritt, it is clear that he did not give a great deal of attention to this point (which did not need to be decided and which would not have been fully argued).

It is considered that the view of Morritt is to be preferred. Rights under the Matrimonial Causes Act are not assets for CGT purposes: no gain arises when a spouse is awarded a capital sum. Accordingly, there is no "consideration" for CGT purposes. However that is a special case and a transfer on divorce is made for consideration in the general sense of the expression.

### 10.38.2 *The HMRC view*

The CG Manual provides:[153]

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152 At [81] "... As for *G v G*, the view expressed by Coleridge J at para 43 regarding potential consequences for the purposes of capital gains tax can hardly be regarded as authoritative in the absence of the revenue. As Coleridge J stated, his view that the wife gave no consideration for the shares transferred to her because 'neither party has any 'rights'... cannot, of course, ultimately bind the Inland Revenue': he merely proceeded "on the footing" that business hold-over relief would be available to the husband. In doing so, he appears to have drawn an unnecessary inference from the decision of this court in the *Xydhias* case."

153 The passage has not been revised after *Hill v Haines,* but as several years have elapsed since that decision, it may be taken as a statement of the HMRC current view.

> **67192. Hold-over relief: Consideration [March 2006]**
> The disposal of an asset from one spouse or civil partner to the other in the circumstances described in CG67191 [that is, a disposal in the year after separation, which does not qualify for the CGT spouse exemption] is, where there is no recourse to the courts, usually made in exchange for a surrender by the donee of rights which they would otherwise be able to exercise to obtain alternative financial provision. In such cases we take the view that the value of the rights surrendered represents actual consideration of an amount which would reduce the gain potentially eligible for hold-over relief to nil. "Consideration" is not limited to money or money's worth.

After considering the case where there is gratuitous intent, which is so rare that it need not be considered here, the Manual continues:

> However, in cases where there is recourse to the courts and a court makes an order
> - for ancillary relief under the Matrimonial Causes Act 1973 which results in a transfer of assets from one spouse to another, or
> - for property adjustment under the Civil Partnership Act 2004, or
> - formally ratifying an agreement reached by the divorcing parties or by the civil partners of a dissolved civil partnership dealing with the transfer of assets,
>
> we take the view that the spouse or civil partner to whom the assets are transferred does not give actual consideration, in the form of surrendered rights, for their transfer. A Court Order, made in these circumstances, reflects the exercise by the court of its independent statutory jurisdiction and is not the consequence of any party to the proceedings agreeing to surrender alternative rights in return for assets.
> This approach represents a change in the Revenue's prevailing practice, following consideration of judicial observations made in the case of *G v G* and applies with effect from 31 July 2002. Therefore, where assets are transferred between divorcing parties or between civil partners of a dissolved civil partnership by reason of a Court Order as described above and a claim for gift hold-over relief is made, or remains unsettled, on or after that date, the relief should not be restricted in accordance with Section 165(7) TCGA 1992 on the grounds that actual consideration has been given by the donee.

Thus in the HMRC view:

(1) A transfer made pursuant to a court order, including a consent or

*Tomlin* order, is not made for consideration.
(2) A transfer not made pursuant to a court order is made for consideration.

It is considered that the position is in both cases the same:
(1) The transfer is made for consideration in the general sense of the word;
(2) The transfer is not made for consideration for CGT purposes.

### 10.38.3 *Are proceeds of divorce settlement "derived property"?*

Suppose T transfers RFI to W as part of a divorce settlement. It is suggested that the funds in the hands of W are not derived from the income. They are received for full consideration (in the general sense of that expression). If that is right, remittance condition B is not satisfied even if:
(1) W remits while still a relevant person (before decree absolute);
(2) W applies the funds for the benefit of relevant persons (eg children or grandchildren of T under 18).

However in case HMRC do not agree, W should not bring the funds to the UK until after decree absolute, by which time she has ceased to be a relevant person; and she should ideally not use the funds for the benefit of relevant persons (in relation to H). Then there is clearly no taxable remittance.[154]

## 10.39 Debit, credit and charge cards

This section considers whether the use of debit, credit and charge cards involves a remittance. The starting point is to understand the legal nature of debit, credit and charge cards. The following analysis draws on *The Law of Bank Payments*.[155]

On the use of a card, three contracts come into being. For present purposes the most important terms of the contracts are as follows:

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154 See 10.19 (Becoming/ceasing to be a relevant person: conditions A and B). As to debt remittance rules, see 10.17.11 (Debt imposed by law).

155 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.

(1) Cardholder and supplier
This is the contract for goods or services between the cardholder and the person from whom the cardholder purchases goods or services ("the supplier"). This contract is the same whether the cardholder pays by card or by cash.

(2) Card-issuer and supplier
The card-issuer undertakes to honour the card by paying the supplier.

(3) Card-issuer and cardholder
(a) A *debit* card is issued only by a bank. The contract between the card-issuer bank and cardholder authorises the bank to debit the cardholder's bank account with the amount of the card transaction.
(b) Charge and credit cards are different. Here the cardholder is required to make a payment to the card-issuer. A *charge* card requires the cardholder to repay the balance outstanding after a set period.[156] A *credit* card allows the cardholder extended credit.

It is necessary to distinguish between use of cards to obtain (1) cash, and (2) goods or services.

### 10.39.1 *Cards used to obtain cash*

If a debit card is used to obtain cash in the UK from a foreign bank account which is in credit,[157] and the card is used at a branch of the bank which issued the card, then there is clearly a remittance of the money. The same applies if the cash is withdrawn from a bank which is not the card-issuing bank, because the third party bank acts as the agent for the card-issuing bank.

The use of a *charge* card to obtain cash in the UK from a foreign bank account is likewise a remittance. The time of the remittance is when the sum is debited from the account, not when the card is used. The position is the same if an individual uses a *credit* card to obtain cash in the UK.

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156 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).

157 If the effect of use of the card is to put an account into debit, there is obviously no remittance on ordinary principles, though the debt remittance rule will in principle apply when the overdrawn account is repaid.

### 10.39.2 *Cards used to obtain goods or services*

Where a debit card is used to obtain goods or services in the UK, remittance condition A is satisfied. Payment of the debt to the card issuer out of income or gains satisfies remittance condition B.

### 10.39.3 *HMRC practice*

The RDR Manual provides:

> **36130 Credit Cards and Debit Cards**
> *Credit card issued in the UK*
> If a taxpayer who is chargeable on the remittance basis uses a UK credit card to pay for goods or services, either in the UK or overseas and he or she subsequently settles their credit card bill using foreign income or gains, the payment is a taxable remittance.
> The remittance does not have to be received in the UK by the taxpayer, it is sufficient that it is received by the credit card company in the UK.

This is not correct, but a remittance basis taxpayer should avoid a UK credit card in order to avoid dispute.

> *Credit card issued by an overseas bank or other financial institution*
> Where an overseas credit card is used in the UK, the cardholder is effectively authorising the credit card company to pay the bill for the goods or service in just the same way as if they had instructed the bank to make a payment directly to the person supplying the goods or services. The terms of credit card agreements may differ as to the moment of "indebtedness" between the cardholder and the credit card company. However the use of the credit card to pay for goods used or received in the UK, or services provided in the UK by, to or for the benefit of a relevant person will create a debt.
> The use of the individual's untaxed foreign income or gains to pay the credit card company in respect of the relevant debt will be a taxable remittance.
> Interest and other such charges should be apportioned accordingly between UK and non-UK goods and services. In most cases a straight proportional split of the interest against each type of expenditure will be acceptable; for example if £400 of the debt relates to UK goods which are taxed as a remittance and £600 to non-UK goods and there is an interest charge in relation to that £1,000 debt of £10, then £4 of the

interest is also a taxable remittance. However some cards may apply different rates where cash is withdrawn, or depending of date of purchase, in which case the taxpayer will need to compute the interest due on the "relevant debt" part of the payment only.

**Note 1:** This section may apply to any credit card debt which the individual satisfies using their foreign income or gains, even if they are not the cardholder.

**Note 2:** If an overseas credit card is used abroad and the account is settled direct to the card company out of overseas income, 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 foreign income used to settle the original account.

*Debit card issued by an overseas bank or other financial institution*

Payments for goods or services that are made using a debit card (for example a Visa debit card or one issued under the brand name "Cirrus") issued by an overseas financial institution are treated in exactly the same way as a cash transaction.

This means that when goods or services are purchased in the UK using a debit card a taxable remittance is made to the extent of the amount of any overseas income or gains in the bank account. Likewise any cash withdrawals from shops or ATM machines in the UK are taxable cash remittances.

Payment by cheque drawn on an overseas account or by electronic transfer of any kind are also treated in exactly the same way as cash and are potentially taxable remittances of overseas income and gains.

## 10.40 Joint accounts

The RDR Manual provides:

**33510 Joint Accounts** [July 2010]

Where a remittance basis user has an offshore bank account held jointly with another person there may be additional difficulties in identifying the nature of the monies in the account, and any transfers of monies from the account. You will need to read these pages together with the rest of RDRM35200: Mixed Funds.

*Earned Income*

Employment income and pensions are not regarded as "joint property" when received by the employee or pensioner – refer to the Independent Taxation Manual IN127+. So any foreign earnings or foreign pension income (taxed as relevant foreign income) is attributable only to the employee or pensioner to whom they "belong".

*Income from jointly held property*

S.836(2) ITA 2007 provides that where a married couple or civil partners are living together and income arises from property held in their joint names, both individuals are treated for income tax purposes as beneficially entitled to one-half of the income regardless of their actual respective beneficial entitlements, unless they make a joint declaration that it shall be otherwise under s.837 ITA 2007. Refer to the Independent Taxation Manual IN115+ for further details.

This general "equal division" rule at s.836(2) ITA 2007 does not apply in some cases (referred to in s836 ITA 2007 as "exceptions").

These are:

- Exception A - any income to which neither of the individuals is beneficially entitled
- Exception B – where the spouses/civil partners make a joint election to HMRC under the terms of s.837 ITA 2007 that one of them is beneficially entitled to the income to the exclusion of the other or they are both entitled to the income in unequal shares
- Exception C - partnership income
- Exception D - income from a UK property business
- Exception E - distributions from close companies
- Exception F – where one of the persons is beneficially entitled to the income but it is treated as being the income of someone else under any other provision of the Taxes Acts

Broadly then, unless the individuals have made a declaration otherwise, foreign income arising from jointly held property will be regarded as belonging to each individual in an equal (that is usually a 50:50) share.

Any interest arising on the jointly held offshore bank account will be split equally between the account holders.

Of course married couples or civil partners may also hold assets separately; and they can divide up joint assets so that they hold them separately for the future. In these circumstances each spouse or civil partner is then taxed on the income from the assets each holds in his or her own name, in the same way as for "earned income".

*Analysing the account*

Where an individual has a "joint account" with someone else and one or both of them chooses to be taxed on the remittance basis it is necessary to fully analyse the account (with due regard being given to the "exceptions" identified above). You will need to do this in order to apply Step 1 s.809Q(3) ITA 2007 (refer to RDRM35200: Mixed funds) which deals with transfers from mixed funds and requires you to find each of the categories of the remittance basis user's income and gains in the mixed fund. A joint account will almost certainly be a mixed fund.

Analyse the account by putting each credit to the account into separate columns, divided between each individual.

Likewise with the debits; transfers out of the account that are clearly made by or for one or other of the individuals and intended to be made out of "their" share of the income should be debited "under" their column.

"Joint" expenses, for example items such mortgage payments where the debt is held jointly, or council tax bills and so on may, if appropriate, be split equally between each individual. Alternatively, such debits may be fully appropriated to just one of the account holders if that reflects the reality of their joint financial arrangements; for example it may be that only one partner is working and contributes most of the "credits" to the account in the form of their income. In such circumstances it may be more appropriate to attribute all expenditure to that partner in so far as the overall balance of the account permits. When separating the account in this way it is important that the overall balance remains consistent. In practice you should try to take the most pragmatic approach that best reflects the reality of both individuals' situations.

*Cases where only one account holder is a remittance basis user*

Individuals who are not using the remittance basis are liable to tax on the arising basis, so they will, where appropriate, have paid UK tax in respect of their share of the income and gains that have been credited to the joint account in the tax year. Because UK tax has been (or will be) paid by that individual he or she may bring to the UK or otherwise use their share of the funds that are in the account in any way they wish without triggering an additional tax charge.

However, if at any time during the year they bring to the UK or otherwise use amounts in excess of their share of the funds in the joint account at that point in time then they will be regarded as using their partner's income or gains instead.

*Example:*

An offshore bank account was opened on 20 June. It is held jointly by A and B, who are civil partners. A is a remittance basis user in this year. The account shows:

| **Date** | **Credit (Debit)** | **Balance** | **Attributable to** |
|---|---|---|---|
| 20 June | £2,000 | £2,000 | A – foreign earnings |
| 27 June | £1,000 | £3,000 | A – relevant foreign income |
| 1 July | (£800) | £2,200 | B – cash taken out in London |
| 27 July | £90 | £2,900 | B – UK rental income |

In analysing the account you need to look at what was in the account i**mmediately before** each debit. In this case, the cash withdrawn by B in London on 1 July can only be attributed to A's income credits and, as B is relevant person RDRM33030, A will be regarded as having remitted that £800. Also refer to RDRM35230: Remittances from mixed funds.

Remember that in most cases the account holders are likely to be relevant persons in relation to each other, so even transfers from the non-remittance basis using individual may be a taxable remittance on the other partner if it is regarded as consisting of or deriving from the other partner's foreign income or gains.

*Cases where both account holders are remittance basis users*

You will still need to analyse the account in order to determine which transfers from the mixed fund are taxable remittances, and to determine which account holder is liable to pay any tax due. Again, you should try to take the most pragmatic approach that best reflects the reality of the situation.

Once the account has been split between the individual account holders, any taxable remittances (refer to RDRM33020 Meaning of remittance) of the foreign income or gains that are the property of the remittance basis user are subject to the normal "ordering" rules that apply to remittances from a "mixed fund".
The following example demonstrates the principles of analysing a joint account and then determining whether the "transfers" are a taxable remittance from a mixed fund. You will also need to refer to RDRM35230 Remittances from mixed funds.

**RDRM33515 - Remittance Basis: Identifying Remittances: Specific Topics: Joint Accounts - example** *(Erica and John)*
E and J have been married for several years, and currently live in the UK. J is domiciled within the UK. E is not domiciled in the UK. E decides to claim the remittance basis for this year.
Both E and J have employment income that is credited to the account. For most of the year E works in the UK but she also has a separate part-time employment with a foreign employer outside of the UK for part of the year.
E and J have a joint bank account in the Isle of Man. Into this account is paid both of their salaries, and some bank interest. They use the account to pay their household bills, including the mortgage on their jointly owned UK home.
*Table to show the amounts credited to the account*

| **Date** | | **Credit (Debit)** | **Balance** |
|---|---|---|---|
| | Opening Balance | | £0 |
| 30 April | UK salary (Erica) | £3,000 | £3,000 |
| 30 April | UK salary (John) | £2,000 | £5,000 |
| 30 April | Overseas salary (not subject to foreign tax) (Erica) | £2,000 | £7,000 |
| 30 April | Bank interest not taxed | £200 | £7,200 |
| 1 May | Direct debit - UK energy coy | (£200) | £7,000 |
| 5 May | Cash withdrawal (UK) | (£1,000) | £6,000 |
| 10 May | Cash withdrawal (UK) | (£1,000) | £5,000 |
| 17 May | Direct debit - mortgage | (£3,000) | £2,000 |
| 31 May | UK salary (Erica) | £3,000 | £5,000 |
| 31 May | UK salary (John) | £2,000 | £7,000 |
| 31 May | Overseas salary (not subject to foreign tax) (Erica) | £800 | £7,800 |
| 1 June | Direct debit - UK energy coy | (£200) | £7,600 |
| 5 June | Cash withdrawal (UK) | (£1,000) | £6,600 |
| 10 June | Cash withdrawal (UK) | (£800) | £5,800 |
| 17 June | Direct debit - mortgage | (£3,000) | £2,800 |

The credits and the debits account can be analysed between E and J with the following results:

| | | Erica | | John | | Overall Account Balance |
|---|---|---|---|---|---|---|
| | | Credit (Debit) | Balance | Credit (Debit) | Balance | |
| 30 April | UK salary Note 1 | £3,000 | £3,000 | | | £3,000 |
| 30 April | UK salary Note 1 | | | £2,000 | £2,000 | £5,000 |
| 30 April | Overseas salary | £2,000 | £5,000 | | | £7,000 |
| 30 April | Bank interest Note 2 | £100 | £5,100 | £100 | £2,100 | £7,200 |
| 1 May | Direct debit to UK energy coy | (£100 ) | £5,000 | (£100) | £2,000 | £7,000 |
| 5 May | Cash w/drawn (UK) Note 3 | (£1,000 ) | £4,000 | | | £6,000 |
| 10 May | Cash w/drawn (UK) Note 3 | | | (£1,000) | £1,000 | £5,000 |
| 17 May | Direct debit – mortgage Note 4 | (£2,000) | £2,000 | (£1,000) | £nil | £2,000 |
| 31May | UK salary | £3,000 | £5,000 | | | £5,000 |
| 31May | UK salary | | | £2,000 | £2,000 | £7,000 |
| 31May | Overseas salary | £800 | £5,800 | | | £7,800 |
| 1 Jun | Direct debit to UK energy supplier | (£100) | £5,700 | (£100) | £1,900 | £7,600 |
| 5 Jun | Cash w/drawn (UK) | (£1,000) | £4,700 | | | £6,600 |
| 10 Jun | Cash w/drawn (UK) | | | (£800) | £1,100 | £5,800 |
| 17 Jun | Direct debit mortgage Note 4 | (£1,900) | £2,800 | (£1,100) | Nil | £2,800 |

**Note 1:**
Earned income is attributed to the employee only
**Note 2:**
Because this is a joint account, the interest arising on it is split equally between E and J.
**Note 3:**
This money is withdrawn in the UK by J and E to meet their own personal expenditure, for example travel, meals and so on.
In this example J's "personal expenditure" can be attributed to his "income" credits into the account. If instead the withdrawals by J were regarded as coming from E's "portion" of the pot, because J is a relevant person and money has been brought into the UK by a relevant person (so Condition A of s.809L(2)(a) ITA 2007 is met (refer to RDRM33120: Condition A – money and property) there

might still be a taxable remittance, with the tax due payable by E (see below).

**Note 4:**

The mortgage payment is made to a UK bank. The mortgage is held on J and E's UK home and is a joint debt of E and J, and each contributes half of the cost. To the extent that J has money in the account it can be accepted that he has used his taxed income to pay his share of the mortgage.

Money has been brought into the UK to pay this mortgage, so Condition A of s.809L(2)(a) ITA 2007 is met (refer to RDRM33120: Condition A – money and property) and there is a "transfer" from a mixed fund.

Because this is a mixed fund s.809Q(2) ITA 2007 is in point (refer to RDRM35230: Remittances from mixed funds). So in order to determine whether this money is regarded as consisting of, or deriving from, a remittance basis users' foreign income or gains (such that there is a taxable remittance under Condition B of s.809L(2)(a) ITA 2007) it is necessary to look at the composition of the fund immediately before the "transfer".

This shows that £2,000 of the mortgage payment made on 17 May must be attributable to E's income or gains in the mixed fund. Similarly, £1,900 of the mortgage payment of 17 June is attributable to E's income in the mixed fund.

So far as E is concerned, her share of the account shows (for the purposes of calculating if and to what extent she has made a taxable remittance of her overseas income) is as follows:

*E's share of the account*

| | | **Credit (Debit)** | **Category (S809Q(4))** |
|---|---|---|---|
| 30 April | UK salary | £3,000 | Para (a) |
| 30 April | Overseas salary (not subject to foreign tax) | £2,000 | Para (b) |
| 30 April | Bank interest | £100 | Para (d) |
| 1 May | Direct Debit (energy coy ) | (£100) | |
| 10 May | Cash | (£1,000) | |
| 17 May | Direct Debit (mortgage) | (£2,000) | |
| 31 May | UK salary | £3,000 | Para (a) |
| 31 May | Overseas salary | £800 | Para (b) |
| 1 June | Direct Debit (energy) | (£100) | |
| 5 June | Cash | (£1,000) | |
| 17 June | Direct Debit (mortgage) | (£1,900) | |

Applying the rules at s809Q ITA 2007 (refer to RDRM35230: Remittances from mixed funds) to the first "transfer" to the UK, which is the payment to the energy company on 1 May. Remember the mixed fund rules require the account to be analysed before every "transfer"

| | | |
|---|---|---|
| **Step 1** – Identify the "amount of transfer" in the relevant year | | **£100** |
| Analyse mixed fund to identify the separate amounts of income, capital gains and capital present for each tax year immediately before | **Para (a)** Employment income (UK employment income) | £3,000 |
| | **Para (b)** Relevant foreign | £2,000 |

| | | |
|---|---|---|
| the date of the transfer | earnings (not subject to a foreign tax) | |
| | **Para (d)** Relevant foreign income (not subject to a foreign tax) | £100 |
| **Step 2** – Identify the earliest paragraph above for the relevant year, which has an amount of income or gain in the mixed fund | **Para (a)** | £3,000 |

**Step 3** If the amount at Step 2 is equal to or more than the amount of the transfer treat the whole of the remaining amount of the transfer as coming from that item of income or gain

> So E's transfer of £100 is treated as coming from her UK employment income; it is not thus a "taxable" remittance when brought to the UK.
> Then apply the rules at s.809Q ITA 2007 (refer to RDRM35230: Remittances from mixed funds) to the next "transfer" to the UK, which is the cash withdrawal.

*Apply the rules at s.809Q ITA 2007 to the next "transfer" to the UK, which is the case withdrawal*

**Step 1** – Identify the "amount of transfer" in the relevant year

| | | |
|---|---|---|
| | | **£1,000** |
| Analyse mixed fund to identify the separate amounts of income, capital gains and capital present for each tax year immediately before the date of the transfer | **Para (a)** Employment income (UK employment income) | £2,900 |
| | **Para (b)** Relevant foreign earnings (not subject to a foreign tax) | £2,000 |
| | **Para (d)** Relevant foreign income (not subject to a foreign tax) | £100 |
| **Step 2** – Identify the earliest paragraph above for the relevant year, which has an amount of income or gain in the mixed fund | **Para (a)** | £1,900 |

**Step 3** If the amount at Step 2 is equal to or more than the amount of the transfer (the last time step 3 was completed) treat the whole of the remaining amount of the transfer as coming from that item of income or gain

> So E's transfer of £1,000 is treated as coming from her UK employment income; it is not thus a "taxable" remittance when brought to the UK.
> Then apply the rules at s809Q ITA 2007 (refer to RDRM35230: Remittances from mixed funds) to the next "transfer" to the UK, which is the mortgage payment.

*Then apply the rules at s809Q ITA 2007 to the next "transfer" to the UK, which is the mortgage payment*

**Step 1** – Identify the "amount of transfer" in the relevant year

**£2,000**

| | | |
|---|---|---|
| Analyse mixed fund to identify the separate amounts of income, capital gains and capital present for each tax year immediately before the date of the transfer | **Para (a)** Employment income (UK employment income) | £1,900 |
| | **Para (b)** Relevant foreign earnings (not subject to a foreign tax) | £2,000 |
| | **Para (d)** Relevant foreign income (not subject to a foreign tax) | £100 |
| **Step 2** – Identify the earliest paragraph above for the relevant year, which has an amount of income or gain in the mixed fund | **Para (a)** | £1,900 |
| **Step 3** Where the amount transferred is greater than the amount identified at Step 2 the amount transferred is treated as reduced by the amount identified in Step 2. | | £2,000 - £1,900 = £100 |
| **Step 4** - Find the next paragraph/amount for that tax year. In the order of preference listed above repeat Steps 2 and 3. | | |
| **Step 2** - repeated | **Para (b)** | £100 |

**Step 3** If the amount at Step 2 is equal to or more than the amount of the transfer (the last time step 3 was completed) treat the whole of the remaining amount of the transfer as coming from that item of income or gain

£1,900 of the transfer is treated as coming from E's UK employment income; it is not thus a "taxable" remittance when brought to the UK. The remaining £100 is treated as a remittance of £100 of E's untaxed overseas earnings.

### 10.40.1 *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.
(2) Section 836 applies so that half the income is deemed to be the income of W.
(3) W is a remittance basis taxpayer.

Income of W arising before 2008/09, being merely deemed income, could not be remitted and could not be subject to tax. But income arising from 2008/09 counts as remitted if it is remitted by H, since H is a relevant person in relation to W.

## 10.41 Gift to charity by remittance basis taxpayer

A remittance basis taxpayer ("T") making a gift to charity should give
(1) money (including foreign currency) (qualifying for gift aid relief) or
(2) foreign assets (qualifying for qualifying investment donation relief).

The gift may be made out of foreign income/gains, or property derived from foreign income/gains. The property should be received by the charity outside the UK. The charity may bring the assets to the UK without a taxable remittance, provided the charity is not a relevant person in relation to T. A charitable trust will not be a relevant person (unless T has made an interest-free loan to it). A charitable company could be a relevant person if it is a close company.

The extension of gift aid relief (and in principle other charity tax reliefs) to EU charities in the F(No.1)A 2010 increases the significance of this.

## 10.42 Transitional rules

Para 81 Sch 7 FA 2008 provides:

> The other[158] amendments made by this Part of this Schedule [ie part 1 which sets out the provisions discussed in this clause] have effect for the tax year 2008-09 and subsequent tax years.

### 10.42.1 *Property remitted to UK before April 2008*

Under the pre-2008 RFI remittance basis, there was no remittance of RFI if property was remitted *in specie* (not in the form of money). This is now caught by remittance condition B.

Para 86 Sch 7 FA 2008 provides a transitional relief:

158 "Other" relates to provisions concerning employment-related securities not discussed here.

> (1) Section 809L of ITA 2007 (meaning of "remitted to the UK") has effect subject to this paragraph.
> (2) If, before 6 April 2008, property (including money) consisting of or deriving from an individual's relevant foreign income was brought to or received or used in the UK by or for the benefit of a relevant person, treat the relevant foreign income as not remitted to the UK on or after that date (if it otherwise would be regarded as so remitted).

At first sight the words "including money" seem odd, because the remittance of *money* to the UK before 2008/09 was in principle a taxable remittance. But the wording does make sense, because para 86(5) incorporates a definition of money which is artificial in that it includes assets which are not money in the normal sense. Such assets would not have been taxable on remittance before 2008 so the provision is needed to give them exemption now.[159]

Suppose:

(1) T borrowed to purchase an asset (not "money") and acquired the asset before 6 April 2008.
(2) T receives the asset in the UK after 6 April 2008.
(3) T repays the borrowing out of RFI after 6 April 2008.

The transitional relief does not apply because the purchased asset is not derived from the RFI.

FAQ Remittances (April 2008) provides:

> Is it true that assets in the UK owned by a non-domiciled individual which were purchased out of untaxed relevant foreign income will be taxed if the asset is still in the UK on 6 April 2008?
> No. Assets owned by a non-domiciled individual that were purchased using untaxed foreign income and that are already in the UK will not give rise to a tax charge as a remittance on 6 April 2008. *If the asset is sold in the UK, then a tax charge can arise under existing rules and that charge will remain.*

The italicised sentence is inaccurate. The exemption in para 86(2) continues to apply even if the asset is sold. This may reflect a change of

159 Para 86(5) provides: "money" has the same meaning as in s.809Y of ITA; see 10.30.2 ("Money"). But since the expression here is "property (including money)", the definition of money is not important.

mind since the FAQ was written as the relief was rewritten at Report Stage. The result is something of a windfall, but there it is.

The RDR manual provides:

> **31460. Property derived from relevant foreign income not treated as a remittance (1)**
>
> ***Background***
>
> The introduction of Chapter A1 Part 14 ITA 2007 has extended the meaning and scope of foreign income and gains that become taxable when remitted to the UK. In certain situations, the operation of the previous remittance rules in respect of relevant foreign income meant that it could be brought to the UK without triggering an immediate tax charge. As an example, if an asset such as a car was purchased abroad using relevant foreign income and the car was then brought into the UK, there would be no income or capital gains[160] tax charge when it is brought in. Instead the charge would only occur if/when the asset was sold or otherwise realised for cash in the UK (also refer to RDRM31250 Changes to old regime - cash only).
>
> Property consisting of, or deriving from, relevant foreign income from tax years up to and including 2007-08 may have been brought into the UK prior to 6 April 2008, and the transitional provisions deal with these situations.
>
> ***Transition***
>
> The transitional position is that the new rules contained in Section 809L do not have effect and that property brought to the UK is not treated as a remittance where:
>
> • Property, including money, was acquired either directly or indirectly using relevant foreign income RDRM31140 and was brought to, received, or used in the UK before 6 April 2008.
>
> ***Effect***
>
> Relevant foreign income brought to or used in the UK by the individual or any other relevant person before 6 April 2008 is not regarded as remitted under Section 809L after 6 April 2008 even if it is still in the UK. So in the example of the car above, even though it is still used in the UK by a relevant person on or after 6 April 2008 it will not be treated as a remittance under Section 809L.
>
> Also, the same money or property can be sent or taken outside the UK and then brought in again. It will not be regarded as a remittance when

160 There is no question of a CGT charge so the words "or capital gain" are confused and irrelevant.

> brought in a second or subsequent time.

The Manual goes on to explain why the rule is restricted to RFI:

> Note: This transitional provision applies only to relevant foreign income because the pre 6 April 2008 position for employment income and capital gains was different. These were always chargeable even if remitted in the form of property rather than cash.

It is debatable whether this correctly states the pre-2008 law, but it does not now matter.

### 10.42.2 *Property acquired before 12 March 2008*

Para 86(3) Sch 7 FA 2008 provides:

> If, before 12 March 2008, property (other than money) consisting of or deriving from an individual's relevant foreign income was acquired by a relevant person, treat the relevant foreign income as not remitted to the UK on or after 6 April 2008 (if it otherwise would be regarded as so remitted).

Para 86(2) provides relief where property (including "money") was *remitted* before 6 April 2008.

Para 86(3) provides relief where property (excluding "money") was *acquired* before 12 March 2008, regardless of the date of remittance.

The RDR Manual provides:

> **31470. Property derived from relevant foreign income not treated as a remittance (2)**
> ***Background***
> As explained at RDRM31460, in certain situations the operation of the previous remittance rules in respect of relevant foreign income RDRM31140 meant that it could be brought to the UK without triggering an immediate tax charge.
> As an example, if before 6 April 2008 an individual bought an asset such as a car abroad using his relevant foreign income and the car was then brought into the UK, there would be no income or capital gains tax charge at that time. Instead, the charge would only occur if and when the asset was sold or otherwise realised for cash in the UK (also refer to RDRM31250 Changes to old regime - cash only).

Property consisting of or deriving from relevant foreign income from tax years up to and including 2007-08 may have been brought into the UK prior to 6 April 2008, and the transitional provisions deal with these situations.

***Transition***

The transitional position is that the new rules contained in Section 809L do not have effect and that property brought to the UK will not be treated as a remittance where:

- property (other than money) was acquired either directly or indirectly by a relevant person using relevant foreign income before 12 March 2008 and is brought to or received in the UK after 5 April 2008.

The exclusion of money is important as it ensures that income arising from sources that have ceased is subject to the rule changes.[161] See Section 809Y ITA 2007 for the definition of money in these circumstances.

***Effect***

This provision is similar to that described in RDRM31460. However this provision applies only to the purchase of property abroad before 12 March 2008 using relevant foreign income, where that property remained abroad and was not brought to or used in the UK before 6 April 2008.

***Example 1*** (Heidi)

H bought a car in Germany on 15 October 2007 using her relevant foreign income. She kept the car at her German apartment until May 2009 when she decided to bring it to the UK to use here. Under the previous rules there would have been no remittance until the car was sold in the UK. Under the new rules at Section 809L the car is regarded as derived from the relevant foreign income and so, without this transitional rule, there would be a taxable remittance of that relevant foreign income in May 2009.

***Example 1A*** (Heidi)

As for example 1 but this time H decides that she needs a bigger car. In August 2009 she sells her car in Germany and brings the proceeds to the UK. The proceeds from the sale of the car derive from H's relevant foreign income and would be regarded as a taxable remittance to the UK under the new rules at Section 809L. But as H's car (the property) was acquired before 12 March 2008 the transitional rule at paragraph 86(3) applies and what would be regarded as remitted is treated as not remitted. The money from the sale of the car that H brings into the UK is not therefore a taxable remittance.

161 I am unable to follow this sentence.

> There will be no foreign chargeable gain on the disposal of the car because her private motor vehicle is not a chargeable asset.

Since the expression in 86(3) is "property (other than money) the definition of "money" is very important. Para 86(5) provides: "money" has the same meaning as in s.809Y of ITA; this provides a wide and artificial meaning of "money"; see 10.30.2 ("Money").

If para 86(3) is taken literally, it disapplies the remittance basis for all RFI held in non-"money" form before 12 March 2008! For instance, it would apply to RFI invested in shares or securities.

The possibilities are:

(1) "Property (other than money)" may be taken literally, ie any form of property other than "money" (as defined).
(2) "Property (other than money)" may be taken to refer to chattels (as the drafter of the RDR manual perhaps assumes).
(3) Since Parliament has failed to express any intention with sufficient clarity, it should be dismissed as meaningless.

None of these solutions are easy:

(1) It is not likely that solution (1) represents the actual intention of the drafter. However the FA 2008 was enacted in such a rush that it is likely that no-one carefully formulated any intention at all.
(2) One might infer from the RDR manual that HMRC intended para 86(3) to apply to RFI invested in chattels but the Manual was written much later, and there was no clear statement at the time the Act was passed, so that may be an afterthought. To read the section in that way amounts to legislation and not construction.
(3) This is the course of desperation.

It is considered that solution (1) is to be preferred.

## 10.43 Transitional loan relief

Para 90 Sch 7 FA 2008 provides a relief which I call "**transitional loan relief**". Para 90(1) provides:

> This paragraph applies if—
> (a) before 12 March 2008, money was lent to an individual outside the UK,
> (b) the loan was made for the purpose of enabling the individual to acquire an interest in residential property in the UK (and for no other

purpose), and

(c) before 6 April 2008—

(i) the money was received in the UK,

(ii) the individual used the money to acquire an interest in residential property in the UK ("the interest"), and

(iii) repayment of the debt for the money ("the debt"), or of payments made under a guarantee of that repayment ("the guarantee"),[162] was secured on the interest.

Para 90(2) provides the relief:

> Relevant foreign income of the individual used outside the UK before 6 April 2028 to pay interest on the debt is treated as not remitted to the UK.

Thus:

(1) Transitional loan relief is restricted to RFI (and does not apply if employment income or gains are used to pay the interest).

(2) The relief is restricted to loans for residential property; (it does not apply even to loans for home improvements).

(3) The relief is restricted to secured loans.

Para 90(3) Sch 7 FA 2008 restricts the relief:

> If, at any time on or after 12 March 2008—

162 Para 90(6) Sch 7 FA 2008 defines "guarantee":

"In this paragraph 'guarantee' includes an indemnity, and 'guaranteed' is to be read accordingly."

March 2009 Qs & As provides:

**Q20:** We would also welcome confirmation that the provisions in paragraph 90(1)(c)(iii) apply to a non-UK loan drawn down before 12 March 2008 where there are two (or more) guarantees in place for repayment of the debt, of which only one is secured on the UK residential property.

**A:** We can only reply in general terms to this query. The way in which this provision will apply will be determined in practice by the details of the particular loan or guarantee transactions in question. We would generally treat repayments of a debt secured on the property itself as falling within the provisions of paragraph 90 regardless of what guarantees might also exist. Likewise, any repayments made under such a guarantee will also be covered by the paragraph. However, any repayments made under a guarantee which is not secured on the UK property will not be covered.

> (a) any term upon which the loan was made, or any term of the guarantee, is varied or waived,
> (b) repayment of the debt, or of payments made under the guarantee, ceases to be secured on the interest,
> (c) repayment of any other debt is secured on the interest or is guaranteed by the guarantee, or
> (d) the interest ceases to be owned by the individual,
>
> sub-para (2) does not apply in relation to relevant foreign income used as mentioned there after that time.

I am unable to see the point of conditions (b) and (c).

Suppose:

(1) H borrowed before 2008 to purchase property.
(2) W used her RFI to pay this interest.

Transitional loan relief does not apply as W is not the individual to whom the money is lent.

The effect of the relief in some cases will be to impose a severe tax penalty on a foreign domiciliary who wishes to move house. It also makes re-financing impossible (from 12 March 2008) as the relief ceases to apply.

Para 90(4) Sch 7 FA 2008 provides:

> If—
> (a) before 12 March 2008, money was lent to the individual outside the UK ("the subsequent loan"),
> (b) the subsequent loan was made for the purpose of enabling the individual to repay—
>   (i) the loan mentioned in sub-para (1), or
>   (ii) another loan in relation to which sub-paras (2) and (3) apply (by virtue of this sub-paragraph),
>
>   and for no other purpose, and
> (c) before 6 April 2008—
>   (i) the individual used the money to repay the loan referred to in para (b)(i) or (ii), and
>   (ii) repayment of the subsequent loan, or of payments made under a guarantee of that repayment, was secured on the interest,
>
> sub-paras (2) and (3) apply in relation to the subsequent loan (and for this purpose references there to the debt or the loan are to be read as references to the subsequent loan).

### 10.43.1 *What is the loan for?*

March 2009 Qs & As provides:

> **Q19:** It would be helpful to understand more fully the meaning of the requirement in paragraph 90(1) (b) that the loan was made for the purpose of acquiring an interest in residential property "and for no other purpose" and in particular to what extent any other purpose might cause the whole loan to fall outside paragraph 90.
>
> In a situation where money is lent before 12 March 2008 from a non-UK bank to an individual (resident but not domiciled in the UK) outside the UK under a facility letter for £5 million. £4.5 million of the facility is initially drawn down and the money used by the individual to purchase a residential property in the UK. Assume for these purposes that the loan was secured on a UK residential property.
>
> Subsequently (and before 12 March 2008) a second tranche of £0.5 million was drawn down under the same loan facility, also outside the UK. The money from the second draw down was used to refurbish the residential property purchased by the first draw down.
>
> **A:** The effect of paragraph 90(1) is to provide transitional provisions for loans made for the purpose of acquiring an interest in residential property in the UK. In this scenario, there are effectively two separate loans, even though they were made under a single facility letter: it is the drawdown of the money rather than the facility letter which constitutes the lending of the money. Therefore the first £4.5m drawn-down was money lent to the individual before 12 March and used to purchase a UK residential property and for no other purpose and was secured on that interest. That being the case, the transitional conditions will apply if, and to the extent which, relevant foreign income is used to pay interest on the debt.
>
> However, because the second £0.5m tranche of money was used to refurbish the property rather than to acquire an interest in it, it is does not meet the conditions set out paragraph 90(1)(b). Therefore, any relevant foreign income which is used to pay interest on this part of the debt will be treated as a taxable remittance in the UK.

What if a loan meets the conditions in part? It appears that HMRC accept there can be an apportionment. March 2009 Qs & As provides:

> **Q21**: We would welcome guidance on the principles for calculating the interest on that part of the debt which can be paid from relevant foreign

> income of the individual outside the UK without triggering a taxable remittance (under paragraph 90(2)). We suggest a reasonable approach is to calculate the interest element based on the loan capital ratio (ie that part of the loan which meets the paragraph 90 conditions over total capital of the loan facility), and apply that ratio to the total amount of interest due.
>
> **A**: The approach you suggest is, in broad terms, one which HMRC would consider acceptable, with the obvious caveat that the actual approach in any specific case would depend entirely on the terms of the loans.

### 10.43.2 *Varying a loan*

The relief is disapplied if:

> any term upon which the loan was made, or any term of the guarantee, is varied or waived

FAQ Remittances (April 2008) states that the relief only applies so long as "no further advances are made on or after 12 March". This is not correct, but if any further advances are made care must be taken with the documentation to ensure that there is a new loan (not a variation of an existing one) and the debt is not secured on the individual's interest in the property.

December 2008 Qs & As confirms this:

> **Q21** Where a taxpayer has an existing mortgage with a non-UK institution, secured on a residential property in the UK, with interest payments made out of untaxed foreign income and that existing facility includes an open credit line, would a draw-down of funds after 12 March 2008 constitute a "further advance"? Just to clarify, no variation to the pre-12 March 2008 terms and conditions of the loan would occur, the draw-down is made under the existing facility.
>
> If such a draw-down would constitute a "further advance", can you clarify whether the payments of interest from that point being treated as remittances would comprise (a) only those (pro rated) interest payments which relate to the further sum advanced or (b) all payments of interest on the full loan sum (ie the pre-existing loan sum plus the further advanced sum)?
>
> **A** A draw down of funds after 12 March 2008 would constitute a further

advance and cannot be exempted from tax under para 90 because the monies have to have been lent before 12 March 2008. Only the interest payments in relation to the loan received before 11 March 2008 would be eligible for exemption from tax.

December 2008 Qs & As provide:

**Q29** If an individual has an offshore mortgage with a two year fixed rate, will the grandfathering provision only last until the two year fixed rate period ends?
**A** Assuming the mortgage meets the other conditions for grandfathering whether relief would continue to apply after the fixed rate period ends would depend on the exact terms of the relevant loan agreement which was entered into before 12 March 2008. If, after the two year point was reached, the existing terms of that agreement would need to be amended, or a new agreement entered into (including a side agreement to the existing loan agreement), there would be a variation of the terms of the original agreement and the grandfathering provisions would no longer apply after that time. But if the loan agreement automatically provided for the move from a fixed rate to a variable rate, that would not on the face of it result in a variation in the agreement, and if so relief would continue.

In practice in the usual case the move to a floating rate will happen automatically, and the relief will continue to apply.

10.43.3 *When is the loan made?*

December 2008 Qs & As provides:

**Q 27 Remittance basis - offshore borrowing** If a mortgage was arranged and contracts for the purchase of the relevant property were exchanged in October 2007 but completion was not until March 31 2008 and the mortgage funds were not drawn down until completion, would this be considered to be an existing mortgage as at 12 March 2008?

HMRC refuse to answer the question:

**A** The conditions for the grandfathering relief to run would only be met if the "lending" took place before 12 March 2008, providing the funds

> were received in the UK and used to acquire the interest in the property in question before 6 April 2008. The answer depends on the terms and conditions of the mortgage arrangement, which determine the point at which the funds are regarded as "lent".

The answer does not depend on the terms and conditions of the mortgage arrangement. It depends on when the money was lent which the question states was not until completion. Thus transitional loan relief is not available. This is of course extremely unfair: it may be because of the obvious unfairness that HMRC chose not to answer the question. But the same question is asked later in the Qs & As, and receives a straight answer:

> **Q** A UK non-domiciled came to the UK in July 2007. He made an offer to purchase a residential property in the UK in November 2007. The deal became unconditional in February 2008 and entry was agreed for 16 March 2008. He has an offshore mortgage and the loan offer was made prior to 12 March but of course not drawn until 16 March. Does para 90 of Schedule 7 of FA 2008 apply?
> **A** The grandfathering provisions for offshore mortgages apply only where the loan was made before 12 March 2008. This means that the money had to be in the hands of the non-domiciled individual (or for example in the Solicitor's client account) before that date.

### 10.43.4 *Joint accounts*

March 2009 Qs & As provides:

> **Q22:** We would welcome confirmation that the remittance protection in paragraph 90 applies where a husband and wife (or civil partners), both of whom are resident but not domiciled in the UK, have a joint non-UK bank account and a joint offshore mortgage. The offshore mortgage meets the conditions set out in paragraph 90 (1).
> If only one spouse (or civil partner) has relevant foreign income and that spouse makes a payment into a joint non-UK bank account using that relevant foreign income and these funds are then used to pay the interest on the offshore mortgage, then it is our understanding that such payment of interest will not constitute a remittance of any of the relevant foreign income by virtue of paragraph 90.
> **A:** We are not able to provide the confirmation you are seeking because whether there is a taxable remittance in this situation will depend on the composition of the joint account and the way in which the mixed fund

rules section 809Q apply to it. Therefore we can again only answer in general terms.
Provided the payment of relevant foreign income by one spouse or civil partner into the joint account is the only income within that account (in other words, section 809Q is not in point) which is then used to pay the interest on the mortgage which meets the conditions within paragraph 90(1), then that payment would also fall within paragraph 90.

### 10.43.5 *Meaning of residential property*

Para 90(5) Sch 7 FA 2008 provides:

> In this paragraph "residential property" has the same meaning as in Part 4 of FA 2003 (see section 116 of that Act).

So we turn to s.116 FA 2003 to find the complex definition:

> (1) In this Part "residential property" means—
> (a) a building that is used or suitable for use as a dwelling, or is in the process of being constructed or adapted for such use, and
> (b) land that is or forms part of the garden or grounds of a building within para (a) (including any building or structure on such land), or
> (c) an interest in or right over land that subsists for the benefit of a building within para (a) or of land within para (b);
> and "non-residential property" means any property that is not residential property. This is subject to the rule in subsection (7) in the case of a transaction involving six or more dwellings.
> (2) For the purposes of subsection (1) a building used for any of the following purposes is used as a dwelling—
> (a) residential accommodation for school pupils;
> (b) residential accommodation for students, other than accommodation falling with subsection (3)(b);
> (c) residential accommodation for members of the armed forces;
> (d) an institution that is the sole or main residence of at least 90% of its residents and does not fall within any of paras (a) to (f) of subsection (3).
> (3) For the purposes of subsection (1) a building used for any of the following purposes is not used as a dwelling—
> (a) a home or other institution providing residential accommodation for children;
> (b) a hall of residence for students in further or higher education;
> (c) a home or other institution providing residential accommodation with personal care for persons in need of personal care by reason of old age, disablement, past or present dependence on alcohol or drugs or past or present mental disorder;
> (d) a hospital or hospice;

(e) a prison or similar establishment;
(f) a hotel or inn or similar establishment.
(4) Where a building is used for a purpose specified in subsection (3), no account shall be taken for the purposes of subsection (1)(a) of its suitability for any other use.
(5) Where a building that is not in use is suitable for use for at least one of the purposes specified in subsection (2) and at least one of those specified in subsection (3)—
(a) if there is one such use for which it is most suitable, or if the uses for which it is most suitable are all specified in the same sub-paragraph, no account shall be taken for the purposes of subsection (1)(a) of its suitability for any other use,
(b) otherwise, the building shall be treated for those purposes as suitable for use as a dwelling.
(6) In this section "building" includes part of a building.
(7) Where six or more separate dwellings are the subject of a single transaction involving the transfer of a major interest in, or the grant of a lease over, them, then, for the purposes of this Part as it applies in relation to that transaction, those dwellings are treated as not being residential property.
(8) The Treasury may by order—
(a) amend subsections (2) and (3) so as to change or clarify the cases where use of a building is, or is not to be, use of a building as a dwelling for the purposes of subsection (1);
(b) amend or repeal subsection (7) and the reference to that subsection in subsection (1).
Any such order may contain such incidental, supplementary, consequential or transitional provision as appears to the Treasury to be necessary or expedient.

## 10.43.6 *Commentary*

No reasons were ever given for the strikingly restricted features of transitional loan relief, so one is left to speculate. If the purpose of the relief is to assist those who have taken out loans on the assumption that the law which existed from 1956 to 2008 would govern the taxation of the interest, and who may now be unable to pay the interest, each of these restrictions are irrational. I surmise that the object was specifically to bolster the residential property market by preventing forced sales by foreign domiciliaries who are made unable to repay their mortgages: if so only the restriction of relief to RFI is irrational.[163]

Why the restriction to residential property? The reason may be that loans

163 It was probably based on the erroneous belief that under the pre-2008 rules, employment income or gains used to pay interest were regarded as remitted.

to acquire let property had a benevolent treatment under the pre-2008 remittance basis: the interest could be paid out of foreign income without a remittance, but the interest was deductible against the rent for the purpose of computing the profits of the UK property business. Similar points apply to other cases where interest is deductible. But if that is the aim then it is achieved in a very rough and ready manner. Those who borrowed to buy a house and improve it are particularly unfairly treated.

Perhaps the matter was not thought out at all and the only thinking was to provide the smallest possible transitional relief consistently with appeasing the banking lobby. Of course in the absence of any reasons being provided by HMRC, all the above can only be speculation.

## 10.44 Basic remittance basis planning: avoiding mixed funds

The best way to avoid any question of a remittance basis liability is simple in concept but administratively cumbersome. It is to keep in separate accounts (or sub-accounts) funds which are charged at different rates on remittance.

The starting point is to separate clean capital and other funds. Clean capital may consist of

(1) funds held before arrival in the UK.
(2) gifts[164] and inheritance.
(3) distributions from trusts if not caught by IT and CGT anti avoidance provisions (which normally requires some care).
(2) funds subject to UK tax (UK source income and gains; for taxpayers who do not claim the remittance basis every year, this includes income and gains from a year in which a remittance basis election is not made).

If funds are large enough, may be worth separating:

(1) Income taxable at 50% on remittance ("the 50% account").
(2) Income taxable at lower rates on remittance (because of DTR).
(3) Capital including gains with DTR.
(4) Capital including gains without DTR.
(5) Clean capital ("the clean capital account").

Funds can then be remitted from accounts with a lower or nil rate of tax. Income taxable at the top rate can be used abroad or reinvested.

164 Unless the donor is a a remittance basis taxpayer making a gift to a relevant person.

The clean capital account should be a sterling account as foreign currency could give rise to chargeable gains (without relief for losses). Treasury gilts would be an alternative investment possibility as no chargeable gains arise. Interest would be paid to the 50% account.

What if the individual does not want to tie up their funds in this way? Borrowing charged on the clean capital account may be a solution.

## 10.45 New relief for investment from 2012/13

The remittance consultation paper provides:

**Types of Business**

2.23 In order to encourage investment in a broad range of businesses the Government proposes to allow tax-free remittances for investment in the following types of business. They would be classed as "qualifying businesses" for the purposes of this policy:

• Businesses carrying out trading activity: it is proposed that this will follow the generally understood definition of "trading" as developed in case law, namely that trade generally involves the exchange of goods or services with a customer for reward. Trading on a commercial basis must constitute a substantial proportion of the overall activities of the business in which the individual invests.

• Businesses undertaking the development or letting of commercial property: this is generally carried on as a commercial business but may not technically fall within the definition of trading activity. The Government recognises that non-domiciles often want to invest in commercial property and that including it will broaden the appeal of the incentive. To qualify for tax relief, development or letting of commercial property must constitute a substantial proportion of the overall activities of the business.

2.24 This broad definition extends to all sectors of the economy and caters for entrepreneurial businesses as well as more traditional ones. It would encompass many of the businesses and sectors in which non-domiciles want to invest, for example manufacturing, retail, technology and importing goods. It would also include financial services businesses where a trade is being carried out.

2.25 In keeping with the intention of drawing this policy widely whilst preventing abuse, there are only a small number of areas that the Government proposes specifically to exclude from the definition of a qualifying business. These exclusions would apply even if the business would otherwise fall under the definition contained in paragraph 2.23:

• Holding and letting residential property: the Government is concerned that including this type of activity would introduce an unacceptable risk of the scheme being used for non-commercial purposes, such as an individual using a business to acquire a residential property in which they live. However, it is not intended to exclude all types of investment in residential property. For example, investing in a business that builds and develops residential property would be permitted, provided this business fell within the definition of trading activity. It is also proposed to allow investment in certain types of residential property such as nursing homes and hospitals where a commercial trade is carried on.

• Leasing: where the leasing of tangible moveable property (such as yachts, cars, furniture, pictures) or the provision of personal services (such as nannies, cooks, chauffeurs) is a part of the activities of the business. Excluding this type of business is consistent with the objective of ensuring the incentive is not used for noncommercial purposes or direct personal benefit.

2.26 The Government does not propose to make any other specific exclusions from the definition of a qualifying business.

**Form of Business**

2.27 The Government proposes to stipulate that overseas income and gains must be invested in companies if they are to be classed as tax-free remittances.

2.28 It is concerned that extending relief on remittances to other forms of business, such as partnerships, trusts and sole traders would expose the Exchequer to an unacceptable risk of avoidance and might allow overseas funds to be used for purposes that are not clearly commercial. For example, partnerships have been prone to being used to create artificial losses that are deducted against an individual's income tax bill.

2.29 Confining the policy to companies will be simple and transparent. The Government expects that, in the vast majority of cases, non-domiciled investors will wish to invest in companies and that this will not put unnecessary or prohibitive restrictions on the incentive. Subject to the definition in paragraph 2.23 and the limited exclusions proposed in paragraph 2.25, investment could be made in companies in any sector.

2.30 The Government is considering whether the new incentive should also apply to investment in companies listed on a recognised stock exchange and companies quoted on exchange-regulated markets, such as AIM and PLUS quoted. This would allow non-domiciles to remit income or capital gains free of tax to invest directly in listed companies, including the buying and selling of existing share capital.

2.31 The inclusion of listed companies would be consistent with the aim of designing a policy that encourages a range of investment activity. It might also avoid the need for provisions to deal with situations where companies become listed or de-list during the period of investment. However, it could mean that the benefit of the incentive would be less targeted at the businesses which have the greatest difficulty raising capital. It could also risk creating administrative complexity, for example due to the potentially high volume of transactions in listed companies and the need to keep records of the numerous purchases and sales of shares.

**Channel of investment**

2.33 A variety of investment vehicles already exist that enable individuals to invest in the UK, including offshore companies and trusts. The UK has rules to ensure that such investment vehicles pay their fair share of tax.

2.34 It is common for non-domiciles to hold money in offshore trusts but the tax treatment of remittances currently deters some offshore trusts and companies from investing in the UK. For this reason, it is not proposed to limit the new tax incentive to investments made directly by the individual. There will be no restriction on individuals remitting overseas income or capital gains which are held in investment vehicles or trusts. This will allow non-domiciles to invest in UK businesses using funds held in offshore companies and trusts without attracting a tax charge on the remittance.

2.35 The Government does not intend to introduce new rules on the tax treatment of income or capital gains generated in the UK by investments made in qualifying businesses through offshore channels. The existing tax treatment will continue to apply.

**Form of investment**

2.36 The Government recognises that funding UK companies through a mixture of share and loan capital is a normal commercial structure. It is common for non-domiciles to invest through preference shares and loans, as well as ordinary shares; often this is attractive as a means of reducing the risk of the investment.

2.37 Therefore, it does not propose to impose any restriction in this area and it will be possible for overseas income and capital gains to qualify as a tax-free remittance whether invested in shares or loans.

**UK businesses**

2.38 The Government wants to ensure that non-domiciles can invest in a range of companies, including those incorporated in other countries, and believes this will broaden the positive economic impact of this incentive. Therefore, it does not propose to restrict tax relief to investment in businesses that are resident in the UK or to businesses carrying out trades wholly or mainly in the UK. Relief will be extended to overseas income and capital gains remitted to invest in non-UK resident companies that have a permanent establishment in the UK.

2.39 While this approach would allow investments to be used for trades outside the UK, nondomiciled investors can already invest in such trades without remitting income or capital gains into the UK. It is therefore likely that in the vast majority of cases, non-domiciles will use the new incentives to invest in UK trades, which they cannot currently do without incurring a tax charge.

**Companies holding shares in other companies**

2.40 The Government proposes that the new tax incentive should also apply to overseas income and capital gains remitted to invest in companies which hold shares in other companies, provided the holding company only holds shares in businesses that:

• carry out business activity as defined in paragraph 2.23 and do not carry out excluded activity described in paragraph 2.25; and
• are companies; and
• are resident in the UK or have a permanent establishment in the UK.

2.41 The Government does not propose to introduce any other restrictions on the type of holding company that can qualify or the degree of ownership the company has over its subsidiary companies. This means that companies that hold shares in other companies and are resident outside the UK would be included. It also means that private equity companies and venture capital companies could qualify even where they do not have a majority ownership stake in the invested companies.

**Size of investment**

2.42 The Government would like to attract investment in the UK from non-domiciles regardless of their level of wealth. Therefore, it does not propose to set any upper or lower limit on the amount of overseas income or capital gains that can be remitted tax-free in a tax year for commercial investment in qualifying businesses. Imposing such limits would be restrictive and create complexity.

**Connection to the qualifying business**

2.43 It is not proposed to impose any restrictions on the investor's connections to the business in which they invest. The Government recognises that an investor may wish to work for or be a director of the business and that to prohibit this would undermine the effectiveness of the policy.

2.44 Investors will also be able to draw commercial remuneration from the company in which they invest. However, there will be provisions to prevent an investor taking non-commercial payments from the business as a way of converting their investment into tax-free money used for personal, rather than commercial, purposes. These are described in more detail in paragraph 2.52.
2.45 Equally, an investor may want to invest in a family-run business for which their children or other members of close family work. Therefore, these principles will extend to individuals who are connected to the investor and it is not proposed to impose any restrictions on such individuals working for, investing in or drawing commercial remuneration from the qualifying business.

**Anti-avoidance**

2.46 It is critical to ensure that Exchequer revenue is protected and that appropriate provisions are put in place to prevent abuse of the new rules for non-commercial purposes.
2.47 In particular, the Government is concerned to prevent:

• non-domiciles investing in low-risk businesses for a limited period and then taking out the original investment tax-free to enjoy in the UK; and
• investment leaking out from companies to individuals for non-commercial purposes during the period of investment.

2.48 At the same time the Government recognises that complicated anti-avoidance provisions could deter non-domiciles from using this new incentive and believes that both these risks can be tackled by relatively straightforward provisions.
2.49 Firstly, it proposes a provision to require that overseas income or capital gains remitted for investment in a qualifying business must be taken out of the UK when the investment is disposed of. It is proposed that this must take place within two weeks of the individual receiving the money generated by the disposal of the investment. If the original investment remains in the UK for longer than this period after receipt of the money, it will be treated as a taxable remittance of the original income or capital gains used for the investment and be subject to the usual remittance basis rules. However, there will be provisions to allow individuals to reinvest the overseas income or capital gains in other qualifying businesses without the need to take themback out of the UK, provided this takes place before the end of a period of two weeks after receipt of the money generated by the disposal of the original investment.
2.50 This provision means that it would be unnecessary to impose restrictions on the length of time for which the investment must be held. It also avoids the need for complicated rules to govern how the money can be used in the UK after disposal of the investment.
2.51 It is not intended to create detailed rules to identify which particular holding of shares in or loans to a company is related to the income or capital gains used for the investment. This would be complicated to legislate and to administer. Therefore, the amount of overseas income or capital gains used to fund the qualifying investment will be identified with the first amounts of value taken out of the business which are not a permitted commercial payment until the amount of the income or gains have been matched.
2.52 Secondly, the Government proposes to introduce a provision to prevent the value of the investment leaking out to the individual either directly through payments or loans which are not arms-length or through transactions designed to pass value to the individual.

For example, it would not be permitted for the company to use the funds invested to guarantee loans made to the individual; nor would it be possible to make payments to a third party which are linked to payments made to the individual. This would not prevent an individual or a connected person enjoying commercial levels of remuneration from the company in which they invest or receiving dividends or interest out of profits made by the business after the investment has occurred.

2.53 In addition, there will be provisions to prevent non-domiciles buying a pre-existing business from themselves by selling it to a new company funded by income remitted from overseas. This would create no new business investment in the UK and would merely transfer legal ownership whilst the individual continues to own the business.

**Claiming the relief**

2.54 This policy will not require non-domiciles to invest in businesses that are approved or vetted by the Government. To do so would create onerous burdens for businesses and potential investors, as well as operational costs for Her Majesty's Revenue and Customs (HMRC). However, it is important for the Government to be able to monitor the policy, assess its effectiveness and police the new rules.

2.55 Any non-domicile who uses this business investment incentive would already be required to complete an annual SA tax return under current rules in order to claim the remittance basis. This is not a new requirement. The Government's preference is to make it mandatory for an individual who pays tax under the remittance basis and remits income or capital gains for business investment to make a claim for this new relief on their SA tax return.

2.56 The Government is conscious that it would be counter-productive to require extensive disclosure. Therefore, it proposes only to request basic information related directly to the business investment incentive. Under this approach the individual could be required to state:

• whether they had remitted income or capital gains to the UK for investment in a qualifying business;
• how much they had remitted for this purpose; and
• in what businesses they had invested.

2.57 The information would enable the Government to monitor how the funds remitted for qualifying business investment are used in the UK. The Government would not require disclosure about the source of income or capital gains remitted to the UK for the purpose of investment or the channel through which they were remitted. Additional disclosure in connection with remittances made for purposes other than business investment or other aspects of the remittance basis would not be required as part of the claim for relief.

**Interaction with the remittance basis charge**

2.58 Individuals who make tax-free remittances under the business investment scheme will still be required to pay the annual £30,000 or £50,000 charge in full if they have been resident in the UK for the relevant number of years and elect to be taxed on the remittance basis. It is not proposed to reduce or waive the remittance basis charge for these individuals. To do so would introduce significant complexity and cost to the policy. The Government considers that the proposed tax relief for business investment provides a strong investment incentive notwithstanding the possible requirement for an individual to pay the remittance basis charge.

2.59 Individuals who choose to be taxed on all their worldwide income and capital gains instead of paying the remittance basis charge will, by definition, not benefit from the business investment incentive because their overseas income or capital gains will be liable to UK tax when they arise and before they are remitted to the UK.It is astonishing that the 2008 reforms failed to include a relief of this kind, thus obstructing UK investment.[165]

Whether the proposed new relief achieves anything useful must remain to be seen, but the length of the explanation of the proposals is not an encouraging start.

165 HMT & HMRC, "Reform of the taxation of non-domiciled individuals: a consultation" (June 2011) accessible *www.hm-treasury.gov.uk/d/consult_condoc_non_domicile_individuals.pdf*.

CHAPTER ELEVEN

# MIXED FUNDS

## 11.1 Mixed funds - Introduction

It may be helpful to outline the problem which the mixed fund rules are intended to address. Suppose a person holds a fund which includes different types of income/gains, or income/gains of different years. If the person remits part of the fund, it is necessary to know which type of income or gains have been remitted (as different rates apply) and income or gains of which year have been remitted (as different rates may apply and different rules may apply to income of different years). The mixed fund rules are intended to answer these questions.

I coin the following terminology:

**"The ITA mixed fund regime"** means the set of rules set out in s.809Q to 809S ITA.

**"The pre-2008 mixed fund regime"** means the case law rules applicable before 2008/09.

## 11.2 Definition of "mixed fund"

Section 809Q(6) ITA provides:

> In this section "mixed fund" means money or other property which, immediately before the transfer, contains or derives from—
> (a) more than one of the kinds of income and capital mentioned in subsection (4), or
> (b) income or capital for more than one tax year.

This is only a section-wide definition so the drafter has to repeat it in the next section where the expression "mixed fund" is used again.

One must first identify what is the fund, and then identify the constituents which it contains (or derives from).

### 11.2.1 *Identifying the fund*

Funds are distinct, ie, not mixed, if they are held in separate accounts or sub-accounts at one bank (even though a bank in principle owes only a single debt to its customer). HMRC agree. The RDR Manual provides:

> **35230 Remittances from mixed funds**
> *No Mixed Fund*
> Also, a mixed fund does not exist just because the individual has several accounts with the same banking institution, if each account is separately constituted and contains only one of the relevant types of income *from only one year*. This will usually include bank accounts set up as sub-accounts under an "umbrella" agreement.
> If income and capital sources from a tax year are maintained separately (sometimes referred to as "kept clean" or "clean capital") no mixed fund is created, and so these rules will not apply.

The manual then gives a straightforward example.[1]

Accordingly one can in principle avoid mixing income with other funds by arranging that the income is paid to a separate bank account. If one does that it will be possible to remit capital and to keep income unremitted.

The RDR Manual provides:

> **33560. Banking Issues** [July 2010]
> *Interest credits to a capital account*
> Often interest on a maturing deposit is credited to the same account comprising the principal capital investment, but under the bank's normal internal system the interest is then immediately and identifiably transferred to an income account.

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1 "For example, an individual maintains three separate accounts with the same offshore institution:
Account A into which he pays his relevant foreign earnings for the tax year
Account B into which he pays some inherited money (clean capital)
Account C into which he pays some relevant foreign income for the tax year
As long as these accounts do not become mixed funds, the individual can bring money into the UK from Account B and that will be accepted as a being a transfer of "clean" capital, and so will not be a taxable remittance."

> Where a mixed fund such as this is created fleetingly by an operation of the banking system, HMRC will accept that the interest credit will not taint the principal and so the mixed fund rules in s809Q to s809S do not apply.

At first sight this practice may seem concessionary. However, it is a sensible commercial construction of the statute to say that a sum only "fleetingly" in an account should not to be said to become "mixed".

The position is different for capital gains. A capital gain has no separate identifiable existence so the proceeds of a disposal giving rise to a gain are always a mixed fund.[2] For accrued income profits see 33.9 (AIP remittance basis).

## 11.3 Ingredients of a mixed fund

We turn to s.809Q(4) ITA to see what kinds of income and capital may make up a mixed fund:

> The kinds of income and capital are—
> (a) employment income (other than income within para (b), (c) or (f)),
> (b) relevant foreign earnings (other than income within para (f)),
> (c) foreign specific employment income (other than income within para (f)),
> (d) relevant foreign income (other than income within para (g)),
> (e) foreign chargeable gains (other than chargeable gains within para (h)),[3]
> (f) employment income subject to a foreign tax,
> (g) relevant foreign income subject to a foreign tax,
> (h) foreign chargeable gains subject to a foreign tax, and
> (i) income or capital not within another paragraph of this subsection.

I refer to these nine categories as "**the mixed fund categories**". The order in which these categories is placed is important: I call this "**the mixed fund priority order**".

An individual needs to classify every mixed fund into these nine

2 See 10.13.2 (What is the gain?)

3 This applies even in the case of an individual who is resident, not ordinarily resident and UK domiciled, who qualifies for the remittance basis for income but not for gains.

categories for 2008/09 and for every subsequent year. This requires vastly more record keeping than the pre-2008 mixed fund regime.

Income which accrues to an individual when they are non-resident is not RFI[4] (even foreign interest, dividends, etc which would be RFI if received by a UK resident). Similarly, earnings received by a non-resident are not employment income.[5] Such income falls into the bottom category (i). But all income of the year of arrival and departure constitutes RFI or employment income, even if ESC A11 applies.

Chargeable gains from non-UK assets which accrue to an individual when they are non-resident *are* foreign chargeable gains.[6] Such gains will fall within category (e) or (h) depending on whether they are subject to a foreign tax.

What if an individual receives foreign income or gains which are taxable, either because they are remitted to the UK or because no remittance basis claim is made in that year? The sums do not cease to be foreign income or gains, so they remain in their relevant categories (a) to (h).

### 11.3.1 *"Foreign tax"*

I refer to income/gains which are subject to a foreign tax as **"foreign-taxed"**. This affects the mixed fund categories in the following way:

| | **Not foreign-taxed** | **Foreign-taxed** |
|---|---|---|
| **RFE** | para (b) | para (f) |
| **FSEI** | para (c) | para (f) |
| **RFI** | para (d) | para (g) |
| **Gains** | para (e) | para (h) |

The object is to increase UK tax by deferring the remittance of items subject to a foreign tax, so deferring foreign tax credits. This (surely unfair) policy comes at a considerable cost in complexity, since it roughly doubles the number of mixed fund categories and the record keeping.

Section 809Q(5) ITA defines "foreign tax":

4 Because it does not meet the condition in s.830(1)(b) ITTOIA; see 9.3.1 (Relevant foreign income).

5 Unless within s.27 ITEPA (duties performed in UK or overseas Crown employment).

6 See 43.1 (Territorial scope of CGT) and 9.3.4 (Foreign chargeable gains).

> In subsection (4) "foreign tax" means any tax chargeable under the law of a territory outside the UK.

At first I thought that tax deducted under the EU Saving Directive is not "foreign tax". The EU is not a territory outside the UK. But if tax is deducted in, say, Luxembourg, perhaps the better view is that the tax is chargeable under the law of *Luxembourg* so the tax is a foreign tax. The position may depend on whether or not the EU directive has direct effect in the MS concerned.

### 11.3.2 *"Subject to a foreign tax"*

The RDR Manual provides:

> **35240 Remittances from mixed funds - Identifying nature of remittance**
> ...
> Occasionally UK resident remittance basis users' UK employment income may be "subject to foreign tax", that is to say another country (usually their country of nationality or citizenship) will also tax them on this income. In these cases HMRC will accept that the individual's UK source employment income may still be regarded as within para (a) in the mixed fund, unless the individual requests otherwise, in which case it will remain to fall within para (f) as employment income subject to a foreign tax.

This is obviously an extra-statutory concession.

> This is only relevant where the other country has in fact subjected the UK employment income under consideration to their tax. In some cases no tax will, in fact, have been due in or paid to the other country due to various exemptions and provisions, (for example the US has a "foreign earned income exclusion" provision to employment income below a certain level), so the UK employment income will be within para (a) anyway.

This is not correct as it is not consistent with the approach applied elsewhere in deciding what is "subject to tax": see 50.22 ("Subject to tax"). But it will normally suit taxpayers to treat UK earnings as category (a) so it will not be contested.

Section 809Q(8) ITA provides:

> References in this section and section 809R to anything deriving from income or capital within para (i) of subsection (4) do not include—
> (a) income or gains within any of paras (a) to (h) of that subsection, or
> (b) anything deriving from such income or gains.

### 11.3.3 *Finding the income and capital for the year*

Step 1 in s.809Q(3) ITA provides:

> For each of the categories of income and capital in paragraphs (a) to (i) of subsection (4), find (applying section 809R) the amount of income or capital of the individual for the relevant tax year in the mixed fund immediately before the transfer.

Income for any year is not difficult to identify, for the tax system often requires one to attribute income to a tax year. Chargeable gains for any year are not difficult to identify, for they accrue on a particular date. What about "other capital" falling within category (i)? That would include:
(1) gifts, inheritance;
(2) borrowed money;
(3) chargeable event gains on a surrender of a life policy.
It is considered these must be capital for the year in which it is received. If an asset is sold, the HMRC examples assume that the capital is received at the date of disposal; see eg the example of Martyn (below).

Suppose:
Year 1: T uses RFI to purchase a policy for £1m.
Year 5: T surrenders the policy for £2m and realises a chargeable event gain of £1m (taxable on the arising basis). T remits £1m.

The £1m remitted is category (i) "other capital" of year 5, so there is no further charge on the remittance.

### 11.3.4 *Derived property*

Section 809R ITA provides:

> **809R Section 809Q: composition of mixed fund**
> (1) This section applies for the purposes of step 1 of section 809Q(3)

> (composition of mixed fund).
> (2) Treat property which derives wholly or in part (and directly or indirectly) from an individual's income or capital for a tax year as consisting of or containing that income or capital.

That seems self evident.

### 11.3.5 *Income/gains used to repay debt*

Section 809R(3) ITA provides:

> If a debt relating (wholly or in part, and directly or indirectly) to property is at any time satisfied (wholly or in part) by—
> (a) an individual's income or capital for a tax year, or
> (b) anything deriving (directly or indirectly) from such income or capital,
> from that time treat the property as consisting of or containing the income or capital if and to the extent that it is just and reasonable to do so.

Suppose:
(1) T borrows from L and receives "the borrowed money".
(2) T uses RFI to repay the debt to L.
In the absence of a statutory deeming provision, one would not say that the borrowed money was derived from the RFI, or that the borrowed money consists of or contains the RFI.[7] However the borrowed money is treated as containing or consisting of the RFI so far as is just and reasonable. When is that just and reasonable? The drafter has given up here. Perhaps only so far as it practical to make that tracing exercise.

## 11.4 Onshore transfer mixed fund rule - Introduction

### 11.4.1 *Scope of onshore transfer rule*

Section 809Q ITA provides:

> (1) This section applies for the purposes mentioned in subsection (2) ...

7 See 10.14.10 (Income/gains used to pay debt).

> (2) The purposes referred to in subsection (1) are—
> (a) determining whether condition B in section 809L is met, and
> (b) if it is met, determining (under section 809P) the amount of income or chargeable gains remitted.

Accordingly, the onshore transfer mixed fund rule does not apply for the purposes of remittance basis conditions C or D. This was presumably because those conditions do not always require the use of foreign income/gains or property derived from it. Fortunately conditions C and D will not often apply. So in practice the mixed fund rule applies for most remittance purposes. When conditions C and D are in point, one applies the pre-2008 mixed fund regime.

### 11.4.2 *Onshore transfer*

Section 809Q(1) ITA provides:

> This section applies ... where condition A in section 809L is met[8] and—
> (a) the property or consideration for the service is (wholly or in part), or derives (wholly or in part, and directly or indirectly) from, a transfer from a mixed fund, ...

The drafter has confused a transfer and the property transferred by a transfer, but the meaning is clear enough. Expanding this, it should be read to mean:

> This section applies ... where condition A in section 809L is met and—
> (a) [i] the property or consideration for the service is (wholly or in part) ... [property transferred by] a transfer from a mixed fund, or
> [ii] the property or consideration for the service ... derives (wholly or in part, and directly or indirectly) from [property transferred by] a transfer from a mixed fund...

The next part of s.809Q(1) deals with debt remittances:

> This section applies ... where condition A in section 809L is met and—
> (b) a transfer from a mixed fund, or anything deriving (wholly or in

8 See 10.11 (Remittance condition A (link to UK)).

> part, and directly or indirectly) from such a transfer, is used as mentioned in section 809L(3)(c).

I refer to a transfer to which s.809Q applies as an **"onshore transfer"**. In short, there is an onshore transfer in six cases:

(1) A relevant person receives UK property which:
 (a) is from a mixed fund or
 (b) is derived from a mixed fund
(2) A relevant person receives a UK service, consideration for which:
 (a) is from a mixed fund or
 (b) is derived from a mixed fund
(3) A relevant debt:
 (a) is satisfied out of a mixed fund or
 (b) is satisfied out of a fund derived from a mixed fund.

### 11.4.3 *Transfer*

Transfer is not defined but the context shows that it means any payment out of the mixed fund, whether or not for consideration.

Section 809Q(7) ITA defines the amount of a transfer:

> References in this section to the amount of the transfer include the market value of it.

Strictly one must value the asset transferred, not the transfer, but the meaning is clear.

## 11.5 Onshore transfer mixed fund rule

We can turn at last to the rule itself. Section 809Q(3) ITA provides:

> The extent to which the transfer is of the individual's income or chargeable gains is to be determined as follows.

Section 809Q(3) ITA then sets out five steps. It is easier to follow the steps if one has an example in mind. Suppose T (a remittance basis taxpayer) receives £100 per annum of each of the mixed fund categories and pays them into one mixed fund:

| Category | Type of income | Year 1 | Year 2 |
|---|---|---|---|
| Para (a) | UK earnings | £100 | £100 |
| Para (b) | relevant foreign earnings | £100 | £100 |
| Para (c) | FSEI | £100 | £100 |
| Para (d) | relevant foreign income | £100 | £100 |
| Para (e) | foreign chargeable gains | £100 | £100 |
| Para (f) | foreign-taxed earnings | £100 | £100 |
| Para (g) | foreign-taxed RFI | £100 | £100 |
| Para (h) | foreign-taxed gains | £100 | £100 |
| Para (i) | other income and capital | £100 | £100 |

There is therefore a mixed fund of £1800. Suppose T remits nothing in year 1 and £1,000 to the UK in year 2. This is an onshore transfer. One follows the steps thus:

> *Step 1*
> *For each of the categories of income and capital in paras (a) to (i) of subsection (4), find (applying section 809R) the amount of income or capital of the individual for the relevant tax year in the mixed fund immediately before the transfer.*
> *"The relevant tax year" is the tax year in which the transfer occurs.*

In the example, the relevant tax year is year 2. I consider this further below but for present purposes assume that "the amount of income or capital of the individual in the mixed fund immediately before the transfer" is as set out in the table above.

> *Step 2*
> *Find the earliest paragraph for which the amount determined under step 1 is not nil.*

The earliest paragraph is para (a) and the amount determined under step 1 is £100.

> *If that amount does not exceed the amount of the transfer, treat the transfer as containing the income or capital within that paragraph (and for that tax year).*

T's transfer is treated as containing £100 employment income category (a) for year 2.

*Otherwise, treat the transfer as containing the relevant proportion of each kind of income or capital within that paragraph (and for that tax year).*
*"The relevant proportion" is the amount of the transfer divided by the amount determined under step 1 for that paragraph.*

(Had the transfer been (say) £50 then the relevant proportion would have been £50 ÷ £100 = 50% so the transfer would have been treated as containing £50 employment income category (a) for year 2.)

*Step 3*
*Treat the amount of the transfer as reduced by the amount taken into account under step 2.*

The amount of the transfer is reduced to £900.

*Step 4*
*If the amount of the transfer (as reduced under step 3) is not nil, start again at step 2.*
*In step 2, read the reference to the earliest paragraph of the kind mentioned there as a reference to the earliest such paragraph which has not previously been taken into account under that step in relation to the transfer.*

Following this iterative process a total of nine times, the transfer is treated as containing:

| | | |
|---|---|---|
| (a) | employment income | £100 |
| (b) | relevant foreign earnings | £100 |
| (c) | foreign specific employment income | £100 |
| (d) | relevant foreign income | £100 |
| (e) | foreign chargeable gains | £100 |
| (f) | foreign-taxed employment income | £100 |
| (g) | foreign-taxed RFI | £100 |
| (h) | foreign-taxed gains | £100 |
| (i) | other income and capital | £100 |
| | **Total** | **£900** |

The amount of the original £1,000 transfer is by this stage treated as reduced to £100. We move to the next step:

*Step 5*
*If the amount of the transfer (as reduced under step 3) is not nil once steps 2 and 3 have been undertaken in relation to all paragraphs of subsection (4) for which the amount determined under step 1 is not nil, start again at step 1.*
*In step 1, read the reference to the relevant tax year as a reference to the tax year immediately before the last tax year for which step 1 has been undertaken in relation to the transfer.*

Thus we repeat step 2 a last and tenth time, reading "the relevant tax year" to mean year 1. So the transfer of £1,000 from the mixed fund is treated as being:

| Category | Type of income | Year | Amount |
|---|---|---|---|
| Para (a) | UK earnings | 2 | £100 |
| Para (b) | relevant foreign earnings | 2 | £100 |
| Para (c) | FSEI | 2 | £100 |
| Para (d) | relevant foreign income | 2 | £100 |
| Para (e) | foreign chargeable gains | 2 | £100 |
| Para (f) | foreign-taxed earnings | 2 | £100 |
| Para (g) | foreign-taxed RFI | 2 | £100 |
| Para (h) | foreign-taxed gains | 2 | £100 |
| Para (i) | other income and capital | 1 | £100 |

In order to reach this answer for one single transfer we have had to carry out 37 steps.[9] Yet it will be common for there to be hundreds or thousands of transfers from any mixed fund.

### 11.5.1 *Commentary: drafting style*

The effect of the onshore transfer mixed fund rule is that transfers from a mixed fund are treated as being made in the mixed fund priority order, taking more recent years before earlier years. Why didn't the statute simply say so? For a discussion of the drafting style, see 45.10.7 (Commentary: step-based drafting). But the fundamental problem is not the drafting, but conception of the mixed fund rule.

9 Steps 1–4 were each carried out 9 times and step 5 once.

### 11.5.2 HMRC examples: mixed funds

The RDR Manual provides examples. I set them out more or less verbatim but rearrange and omit some irrelevant detail for clarity.

### 11.5.3 *One transfer from mixed fund: RFE, RFI and UK EI of one year*

The first example involves a single onshore transfer out of a mixed fund containing RFE, RFI and UK employment income of one year.

> **RDRM 35280**
> **Example 1 (Amelia)**
> A, a remittance basis user, has an offshore account with mixed funds as follows:
> - foreign earnings from two employers totalling £40,000 per month, half of which is subject to foreign tax [mixed fund categories (b) and (f)]
> - relevant foreign income of £10,000 per quarter, which is not subject to foreign tax [mixed fund category (d).
> - some of her UK employment income (£50,000 per month) which has already been subject to tax in the UK is paid into the same offshore bank account [mixed fund category (a)]
> On 15 October 2010 A purchases an aircraft for £460,000, which she brings to the UK.

Since the account was opened in the tax year, we have an account with 20 credits and one debit (an onshore transfer) thus:

| **2009-10** | | **Credit (Debit)** | **Balance** | **Category S809Q(4)** |
|---|---|---|---|---|
| 30 April | UK salary | £50,000 | £50,000 | Para (a) |
| 30 April | Overseas salary NFT[10] | £20,000 | £70,000 | Para (b) |
| 30 April | Overseas salary FT[11] | £20,000 | £90,000 | Para (f) |
| 31 May | UK salary | £50,000 | £140,000 | Para (a) |
| 31 May | Overseas salary NFT | £20,000 | £160,000 | Para (b) |
| 31 May | Overseas salary FT | £20,000 | £180,000 | Para (f) |
| 2 June | RFI | £10,000 | £190,000 | Para (d) |
| 30 June | UK salary | £50,000 | £240,000 | Para (a) |
| 30 June | Overseas salary NFT | £20,000 | £260,000 | Para (b) |
| 30 June | Overseas salary FT | £20,000 | £280,000 | Para (f) |
| 31 July | UK salary | £50,000 | £330,000 | Para (a) |
| 31 July | Overseas salary NFT | £20,000 | £350,000 | Para (b) |
| 31 July | Overseas salary FT | £20,000 | £370,000 | Para (f) |

10 Not foreign-taxed.

11 Foreign-taxed.

| | | | | |
|---|---|---|---|---|
| 31 Aug | UK salary | £50,000 | £420,000 | Para (a) |
| 31 Aug | Overseas salary NFT | £20,000 | £440,000 | Para (b) |
| 31 Aug | Overseas salary FT | £20,000 | £460,000 | Para (f) |
| 2 Sept | RFI | £10,000 | £470,000 | Para (d) |
| 30 Sept | UK salary | £50,000 | £520,000 | Para (a) |
| 30 Sept | Overseas salary FT | £20,000 | £540,000 | Para (f) |
| 30 Sept | Overseas salary NFT | £20,000 | £560,000 | Para (b) |
| 15 Oct | Aircraft purchase | (£460,000) | £100,000 | |

| | |
|---|---|
| **Step 1** Identify the "amount of transfer" in the relevant year (2010-11) | £460,000 |
| Analyse mixed fund to identify the separate amounts of income, capital gains and capital present for each tax year immediately before the date of the transfer: | |
| Para (a) UK employment income | £300,000 |
| Para (b) Relevant foreign earnings (not subject to a foreign tax) | £120,000 |
| Para (d) RFI (not subject to a foreign tax) | £20,000 |
| Para (f) Employment income subject to a foreign tax | £120,000 |
| **Step 2** Identify the earliest paragraph above for the relevant year, which has an amount of income or gain in the mixed fund: Para (a) | £300,000 |
| **Step 3** Where the amount transferred is greater than the amount identified at Step 2 the amount transferred is treated as reduced by the amount identified in Step 2. | £460k less £300k = <u>£160,000</u> |
| **Step 4** Find the next paragraph/amount for that tax year. In the order of preference listed above repeat Steps 2 and 3. | |
| **Step 2** repeated: Para (b) | £120,000 |
| **Step 3** repeated Amount transferred further reduced to: | £40,000 |
| **Step 4** In the order of preference listed above repeat Steps 2 and 3. | |
| **Step 2** repeated: Para (d) | £20,000 |
| **Step 3** repeated Amount transferred further reduced to: | £20,000 |
| **Step 4** In the order of preference listed above repeat Steps 2 & 3. | |
| **Step 2** Para (f) | £120,000 |
| **Step 3** If the amount at Step 2 is equal to or more than the remaining amount of the transfer (the last time step 3 was completed) treat the whole of the remaining amount of the transfer as coming from that item of income or gain | £nil |

There has been a transfer to the UK of £460,000. Of this, £300,000 is from UK employment income which has already been taxed, so will not be taxed again. There have also been taxable remittances of A's relevant foreign earnings (£140,000 (£20,000 of which was subject to a foreign tax) and relevant foreign income (£20,000)).
£100,000 of taxed foreign employment income (para f) remains in the offshore account fund.

*Moral:* A should have kept her taxed foreign earnings separate so that they could be remitted. The tax on that remittance would be less because the foreign tax credit would be available. If A had kept all the sources of income separately, she would also have been saved the significant administrative costs of the computation.

### 11.5.4 *Single transfer: mixed fund RFI of earlier years and gain of later year*

The next example is a single onshore transfer from a mixed fund with RFI of earlier years and a chargeable gain of a later year.

**RDRM 35290**
**Example 2** (Jason)
In Year 1 J purchases shares in a foreign company for £8m. The £8m represents J's 'clean' capital, being perhaps an inheritance or similar such windfall.
In Year 3 J later sells the shares for £10m, which produces a £2m chargeable gain. The sale proceeds are credited in Year 3 to his overseas bank account that contains some relevant foreign income from the last two tax years, but no other monies.
There is now a mixed fund, containing capital from Year 1, and a foreign chargeable gain from Year 3 and some relevant foreign income from Years 2 and 3.
Later in Year 3 J, a remittance basis user, brings £5m to the UK from that account. The ordering rules in ITA07/s809Q mean that all of the relevant foreign income and the £2m gain from Year 3 is treated as remitted before any of the capital can be considered as remitted.
If the mixed fund also included other amounts of income or capital gains for that tax year (Year 2 or 3), those amounts must also be taken into account before any of the 'capital' element of the proceeds, (that is the £8m that is not a gain) realised by the sale of shares can be considered.

## 11.5.5 *Example: transfers from mixed fund accruing over 2 years*

The next example involves a single onshore transfer out of a mixed fund of RFE, RFI and UK earnings and chargeable gains, accruing over a two year period.

**RDRM 35300, 35310**
**Example 3** (Jeff)
J has:
- UK salary of £10,000 a month paid into an overseas bank account [mixed fund category (a)]
- a salary for overseas employment and his net salary for that work of £5,000 a month is paid into the same bank account. Both salaries are paid on the last day of each month [mixed fund category (f)]
- Dividends from a shareholding in a foreign company are also paid into the account [assumed subject to a foreign tax - mixed fund category (g)]

In Year 0, J had purchased shares in a foreign company for £8m. The £8m is accepted as representing J's "clean" capital, an inheritance. J sells the shares in Year 2 for £10m, which produces a £2m chargeable gain [mixed fund category (e) and (i)].

J's remittances to the UK from this fund in that year are £10m.

His UK salary is credited net of PAYE and NIC. His overseas salary is subject to a foreign tax deducted at source, and is credited net. His overseas dividends are credited gross.

| | | **Credit (Debit)** | **Balance** | **Category** |
|---|---|---|---|---|
| **Year 1** | | | £nil | |
| 31 March | UK salary (net of tax) | £10,000 | £10,000 | Para (a) |
| 31 March | Overseas salary FT | £5,000 | £15,000 | Para (f) |
| **Year 2** | | | | |
| 30 Apr | UK salary | £10,000 | £25,000 | Para (a) |
| 30 Apr | Overseas salary | £5,000 | £30,000 | Para (f) |
| 15 May | Dividend | £2,000 | £32,000 | Para (g) |
| 15 May | UK salary | £10,000 | £42,000 | Para (a) |
| 31 May | Overseas salary | £5,000 | £47,000 | Para (f) |
| 18 June | Sale of shares (£8m capital and £2m gain) | £2,000,000 | | Para (e) |
| | (no foreign tax) | £8,000,000 | £10,047,000 | Para (i) |
| 30 Jun | UK salary | £10,000 | £10,057,000 | Para (a) |
| 30 Jun | Overseas salary | £5,000 | £10,062,000 | Para (f) |
| 25 Jul | Dividend | £2,000 | £10,064,000 | Para (g) |
| 31 Jul | UK salary | £10,000 | £10,074,000 | Para (a) |
| 31 Jul | Overseas salary | £5,000 | £10,079,000 | Para (f) |
| 31 Jul | Bank interest | £5,000 | £10,084,000 | Para (d) |
| 14 Aug | Transfer to UK account | (£10,000,000) | £84,000 | |
| 31 Aug | UK salary | £10,000 | £94,000 | Para (a) |
| 31 Aug | Overseas salary | £5,000 | £99,000 | Para (f) |

Applying the ordering rules in S809Q to the account immediately before the transfer:

**Step 1** Identify the "amount of transfer" in the relevant tax year (Year 2) — £10,000,000

Analyse mixed fund to identify the separate amounts of income, capital gains and capital present for each tax year immediately before the date of the transfer:

| | |
|---|---|
| **Para (a)** Employment income (including UK employment income) not subject to a foreign tax | Year 1 – £10,000<br>Year 2 – £40,000 |
| **Para (d)** Relevant foreign income (not subject to a foreign tax) | Bank interest<br>Year 2 - £5,000 |
| **Para (e)** Foreign chargeable gains (not subject to a foreign tax) | Year 2 - £2,000,000 |

| | |
|---|---|
| **Para (f)** Employment income subject to a foreign tax | Year 1 - £5,000<br>Year 2 - £20,000 |
| **Para (g)** Relevant foreign income subject to a foreign tax | Foreign dividends<br>Year 2 - £4,000 |
| **Step 2** Identify the earliest paragraph above for the relevant year, which has an amount of income or gain in the mixed fund: | |
| **Para (a)** | £40,000 |
| **Step 3** Where the amount of the remittance is greater than the amount identified at Step 2 the amount remitted is treated as reduced by the amount identified in Step 2. | £10m less £40k = <u>£9,950,000</u> |
| **Step 4** Find the next paragraph/amount for that tax year. In the order of preference listed above repeat Steps 2 and 3. | |
| **Step 2** **Para (d)** | £5,000 |
| **Step 3** | £9,955,000 |
| **Step 4** In the order of preference listed above repeat Steps 2 and 3 | |
| **Step 2** **Para (e)** | £2m |
| **Step 3** | £7,955,000 |
| **Step 4** In the order of preference listed above repeat Steps 2 and 3 | |
| **Step 2** **Para (f)** | £20,000 |
| **Step 3** | £7,935,000 |
| **Step 4** In the order of preference listed above repeat Steps 2 and 3 | |
| **Step 2** **Para (g)** | £4,000 |
| **Step 3** | £7,931,000 |
| **Step 4** In the order of preference listed above repeat Steps 2 and 3 | |
| **Step 2** If the amount is more than the [residual] "relevant amount", treat the whole of the remittance as coming from that item of income or gain. **Para (i)** | £8m |

The result of this exercise is that

- All of J's UK salary in tax year 2 is deemed to have been brought to the UK first.
- Similarly all of his foreign income and gains of tax year 2 are treated as remitted to the UK and chargeable to tax at the appropriate rates of tax – allowing credit for foreign taxes charged on that same income as appropriate.
- £7,931,000 capital has also been brought to the UK.

Until such time as further amounts of income and gains are credited to the overseas account, the mixed fund contains £69,000 of capital (from the sale of shares) together with £15,000 income of the previous tax year (Year 1).

The next part of the example has two more transfers from the mixed fund.

**Remittances from mixed funds – identifying nature of remittance – Example 3a (continuation)**

Immediately after the £10m transfer in Year 2 (see example 3) J's mixed fund contains £69,000 of capital (from the sale of shares) and £5,000 overseas employment income of the previous tax year (Year 1).

For the rest of Year 2, J continues to have his UK salary of £10,000 a month and his relevant foreign earnings of £5,000 a month paid into that same account. Both salaries are paid on the last day of each month. There are no further credits or debits from the account in Year 2.

J also writes two cheques to pay bills. These amounts are identified as being 15 October to buy a car and 3 February to pay for building work on his UK property. The final debit on the account (£100,000) is for the purchase of shares in a UK company. All three of these amounts are remittances from a mixed fund to which the rules in s809Q apply.

His UK salary is credited net of PAYE and NIC. His overseas salary is subject to a foreign tax deducted at source, and is credited net. His overseas dividends are also credited to the account net of overseas withholding taxes.

| | | Credit (Debit) | Balance | Category |
|---|---|---|---|---|
| **Year 2** | Balance b/f | | £99,000 | |
| 30 Sept | UK salary (net of tax) | £10,000 | £109,000 | Para (a) |
| 30 Sept | Overseas salary (net of tax) | £5,000 | £114,000 | Para (f) |
| 31 Oct | UK salary | £10,000 | £124,000 | Para (a) |
| 31 Oct | Overseas salary | £5,000 | £129,000 | Para (f) |
| 30 Nov | UK salary | £10,000 | £139,000 | Para (a) |
| 30 Nov | Overseas salary | £5,000 | £144,000 | Para (f) |
| 31 Dec | UK salary | £10,000 | £154,000 | Para (a) |
| 31 Dec | Overseas salary | £5,000 | £159,000 | Para (f) |
| 31 Jan | UK salary | £10,000 | £169,000 | Para (a) |
| 31 Jan | Overseas salary | £5,000 | £174,000 | Para (f) |
| 28 Feb | UK salary | £10,000 | £184,000 | Para (a) |
| 28 Feb | Overseas salary | £5,000 | £189,000 | Para (f) |
| 31 Mar | UK salary | £10,000 | £199,000 | Para (a) |
| 31 Mar | Overseas salary | £5,000 | £204,000 | Para (f) |
| **Year 3** | | | | |
| 30 April | UK salary | £10,000 | £214,000 | Para (a) |
| 30 April | Overseas salary | £5,000 | £219,000 | Para (f) |
| 15 May | Dividend | £2,000 | £221,000 | Para (g) |
| 31 May | UK salary | £10,000 | £231,000 | Para (a) |
| 31 May | Overseas salary | £5,000 | £236,000 | Para (f) |
| 30 June | UK salary | £10,000 | £246,000 | Para (a) |
| 30 June | Overseas salary | £5,000 | £251,000 | Para (f) |
| 30 June | purchase UK shares | (£150,000) | £101,000 | |
| 3 July | Transfer to UK | (£5,000) | £96,000 | |

**Note 1**

The direct debit on 30 June (£150,000) is a remittance from a mixed fund. Applying the ordering rules in S809Q to the account immediately before the transfer:

Step 1 Identify the "amount of transfer" in the relevant tax year (Year 3) **£150,000**

Analyse mixed fund to identify the separate amounts of income, capital gains and capital present for the relevant tax year (Year 3) immediately before the date of the transfer:

| | |
|---|---|
| **Para (a)** Employment income (including UK employment income) not subject to a foreign tax | £30,000 |
| **Para (f)** Employment income subject to a foreign tax | £15,000 |
| **Para (g)** Relevant foreign income subject to a foreign tax | £2,000 |

Step 2 Identify the earliest paragraph above for the relevant year (Year 3), which has an amount of income or gain in the mixed fund:

**Para (a)** £30,000

**Step 3** Where the amount of the remittance is greater than the amount identified at Step 2 the amount remitted is treated as reduced by the amount identified in Step 2. £150,000 less £30,000= <u>£120,000</u>

Step 4 Find the next paragraph/amount for that tax year. In the order of preference listed above repeat Steps 2 and 3.

**Step 2** Identify the earliest paragraph: **Para (f)** £15,000

**Step 3** Where the amount of the remittance is greater £120,000 less £15,000 = <u>£105,000</u>

**Step 4** Repeat Steps 2 and 3.

**Step 2** Identify the earliest paragraph: **Para (g)** £2,000

Step 3 Where the amount of the remittance is greater £105,000 less £2,000 = <u>£103,000</u>

At this stage all of the amounts credited to the account in Year 3 have been matched against remitted amounts. Income and capital of the next previous year (Year 2) must now be considered - so return to Step 1 for Year 2.

**Step 1** Identify the separate amounts of income, capital gains and capital present for Year 2 before transfer:

| | |
|---|---|
| **Para (a)** Employment income (including UK employment income) not subject to a foreign tax | Year 1 – £10,000<br>Year 2 – £80,000 |
| **Para (f)** Employment income subject to a foreign tax | Year 1 – £5,000<br>Year 2 – £40,000 |
| **Para (i)** Capital | Year 2 – £69,000 |

**Step 2** Identify the earliest paragraph above for the relevant year (Year 2) , which has an amount of income or gain in the mixed fund: **Para (a)** £80,000

**Step 3** Where the amount of the remittance is greater than the amount identified at Step 2 the amount remitted is treated as reduced by the amount identified in Step 2. £103,000 less £80,000 = <u>£23,000</u>

**Step 4** Find the next paragraph/amount for that tax year.
In the order of preference listed above repeat Steps 2 and 3.

| | | |
|---|---|---|
| **Step 2** Identify the earliest paragraph: | **Para (f)** | £40,000 |
| **Step 3** If the amount is more than the [residual] "transfer amount", the whole of the remittance comes from that paragraph. | | £23,000 |

The £150,000 transfer is therefore regarded as a remittance of:

| | | |
|---|---|---|
| £110,000 | UK employment income | (within para a) |
| £38,000 | relevant foreign income | (within para f) |
| £2,000 | relevant foreign earnings | (within para g) |

**Note 2**

The transfer on 3 July of £5,000 to meet daily living expenses will similarly be regarded as coming from the "earliest paragraph" in the mixed fund, which is paragraph (f) containing relevant foreign earnings from Year 2.

The result of this exercise is that:

- J's UK salary in Year 3 is deemed to have been brought to the UK first and is not a taxable remittance.
- Similarly all of his relevant foreign income and overseas employment income of Year 3 are treated as remitted to the UK and chargeable to tax at the appropriate rates of tax – allowing credit for foreign taxes charged on that same income as appropriate.

*Reconciliation*

The mixed fund still contains:

| | |
|---|---|
| £69,000 | capital (from the sale of shares in Year 2) together with |
| £12,000 | relevant foreign earnings from Year 2, and |
| £10,000 | UK employment income from Year 1 |
| £5,000 | relevant foreign earnings from Year 1 |
| £96,000 | |

*Moral:* J should have kept his capital receipt separate and remitted from that. That would have reduced the rate of tax on the remittance and saved the costs of the computation.

## 11.6 Offshore transfer mixed fund rule

Section 809R(4) ITA provides:

> Treat an offshore transfer from a mixed fund as containing the appropriate proportion of each kind of income or capital in the fund immediately before the transfer.
> "The appropriate proportion" means the amount (or market value) of the transfer divided by the market value of the mixed fund immediately before the transfer.

I refer to this as **"the offshore transfer mixed fund rule".**

"Transfer" must have the same meaning as in s.809Q so it includes any type of payment, whether or not made for consideration.

### 11.6.1 *Meaning of "offshore transfer"*

Section 809R(5) ITA defines "offshore transfer":

> A transfer from a mixed fund is an "offshore transfer" for the purposes of subsection (4) if and to the extent that section 809Q does not apply in relation to it.

So far the definition seems clear. One must ask whether s.809Q applies. Section 809Q applies (in short) if a sum is received in the UK by a relevant person.[12] A transfer to a UK bank account is an onshore transfer. So a transfer to a foreign account appears to be an offshore transfer. But suppose:
Year 1: a sum is transferred to a foreign account ("the first transfer")
Year 2: the sum is transferred to a UK account ("the second transfer").
It appears that in year 1 the first transfer is not an onshore transfer, but in year 2 it becomes one.[13] To avoid this result, s.809R(6) ITA provides:

> Treat a transfer from a mixed fund as an "offshore transfer" (and section 809Q as not applying in relation to it, if it otherwise would do) if and to the extent that, at the end of a tax year in which it is made—
> (a) section 809Q does not apply in relation to it, and
> (b) on the basis of the best estimate that can reasonably be made at that time, section 809Q will not apply in relation to it.

If condition (a) and (b) of this subsection are *both* satisfied, there are two consequences:

(1) One must treat the transfer as an offshore transfer.
(2) One must treat section 809Q as not applying in relation to it, if it otherwise would do.

Unless condition (a) and (b) are both satisfied, this subsection does not apply.

The condition in subsection (6)(a) is clear enough. One asks whether

12 See 11.4.2 (Onshore transfer).

13 Because remittance condition A is met, and the property received in the UK derives indirectly from the first transfer.

s.809Q applies at the end of the tax year. Eg this condition is met if:
(1) T transfers a sum from a mixed fund to a new offshore account on 6th April 2008, and
(2) the money is still there on 5th April 2009, or the money has been used to purchase a non UK asset.

Subsection (6)(b) is a challenge. At the end of the tax year, one must ask whether one can say that s.809Q will not apply in relation to the transfer. In relation to some transfers one can say with certainty that s.809Q will not apply. If the transferor draws a sum from a mixed fund to pay for a dinner outside the UK, then s.809Q will not apply to it because nothing will be received in the UK. That is an offshore transfer.

If a person transfers a sum to an offshore account and does expect to spend it in the UK that is an onshore transfer when remitted to the UK.

### 11.6.2 *Recomputation problem*

I use the term "**problematic transfer**" (for reasons which will become clear) to describe a transfer made in the following circumstances (by no means unusual):
(1) In year 1 T transfers a sum from a mixed fund to an account outside the UK.
(2) At the end of year 1 the transferred sum is not received in the UK.
(3) T cannot say at the end of the year 1 that "section 809Q will not apply in relation to" the problematic transfer. This may be because:
    (a) At the end of year 1, T does expect to spend the sum in the UK but not until a later year, say, year 5; or
    (b) T does not know whether T intends to remit the sum to the UK.

    At the end of year 1, the problematic transfer is not an onshore transfer. It is an offshore transfer within the definition in s.809R(5). Admittedly it is not within subsection 809R(6) but that subsection does not stop any transfer being an offshore transfer, if applicable it treats non-offshore transfers as offshore transfers.
(4) Suppose in a later year (say year 5) T transfers the sum to the UK. I refer to this as its **"subsequent remittance**."

On one view, the problematic transfer changes status at the time of its subsequent remittance and becomes an onshore transfer. That is workable if in the meantime T has not made any other onshore transfers from the mixed fund. It is not workable if in the meantime T has made other transfers from the mixed fund, because:

(1) T needed to know at the time what income or gains those other transfers included.
(2) There cannot possibly be a recomputation of the tax effect of the other transfers in earlier years on the basis that the problematic transfer has turned out to be an onshore transfer after all. I think that is obviously impractical, but for good measure it is also inconsistent with s.809R(9) ITA which provides:

> If section 809Q applies in relation to more than one transfer from a mixed fund, when undertaking step 1 in relation to the second or any subsequent transfer take into account the effect of step 2 of section 809Q(3) (composition of transfer) as it applied in relation to each earlier transfer.

It is almost impossible to make a coherent tax regime out of this intractable statutory material, which is not surprising given the way in which it was enacted. I think the best solution is to say that s.809R(6)(b) is misconceived, that a problematic transfer is only an onshore transfer if s.809Q applies to it in the year of the transfer. If at the end of the year it is an offshore transfer, its status does not change later. This can be justified on the basis that IT is an annual tax.

The alternative view is that the problematic transfer does change its status and becomes an onshore transfer, on the occasion of its subsequent remittance. One carries through the implications for tax purposes so far as that is possible, so the result is that tax is charged as if the problematic transfer was made after the subsequent transfers.

If that were so, another issue arises. Suppose when asked whether the sum will be remitted, T says (as may well be said) that T will remit it if represents an offshore transfer. The question whether a sum will be remitted to the UK may depend on the tax position, ie if it represents an offshore transfer it will be remitted and if it represents an onshore transfer it will not. It is therefore impossible to answer the s.809R(6)(b) question, whether the sum will be remitted, on the view that a problematic transfer becomes an onshore transfer when remitted; for if it is an offshore transfer it will be remitted (and so is an onshore transfer) but if it is an onshore transfer it will not be remitted (and so is an offshore transfer).

### 11.6.3 *HMRC explanation*

EN Clause 23 Schedule 7 Remittance Basis Amendments 463 to 481 explains s.809R(4) ITA:

> 7. Amendment 465 introduces a new subsection [4], dealing with cases where transfers are made wholly offshore. The new rules aim to ensure that where a transfer is made offshore from fund A to fund B, and remittances to the UK are then made from fund A or fund B, the normal ordering rules for mixed funds apply, as they would have done had the transfer to Fund B not been made before the remittance.

In fact the offshore transfer mixed fund rule does nothing of the sort. The EN continues:

> 8. So if fund A consisted of equal amounts of untaxed income and capital, and half the fund was transferred to fund B, it cannot be argued that fund A or B consisted solely of capital, and remittances from fund A or B were not therefore taxable. Instead, where there is an offshore transfer, so that the normal mixed fund ordering rules do not apply, fund B is to be treated as containing the same proportion of the different categories of income and capital as the original fund, in relation to the amount transferred.

### 11.6.4 HMRC examples: onshore and offshore transfers

The RDR Manual provides a straightforward example of onshore and offshore transfers from an account with different categories of income and gains:

**RDRM 35430, 35440**
**Example 1** (Ahmid)
A, a remittance basis user has an offshore bank account into which is paid both UK source (taxed) income and his foreign income and gains. A makes regular **transfers from this account to his UK account to meet his UK living expenses.**

| | | Credit/(Debit) | Balance | Category S809Q(4) | See Note |
|---|---|---|---|---|---|
| 10 April | XYZ (CI) Ltd – proceeds from sale of shares | £1,000,000 | £1,000,000 | e | 1 |
| 15 April | RFI dividend | £10,000 | £1,010,000 | g | |
| 30 April | UK salary | £10,000 | £1,020,000 | a | 2 |
| 30 April | Bank interest | £5,000 | £1,025,000 | d | |
| 30 April | Overseas salary (net of tax) | £5,000 | £1,030,000 | f | |
| 3 May | Transfer to UK a/c | (£5,000) | £1,025,000 | | 2 |

| | | | | | |
|---|---|---|---|---|---|
| 15 May | Offshore dividend | £2,000 | £1,027,000 | g | |
| 31 May | UK salary | £10,000 | £1,037,000 | a | |
| 31 May | Overseas salary (net of tax) | £5,000 | £1,042,000 | f | |
| 31 May | ABC (IoM) Ltd – purchase of shares in foreign company | (£1,000,000) | £42,000 | | 3 |
| 3 June | Transfer to UK a/c | (£5,000) | £37,000 | | 4 |
| 30 June | UK salary | £10,000 | £47,000 | a | |
| 30 June | Overseas salary (net of tax) | £5,000 | £52,000 | f | |
| 3 July | Transfer to UK a/c | (£5,000) | £47,000 | | 5 |
| 31 July | UK salary | £10,000 | £57,000 | a | |
| 31 July | Overseas salary (net of tax) | £5,000 | £62,000 | f | |
| 3 Aug | Transfer to UK a/c | (£5,000) | £57,000 | | 6 |
| 15 Aug | Cheque – ZZZ Cars Ltd London | (£25,000) | £32,000 | | 7 |

**Note 1**

The sale price of the shares includes a gain over the original purchase price of £150,000 that has not been taxed. The purchase was made long before 6 April 2008 and was made using accumulated foreign income and gains which were treated as clean capital.

The mixed fund provisions do not apply to foreign income or gains that arose or accrued before 6 April 2008 (Sch 7 FA 2008 para 89). This means that it is not possible to apply the "mixed fund" rules to the £850,000 used to buy the shares.

**Note 2**

Using the ordering rules at ITA07/s809Q(1), the remittance to the UK on 3 May is matched against the UK salary from that tax year credited to the account on 30 April, as this is the "earliest paragraph" of income or gains within the mixed fund.

Working this through:

The £5,000 transfer to the UK on 3 May is a "transfer" from a mixed fund within section 809Q. Applying the ordering rules in that section, and analysing the mixed fund to identify the separate amounts of income, capital gains and capital in the account for each tax year immediately before the date of the transfer:

| | | |
|---|---|---|
| Para (a) | employment income | £10,000 |
| Para (d) | RFI | £5,000 |
| Para (e) | Chargeable gains | £150,000 |
| Para (f) | Earnings subject to a foreign tax | £5,000 |
| Para (g) | RFI subject to tax | £10,000 |
| Para (i) | Income or capital not within another paragraph | £850,000 |

The remittance is regarded as coming from the "earliest paragraph", that is para (a), so the £5,000 is UK employment income. Although money has been brought into the UK, there is no taxable remittance as the money has already been taxed.

**Note 3**

The purchase of shares on 31 May is an "offshore transfer"; by the end of the tax year the shares purchase have not, nor on best estimate are they likely to be, a remittance transfer so that s809Q applies.

The account is treated as including the amounts of foreign income and gain that were present immediately before the transfer (ITA07/s809R(4)). The transfer has no effect on the amount remitted in the current tax year but may need to be taken into account in a later tax year.

Immediately before the offshore transfer the mixed fund consists of:

| | | |
|---|---|---|
| Para (a) | employment income | £15,000 |
| Para (d) | RFI | £5,000 |
| Para (e) | Chargeable gains | £150,000 |
| Para (f) | Earnings subject to a foreign tax | £10,000 |
| Para (g) | RFI subject to tax | £12,000 |
| Para (i) | Income or capital not within another paragraph | £850,000 |
| | | £1,042,000 |

The offshore transfer consists of an appropriate proportion of each kind of income, gain or capital, within the mixed fund, that is:

| | | |
|---|---|---|
| Para (a) | employment income | £14,396 |
| Para (d) | RFI | £4,798 |
| Para (e) | Chargeable gains | £143,953 |
| Para (f) | Earnings subject to a foreign tax | £9,597 |
| Para (g) | RFI subject to tax | £11,517 |
| Para (i) | Income or capital not within another paragraph | £815,739 |
| | | £1,000,000 |

**Note 4**

The £5,000 transfer on 3 June to the UK is a "transfer" to the UK from a mixed fund, and is within s809Q(1). Applying the ordering rules in that section, and analysing the mixed fund to identify the separate amounts of income, capital gains and capital present for each tax year immediately before the date of the transfer:

| | | |
|---|---|---|
| Para (a) | employment income | £604 |
| Para (d) | RFI | £202 |
| Para (e) | Chargeable gains | £6,047 |
| Para (f) | Earnings subject to a foreign tax | £403 |
| Para (g) | RFI subject to tax | £483 |
| Para (i) | Income or capital not within another paragraph | £34,261 |

The transfer is regarded as coming from each of the paragraphs in order; that is £604 from para (a), and a taxable remittance of £4,396, being £202 from para (d) and £4,194 from para (e).

**Note 5 and 6**

Both of these £5,000 transfers are to the UK. There have been credits to the fund between the last transfer (note 4) and this transfer and the fund now contains some employment income (para a) and additional amounts of foreign earning subject to foreign tax (para f) in addition to the residue following the last transfer.

The £5,000 transfers made on 3 July and 3 August are regarded as coming from the earliest paragraph of income, that is para (a) – £10,000 of UK employment income credited to the account on 30 June.

**Note 7**

The cheque remittance on 15 August is £25,000. This amount was used to buy a car from a UK company. This is also a remittance within s809Q. Immediately before the transfer the mixed fund consists of:

| | | |
|---|---|---|
| Para (a) | employment income | £10,000 |
| Para (d) | RFI | £nil |
| Para (e) | Chargeable gains | £1,853 |
| Para (f) | Earnings subject to a foreign tax | £10,403 |
| Para (g) | RFI subject to tax | £483 |
| Para (i) | Income or capital not within another paragraph | £34,261 |

The cheque remittance is regarded as coming from each of the paragraphs in order; that is £10,000 from para (a), £1,853 from para (e) and £10,403 from para (f), £483 from para (g) and £2,261 from para (i).

The remaining £32,000 at 15 August is also within para (i)

**Example 1(a) – Transfer to another account** To continue the offshore account in example 1:

| **Date** | | **Credit/(Debit)** | **Balance** | **Category S809Q(4)** | **Note** |
|---|---|---|---|---|---|
| | Balance b/f | | £32, 000 | | |
| 31 Aug | Overseas salary (net of tax) | £5,000 | | f | |
| 31 Aug | UK salary | £10,000 | | a | |
| 3 Sept | Transfer to UK a/c | (£5,000) | | | 1 |
| 15 Sept | Cheque – XYZ Travel Services (CI) Ltd | (£10,000) | | | 2 |
| 30 Sept | Overseas salary (net of tax) | £50,000 | | f | |
| 30 Sept | Overseas Dividend | £350,000 | | g | |
| 30 Sept | UK salary | £180,000 | | a | |
| 3 Oct | Transfer to UK a/c | (£5,000) | | | 3 |
| 15 Oct | Transfer to Swiss a/c | (£350,000) | | | 4 |

**Note 1**

Immediately before the transfer on 3 September the mixed fund contained:

| | | |
|---|---|---|
| Para (a) | employment income | £10,000 |
| Para (f) | Earnings subject to a foreign tax | £5,000 |
| Para (i) | Income or capital not within another paragraph | £32,000 |

The transfer is regarded as coming from the "earliest paragraph", that is para (a), so the £5,000 is UK employment income. Although money has been brought into the UK, there is no taxable remittance as the money has already been taxed,

**Note 2**

The next payment from the account is £10,000 for the family holiday flights to the USA. The full payment is a remittance because the service provided is in the UK – the flights begin or end in London.

The transfer is regarded as coming from each of the paragraphs in order; that is £5,000 from para (a) and a taxable remittance consisting of £5,000 from para (f).

**Note 3**

Immediately before the remittance on 3 October the mixed fund contained:

| | | |
|---|---|---|
| Para (a) | employment income | £180,000 |
| Para (f) | Earnings subject to a foreign tax | £50,000 |
| Para (g) | RFI | £350,000 |
| Para (i) | Income or capital not within another paragraph | £32,000 |

The transfer is regarded as coming from the "earliest paragraph", that is para (a), so the £5,000 is UK employment income.

**Note 4**

The transfer of £350,000 to a new Swiss bank account is an offshore transfer. Immediately before the offshore transfer on 15 October the offshore bank account (mixed fund) is regarded as containing:

| | | |
|---|---|---|
| Para (a) | employment income | £175,000 |
| Para (f) | Earnings subject to a foreign tax | £50,000 |
| Para (g) | RFI | £350,000 |
| Para (i) | Income or capital not within another paragraph | £32,000 |
| | | £607,000 |

The offshore transfer consists of an appropriate proportion of each kind of income, gain or capital, within the mixed fund, that is:

| | | |
|---|---|---|
| Para (a) | employment income | £100,906 |
| Para (f) | Earnings subject to a foreign tax | £28,830 |
| Para (g) | RFI | £201,812 |
| Para (i) | Income or capital not within another paragraph | £18,452 |

The Swiss bank account is another "mixed fund", containing the income, gains and capital of the transferred amount. Assuming nothing else is added or taken away from to the Swiss account in the interim, if in a couple of years time A decides to remit £120,000 to the UK from his Swiss bank account, the same ordering rules will apply to the Swiss fund, so the remittance is regarded as consisting of £100,906 from para (a) and £19,094 from para (f).

The next example has another mix of offshore and onshore transfers.

**RDRM 35450**

**Example 2 (Lorraine)**

L, a remittance basis user, opens an offshore bank account in Bermuda into which is paid both UK source (taxed) income and her foreign income and gains. L makes a few transfers from this account to her UK account to meet UK living expenses. She also transfers money from this account to her other offshore account in Jersey, as well as using it for several offshore purchases.

**Account 1 Bermuda**

| | | Credit (Debit) | Balance | Category S809Q(4) | Note |
|---|---|---|---|---|---|
| **Year 1** | | | | | |
| 15 Jan | Capital | £1,000,000 | £1,000,000 | i | 1 |
| 30 Jan | UK salary | £10,000 | £1,010,000 | a | |
| 30 Jan | Bank interest | £5,000 | £1,015,000 | d | |
| 30 Jan | Overseas salary (net of tax) | £5,000 | £1,020,000 | f | |
| 3 Feb | Transfer to UK a/c | (£5,000) | £1,015,000 | | 2 |
| 28 Feb | Dividend | £2,000 | £1,017,000 | g | |
| 28 Feb | UK salary | £10,000 | £1,027,000 | a | |
| 28 Feb | Overseas salary | £5,000 | £1,032,000 | f | |
| 3 March | Purchase of shares in foreign company | (£800,000) | £232,000 | | 3 |
| 10 March | Transfer to UK a/c | (£5,000) | £227,000 | | 4 |
| 31 March | UK salary | £10,000 | £237,000 | a | |
| 31 March | Overseas salary (net of tax) | £5,000 | £242,000 | f | |
| 2 Apr | Transfer to UK a/c | (£5,000) | £237,000 | | 5 |
| **Year 2** | | | | | |
| 30 April | UK salary | £10,000 | £247,000 | a | |
| 30 April | Overseas salary (net of tax) | £5,000 | £252,000 | f | |
| 3 March | Transfer to UK a/c | (£5,000) | £247,000 | | 6 |
| 15 March | Transfer to UK a/c | (£100,000) | £147,000 | | 7 |
| 31 May | UK salary | £10,000 | £157,000 | a | |
| 31 May | Overseas salary (net of tax) | £5,000 | £162,000 | f | |
| 8 June | Transfer – A2Z travel services | (£20,000) | £142,000 | | 8 |

**Year 1**

**Note 1**

The £1,000,000 credited to the account on 15 January was inherited under L's great aunt's will, and is "clean" capital.

**Note 2**

The £5,000 transfer to the UK on 3 May is a "remittance" from a mixed fund within section 809Q(1). Applying the ordering rules in that section, and analysing the mixed fund to identify the separate amounts of income, capital gains and capital in the account for each tax year immediately before the date of the transfer:

| | | |
|---|---|---|
| Para (a) | employment income | £10,000 |
| Para (d) | RFI | £5,000 |
| Para (f) | Earnings subject to a foreign tax | £5,000 |
| Para (i) | Inherited capital | £1,000,000 |

The remittance is regarded as coming from the "earliest paragraph", that is para (a), so the £5,000 is UK employment income, so there is no taxable remittance of foreign income nor further tax to pay upon remittance.

**Note 3**

The purchase of shares on 3 March (£800,000) is an "offshore transfer". By the end of the tax year the shares purchased have not been sold, brought to the UK or otherwise used so that s809Q applies.

The account is treated as including the amounts of foreign income and gain that were present immediately before the transfer (ITA07/s809R(4)). The transfer has no effect on the amount remitted in the current tax year but may need to be taken into account in a later tax year.

Immediately before the offshore transfer the mixed fund consists of:

| | | |
|---|---|---|
| Para (a) | Employment income | £15,000 |
| Para (d) | Relevant foreign income | £5,000 |
| Para (f) | Earnings subject to a foreign tax | £10,000 |
| Para (g) | Relevant foreign income subject to tax | £2,000 |
| Para (i) | Inherited capital | £1,000,000 |
| | | £1,032,000 |

The "offshore transfer" (the shares purchase) consists of an appropriate proportion (100/129) of each kind of income, gain or capital, within the mixed fund, that is:

| | | |
|---|---|---|
| Para (a) | employment income | £11,628 |
| Para (d) | RFI | £3,876 |
| Para (f) | Earnings subject to a foreign tax | £7,752 |
| Para (g) | RFI subject to tax | £1,550 |
| Para (i) | Income or capital not within another paragraph | £775,194 |
| | | £800,000 |

**Note 4**

The £5,000 transfer to the UK on 10 March is a "remittance" from a mixed fund within section 809Q(1). Applying the ordering rules in that section, and analysing the mixed fund to identify the separate amounts of income, capital gains and capital in the account for each tax year immediately before the date of the transfer the mixed fund consists of:

| | | |
|---|---|---|
| Para (a) | employment income | £3,372 |
| Para (d) | RFI | £1,124 |
| Para (f) | Earnings subject to a foreign tax | £2,248 |
| Para (g) | RFI subject to tax | £450 |
| Para (i) | Income or capital not within another paragraph | £224,806 |
| | | £232,000 |

The remittance is regarded as coming from the "earliest paragraph", that is para (a), £3,372, para (d) £1,124 and para (f) £504. Of this amount, £1,124 and £504 are taxable remittances.

**Note 5**

The next remittance on 2 April is again £5,000. Two further amounts have been credited to the account which now consists of

| | | |
|---|---|---|
| Para (a) | employment income | £10,000 |
| Para (f) | Earnings subject to a foreign tax | £6,744 |
| Para (g) | RFI subject to tax | £450 |

| | | |
|---|---|---|
| Para (i) | Income or capital not within another paragraph | £224,806 |

The remittance is regarded as coming from the "earliest paragraph", that is para (a), so the £5,000 is UK employment income, so there is no taxable remittance of foreign income nor further tax to pay upon remittance.

The account now consists of:

| | | |
|---|---|---|
| Para (a) | employment income | £5,000 |
| Para (f) | Earnings subject to a foreign tax | £6,744 |
| Para (g) | RFI subject to tax | £450 |
| Para (i) | Income or capital not within another paragraph | £224,806 |
| | | £237,000 |

At the end of the tax year, L has made taxable remittances of: £1,628 (para (d) £1,124 and para (f) £504). She has also made two offshore transfers:

**Year 2**

At the start of the next tax year, L continues to make remittances to the UK from the overseas account. The "mixed fund" rules mean that income gains and capital of a tax year are treated in priority to income gains and capital of a previous year.

**Note 6**

The £5,000 transfer to the UK on 3 May is a "remittance" from a mixed fund within s809Q(1). Applying the ordering rules in that section, and analysing the mixed fund to identify the separate amounts of income, capital gains and capital in the account for tax Year 2 immediately before the date of the transfer:

| | | |
|---|---|---|
| Para (a) | employment income | £10,000 |
| Para (f) | Earnings subject to a foreign tax | £5,000 |

The remittance is regarded as coming from the "earliest paragraph", that is para (a), so the £5,000 is UK employment income, so there is no taxable remittance of foreign income nor further tax to pay upon remittance.

**Note 7**

On 15 May, L transfers £100,000 to her UK bank account. This is a "remittance" from a mixed fund within section 809Q(1).

Applying the ordering rules section 809Q, and analysing the mixed fund to identify the separate amounts of income, capital gains and capital in the account for tax Year 2 immediately before the date of the transfer:

| | | |
|---|---|---|
| Para (a) | employment income | £5,000 |
| Para (f) | Earnings subject to a foreign tax | £5,000 |

So £10,000 of the transfer comes from these two paragraphs of Year 2 income. The outstanding balance of £90,000 must be identified by applying the ordering rules section 809Q, and analysing the mixed fund to identify the separate amounts of income, capital gains and capital in the account for tax Year 1 immediately before the date of the transfer:

| | | |
|---|---|---|
| Para (a) | employment income | £5,000 |
| Para (f) | Earnings subject to a foreign tax | £6,744 |
| Para (g) | RFI subject to tax | £450 |
| Para (i) | Income or capital not within another paragraph | £224,806 |

So the remaining £90,000 of the transfer will regarded as consisting of monies

from para (a) £5,000, Para (f) £6,744, Para (g) £450 and Para (i) £77,806 from Year 1.
The mixed fund now consists of:
Para (i) Income or capital not within another paragraph £147,000

## 11.6.5 *Repayment of loan from mixed fund*

The next HMRC example involves an offshore transfer which is repayment of a loan (not a relevant loan) from a mixed fund.

**RDRM 35470**
**Example (Frankie)**
F, a remittance basis user, has a bank account in Jersey into which is paid both UK source (taxed) income and foreign income and gains. F makes transfers from the Jersey account to his UK account to meet his UK living expenses.
On 28 May, F acquires a loan from his Jersey bank that he uses to purchase an asset in Jersey for £200,000 – Note 3. He repays the [capital of the] loan from this account.

| | | Credit (Debit) | Balance | Category | Note |
|---|---|---|---|---|---|
| 6 Apr | Clean capital | £80,000 | £80,000 | i | |
| 15 Apr | RFI NFT | £10,000 | £90,000 | d | |
| 30 Apr | UK salary | £10,000 | £100,000 | a | |
| 30 Apr | RFI bank interest | £5,000 | £105,000 | d | |
| 30 Apr | RFE NFT | £5,000 | £110,000 | b | |
| 3 May | Transfer to UK a/c | (£5,000) | £105,000 | | 1 |
| 15 May | RFI | £2,000 | £107,000 | d | |
| 31 May | UK salary | £10,000 | £117,000 | a | |
| 31 May | Overseas salary | £5,000 | £122,000 | b | |
| 3 Jun | Transfer to UK a/c | (£5,000) | £117,000 | | 2 |
| 28 Jun | bank loan repayment[14] | (£15,000) | £102,000 | | 3 & 4 |
| 30 Jun | UK salary | £10,000 | £112,000 | a | |
| 30 Jun | Overseas salary | £5,000 | £117,000 | b | |
| 3 Jul | Transfer to UK a/c | (£5,000) | £112,000 | | 5 |
| 28 Jul | bank loan repayment | (£15,000) | £97,000 | | 6 |
| 31 Jul | UK salary | £10,000 | £107,000 | a | |
| 31 Jul | Overseas salary | £5,000 | £109,000 | b | |
| 3 Aug | Transfer to UK a/c | (£5,000) | £102,000 | | 7 |
| 15 Aug | Cheque – ZZZ Cars | (£25,000) | £77,000 | | 8 |
| 28 Aug | bank loan repayment | (£15,000) | £62,000 | | 9 |
| 31 Aug | Overseas salary | £5,000 | £67,000 | b | |
| 31 Aug | UK salary | £10,000 | £72,000 | a | |

14 In this example there are monthly repayments of the capital of the loan, but no payments of interest.

| | | | | |
|---|---|---|---|---|
| 3 Sep | Transfer to UK a/c | (£5,000) | £67,000 | 10 |

The first two transfers are straightforward:

**Note 1**
Using the ordering rules at ITA07/s809Q, the remittance to the UK on 3 May is matched against the UK salary from that tax year credited to the account on 30 April, as this is the "earliest paragraph" of income or gains within the mixed fund.
**Note 2**
The remittance on 3 June is also matched against the UK salary from that tax year credited to the account before that date.

We now turn to the point of the example:

**Note 3**
The £200,000 used to pay for the assets is borrowed capital and is not in itself a remittance or an offshore transfer.

The reason that the payment of £200k is not an offshore transfer is that the sum is not mixed into the mixed fund. If it had been paid into the account (and withdrawn from there to purchase the asset) the position would have been entirely different.

However, subsequent payments of interest and capital used to repay the loan are offshore transfers.
**Note 4**
At the time immediately before the first repayment of the debt occurs on 28 June, the mixed fund is composed as follows:

| | | |
|---|---|---|
| Clean capital | £80,000 | |
| UK salary | £10,000 | see note 4(a)[15] |
| Relevant foreign earnings | £10,000 | |
| Relevant foreign income | £17,000 | |
| | £170,000[16] | |

The repayment of the monthly bank loan of £15,000 is an offshore transfer, consisting of an appropriate proportion of each kind of income within the mixed fund, that is:

15 Note 4(a) provides: "Although £20,000 of F's UK salary has been credited to the account, £10,000 has already been remitted prior to 28 June (see Notes 1 and 2)."
16 *Sic;* the manual has a typographic or an arithmetical error here.

| | |
|---|---|
| Clean capital | £10,256 |
| UK salary | £1,282 |
| Relevant foreign earnings | £1,282 |
| Relevant foreign income | £2,180 |
| | £15,000 |

The property acquired by F using the loan is now regarded as containing this income.[17]

The next remittance is straightforward:

**Note 5**
The next remittance on 3 July is again £5,000 that is matched against the UK salary credited to the account before that date.

Now comes the second loan repayment:

**Note 6**
At the time immediately before the repayment on 28 July, the "mixed fund" is composed as follows:

| | |
|---|---|
| Clean capital | £69,744 |
| UK salary | £13,718 |
| Relevant foreign earnings | £13,718 |
| Relevant foreign income | £14,820 |
| | £112,000 |

The repayment of the monthly bank loan of £15,000 is an offshore transfer, consisting of an appropriate proportion of each kind of income within the mixed fund, that is:

| | |
|---|---|
| Clean capital | £9,339 |
| UK salary | £1,838 |
| Relevant foreign earnings | £1,838 |
| Relevant foreign income | £1,985 |
| | £15,000 |

The property acquired by F is now regarded as containing this income.

Next come two straightforward onshore transfers:

**Note 7**
A further £5,000 remittance on 3 August is again matched against UK salary.

17 See 11.3.5 (Income/gains used to repay debt).

**Note 8**

The payment of £25,000 to ZZZ Cars is to buy a car and is a taxable remittance. Immediately before the transfer the mixed fund is composed as follows:

| | |
|---|---|
| Clean capital | £60,405 |
| UK salary | £16,880 |
| Relevant foreign earnings | £16,880 |
| Relevant foreign income | £12,835 |
| | £107,000 |

This £25,000 remittance is matched firstly against UK salary (£16,880), then against relevant foreign earnings (£8,120).

Next another loan repayment

**Note 9**

At the time immediately before the repayment on 28 August, the mixed fund is composed as follows:

| | |
|---|---|
| Clean capital | £60,405 |
| UK salary | £nil |
| Relevant foreign earnings | £8,760 |
| Relevant foreign income | £12,835 |
| | £82,000 |

The repayment of the monthly bank loan of £15,000 is an offshore transfer, consisting of an appropriate proportion of each kind of income within the mixed fund, that is:

| | |
|---|---|
| Clean capital | £11,049 |
| Relevant foreign earnings | £1,603 |
| Relevant foreign income | £2,348 |
| | £15,000 |

**Note 10**

The fifth remittance on 3 September is again £5,000 that is matched against the UK salary from that tax year credited to the account before that date.

The account now contains £77,000, being

| | |
|---|---|
| Clean capital | £49,356 |
| UK salary | £5,000 |
| Relevant foreign earnings | £12,157 |
| Relevant Foreign Income | £10,487 |

For the purposes of this example, assume that on 8 September F wins the Jersey local lottery ("clean capital") and uses his winnings to pay off the outstanding loan.

Three years later, F brings the property acquired with the loan to the UK.

The property is a mixed fund, and it is regarded as containing the income and capital used to pay off the loan, that is:

| | |
|---|---|
| UK salary | £3,120 |
| Relevant foreign earnings | £4,723 |
| Relevant foreign income | £6,513 |
| Clean capital. | £185,644 |

F has remitted foreign income of £11,236.

The moral which follows from these examples is the imperative of not mixing funds of different types of income or gains, so far as possible.

## 11.7 Mixed fund anti-avoidance rule

Section 809S ITA provides:

> (1) This section applies if, by reason of an arrangement[18] the main purpose (or one of the main purposes) of which is to secure an income tax advantage or capital gains tax advantage, a mixed fund would otherwise be regarded as containing income or capital within any of paras (f) to (i) of section 809Q(4).
> (2) Treat the mixed fund as containing so much (if any) of the income or capital as is just and reasonable.

I refer to this as "**the mixed funds anti-avoidance rule**".

IT advantage and CGT advantage have the standard (wide) definitions.[19]

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18 Section 809S(3) ITA contains the usual (unnecessary) commonsense definition of "arrangement":

"'Arrangement' includes any scheme, understanding, transaction or series or transactions (whether or not enforceable)."

19 Section 809S provides:

(4) "Income tax advantage" means—

(a) a relief from income tax or increased relief from income tax,

(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; and for this purpose "relief from income tax" includes a tax credit.

(4A) For the purposes of subsection (4)(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

The terms are not limited to tax avoidance in the strict sense.

Section 809S is clearly intended to override the offshore mixed fund transfer rule although this is not expressly stated.[20]

Suppose:

(1) T has a mixed fund containing £2m, 50% income and 50% capital.

(2) T transfers £1m, half the amount, to another account (an offshore transfer). T intends to keep that amount offshore.

(3) T then remits the funds in the first account to the UK.

Applying the offshore transfer mixed fund rule the first account, which is remitted, consists of 50% income and capital, so on remittance 50% of the sum received is tax free. In the absence of the offshore transfer, the whole of the £1m remitted would have been subject to income tax. The offshore transfer is an arrangement which secures an IT advantage. Assuming this was one of the main purposes, s.809S applies.

One then has to ask what is "just and reasonable". The drafter has given up here and left the courts to sort it out. One might say that it is reasonable to apply the pre-2008 mixed fund regime. That can hardly be described as unjust or unreasonable. But it is considered that the expression "just and reasonable" should be construed in accordance with the policy of the onshore transfer mixed fund rule. So an arrangement of the kind discussed above would be set aside and it would be just and reasonable to raise tax as if the offshore transfer had not been made. To put it another way, it is just and reasonable that transfers whose main purpose is to obtain a tax advantage should not do so.

If that were wrong, what would happen if there were a second transfer from the first account: in this way one could reduce the income element of any mixed fund to a relatively small sum by a series of offshore transfers.

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(b) by a deduction in calculating profits or gains.

(5) "Capital gains tax advantage" means—

(a) a relief from capital gains tax or increased relief from capital gains tax,

(b) a repayment of capital gains tax or increased repayment of capital gains tax,

(c) the avoidance or reduction of a charge to capital gains tax or an assessment to capital gains tax, or

(d) the avoidance of a possible assessment to capital gains tax.

20 The mixed funds anti-avoidance rule could also override the *onshore* transfer mixed fund rule, but it is not likely ever to be just and reasonable to substitute any other set of rules.

### 11.7.1 *Scope of mixed funds anti-avoidance rule*

The mixed fund anti-avoidance rule applies only if the mixed fund contains income or capital within mixed fund categories (f) to (i). So if a mixed fund consisted of (say) RFI within category (d) and chargeable gains within category (e), the anti-avoidance provision does not apply. This is a little surprising and it might be that s.809S(1) contains a typographical error, (f) being a slip for (a). But it is not obvious that there has been an error, as there is rather more scope for manipulation of the rules in a mixed account which contains categories (f) to (i). So a court should construe the section to mean what it says. In practice the point is not so important as a mixed fund will usually contain some item within categories (f) to (i).

## 11.8 Remittance of part of funds transferred

Section 809R(8) ITA provides:

> If section 809Q applies in relation to part of a transfer, apply that section in relation to that part before applying subsection (4) in relation to the rest of the transfer.

## 11.9 Mixed funds of third parties

So far we have considered the ITA mixed fund regime where an individual transfers from a mixed fund containing their own income or gains. The position is more complex when a third party is involved. This may arise in (at least) four circumstances:

(1) A gain accrues to non resident company within s.13 TCGA so that a s.13 deemed gain accrues to an individual participator taxable on the s.13 remittance basis. There is a tax charge if the company remits its gain to the UK. What if that gain forms part of a mixed fund (ie the gain is mixed with other funds of the company)?

(2) Income arises to a person abroad within s.720, so that s.720 deemed income arises to an individual transferor, taxable on the s.720 remittance basis. There is in principle a tax charge if the person abroad remits its income to the UK. What if that income forms part of a mixed fund (ie the income is mixed with other funds of the person abroad)?

It is suggested that the ITA mixed fund regime does apply in these two circumstances. Step 1 of s.809Q(3) requires us to find the income or gain of the "individual" but the funds in the hands of the third person are derived (or are treated as derived) from the income or gains of the individual, so applying s.809R(2) ITA the funds in the hands of the third party are treated as consisting of that income or capital. This view may favour the taxpayer, particularly for a company which is within s.720 but not s.13, or for a company which is within s.13 but not s.720.

(3) Income or gains accrue to an individual and the individual gives the income or gains to a relevant person ("R"). There is a tax charge if R remits the gifted funds to the UK. What if the income or gains form part of a mixed fund (ie the income or gains are mixed with other funds of R)?
(4) An individual makes a gift of an asset to a relevant person ("R"), on which a deemed gain arises. The asset is treated as derived from that gain and there is a tax charge if the asset is remitted to the UK. What if the asset forms part of a mixed fund (ie the asset is mixed with other funds of R)?

If R is not UK resident, the ITA mixed fund regime could apply. If R is UK resident, there is a problem. Suppose:

(1) T gives income ("T's income") to R.
(2) R mixes T's income with gains of R (accruing in the same year).
(3) R remits part of the mixed fund.

Has R remitted T's income or R's gains? It is in R's interest to argue that R has remitted T's income and in T's interest to argue that R has remitted R's gains. It is tentatively suggested that R has remitted T's income first.

## 11.10 Transitional rules for pre-2008 mixed fund

Para 89 Sch 7 FA 2008 provides:

> Sections 809Q to 809S of ITA 2007 (transfers from mixed funds) do not apply for the purposes of determining whether income or chargeable gains for the tax year 2007-08 or any earlier tax year are remitted to the UK (or the amount of any such income or chargeable gains so remitted).

Suppose:

(1) A mixed fund consists only of pre-2008 income/gains (no post 2008 income/gains).

(2) A transfer from that fund is made after 2008.

One needs to determine what part of that fund is remitted to the UK. Para 89 means that one disregards the ITA mixed fund regime (and instead applies the pre-2008 mixed fund regime).[21] This is the approach taken in HMRC's examples in the RDR Manual.

Suppose:

(1) A mixed fund includes pre-2008 income/gains and post 2008 income/gains.
(2) A transfer from that fund is made after 2008.

One needs to determine what part of that fund is remitted to the UK. The analysis comes in two stages.

(1) First, one has to determine whether the remittance consists of pre-2008 or post-2008 income/gains.
(2) (a) If the remittance consists of pre-2008 income/gains, one applies the pre-2008 mixed fund regime to identify what is remitted.
    (b) If the remittance consists of post-2008 income/gains, one applies the ITA mixed fund regime to determine what is remitted.

Which set of rules apply at stage 1? The ITA mixed fund regime raises difficult transitional issues which this statutory provision does not properly address, leaving HMRC, taxpayers and the courts to sort it out as best they can. It is tentatively suggested that one applies the ITA mixed fund regime so far back as 2008/09 and then the pre-2008 mixed fund regime. This is the approach taken in HMRC's examples in the RDR Manual.

## 11.11 From which fund is remittance made: bank errors

The RDR Manual provides:

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21 It does not mean that one disregards the ITA mixed fund regime (and instead applies the pre-2008 mixed fund regime) in ascertaining whether a pre-2008 transfer from a mixed fund constituted income/gains. (This question arises in order to identify the ingredients of the mixed fund for post-2008 transfers.) First my view is the more natural reading. Secondly, the alternative view would require an individual to classify the constituents of a mixed fund held at 6/4/08 by date and by the nine mixed fund categories, going back without limit of time. Records in many cases will not exist.

> **33560 Banking Issues** [July 2010]
> *Bank Errors and Mistakes*
> Where a bank acts contrary to express instructions by an account holder, and that mistake inadvertently results in a taxable remittance to the UK by the account holder, the account holder and the bank may alter the transaction in line with the original instructions given.
> If the bank does this, HMRC will treat the earlier [mistaken] transaction as not having taken place and the new transaction as being the original transaction in looking at whether there has been a taxable remittance from that account.

This is soundly based on *Duke of Roxburghe's Executors v IRC* 20 TC 711 where a taxpayer received and held offshore:
(1) income subject to UK tax on an arising basis ("taxed income");[22] and
(2) foreign income which qualified for the remittance basis, and which was therefore taxed if remitted ("untaxed income").

These were wisely held in separate accounts in one bank and so a remittance out of the taxed income account would not be 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 Court of Session identified the sum remitted as taxed income because the taxpayer had *intended* the remittance to come out of taxed income.[23]

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22 Being foreign source income of a class not then qualifying for the remittance basis and so subject to UK income tax on an arising basis.

23 "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." Lord Normand at p.726 (emphasis added). This was also the view of Lord Fleming at p.732: "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."
A second ground of the decision was that a remittance out of a mixed fund with taxed and untaxed income is in general to be treated as out of the taxed income regardless of the intention of the taxpayer. The second ground is now reversed by the ITA mixed fund regime.

## 11.12 Remittance when ITA mixed fund regime does not apply

Suppose an individual holds in one mixed fund two different types of RFI, both subject to foreign tax but one suffers a higher rate of foreign tax than the other. The ITA mixed fund regime gives no guidance because both fall into the same mixed fund category. It is considered that the *Duke of Roxburghe* 20 TC 711 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 to pay the two types of income into separate accounts. Then this issue does not arise and a remittance from the appropriate account can easily be identified as qualifying for the appropriate relief.

## 11.13 ITA mixed fund regime: commentary

The ITA mixed fund regime operates on a daily, indeed minute by minute basis, as the rules must be applied at the time of every onshore and offshore transfer. They do not operate within a given tax year on a pro rata basis (contrast the s.87 or s.731 matching rules). The reader who has studied the text to here, and who contemplates applying these rules to the actual circumstances of clients accounts containing hundreds or thousands of entries, will agree that the mixed fund rule is unworkable.

Joint Forum on Expatriates Tax and NICs Note of Meeting 18 September 2008 records:

> Delegates asked whether HMRC would be prepared to allow for apportionment on an annualised (rather than a monthly) basis. The legislation concentrates on transfers from mixed funds on the occasion of each and every transfer. HMRC did not think it was possible to override the intention of the legislation but agents considered that it would be unworkable to examine each and every debit and credit on the basis envisaged within a new legislation. ... The overwhelming view put forward by external delegates was that without the availability of a methodology along the lines of SP 5/84 it would be impractical for any inward expatriate to claim access to the remittance basis because it would not be possible to perform the calculations required by the legislation.[24]

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24 Accessible *www.hmrc.gov.uk/consultations/expat-mins-180908.htm*

The mixed fund legislation is a disaster; it needs to be rethought from beginning to end – an immensely challenging task, which could not possibly have been done in the few days available as Schedule 7 FA 2008 hurtled to the deadline for enactment.

In their defence, HMRC make two points:

> [1] HMRC reminded delegates that use of the remittance basis is voluntary as from 6 April 2008 and [2] that HMRC had been asked to bring in rules on remittance from mixed funds and rules relating to overseas transfers.

But as to point [1], the fact that the remittance basis is voluntary is no excuse for unworkable tax law. HMRC have overlooked that the remittance basis is intended to make the UK an *attractive* place for foreign domiciliaries to reside.[25] There is no need to comment on point [2].

A few months later HMRC issued SP 1/09 so the step thought impossible apparently proved to be possible after all.[26] But while helping the employee who is resident and not ordinarily resident, that does not help the rest of the body of remittance basis taxpayers stuck with the same problems. Why were resident non-ordinarily resident employees singled out for special relief? The reason was presumably down to effective lobbying rather than any rational policy consideration.

## 11.14 Pre-2008 mixed fund regime

### 11.14.1 *Remittance from mixture of taxed and untaxed income*

The former Inspectors Manual provided:

> **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.

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25 An alternative inference is that a decision was made deliberately to undermine the remittance basis by making it impracticably difficult to operate.

26 See 12.25 (Remittance from earnings for mixed UK/foreign duties).

Similarly, RDR Manual on the example of Martyn provides:

> **35320 Mixed Funds: Example 4 - remittances before 6 April 2008**
> **Note 2**
> Where an overseas "mixed fund" contained an amount that has already suffered UK tax, for example UK salary dealt with under PAYE, the practice (*Sterling Trust v IRC* 12 TC 868) was that a taxpayer was entitled to say that he or she has remitted income which has already suffered UK tax (to the extent that such income exists in the fund) in priority to income which is assessable on the arising basis.

This is soundly based on *Duke of Roxburghe's Executors v IRC.*[27]

### 11.14.2 *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, ie capital. The loans had in some cases been repaid only very shortly before the remittance.
(3) The sum remitted (£200,000) was small compared to the amount of the loans and the interest received (each about £1.5m).

It was held that the remitted sum was the foreign income, not capital. The Lord Chancellor said:

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27 20 TC 711 discussed in another context at 11.11 (From which fund is remittance made: bank errors).
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.

> 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] ...[28]

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.

This is explained by Lord Shand in argument:

> If it is capital you have brought back and distributed as bonus, you have

28 Similarly 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."

> 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, [ie income] ...

The former Inspectors Manual para 1566 gave 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 Inspectors Manual over-simplified 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.

HMRC express a different view in the example of Martyn in RDRM 35320 Note 2:

> For tax years up to 5 April 2008, there are no statutory rules to determine what amounts remitted from "mixed funds" actually consisted of. Broadly HMRC practice was based on House of Lords decisions, in particular that of *Scottish Provident v Allan* (4 TC 409/591). In the Court of Exchequer, Lord McLaren said (page 419)
>
> > " ... unappropriated remittances ... must be dealt with according to the ordinary course of business, and these remittances must be

> presumed to be paid in the first place out of interest so far as they are income, and in the second place of principal or capital. I think that rule results from the fact that no prudent man of business will encroach upon his capital for investment when he has income uninvested lying at his disposal". [29]
>
> The House of Lords considered that the question of whether any amount of income had actually been received in the UK is essentially one of fact – of tracing in the first instance, or, where direct tracing proves to be impossible, of inference from the known facts.
>
> The principle followed is, therefore, that in the absence of any evidence to the contrary, where capital and income have been paid into a single fund overseas so that they are no longer distinguishable, remittances to the UK out of the fund will be presumed to be income to the extent that there is income existing in the fund at the time that the remittance was made.

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 two different kinds of income or two different kinds of capital.

At first sight there is some tension between *SPI v Allan* and *Duke of Roxburghe* 20 TC 711. 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.

### 11.14.3 *Remittance from mixture of untaxed income and income qualifying for DT relief*

Suppose an individual holds in one pre-2008 mixed fund:

(1) income which is subject to foreign tax and qualifies for UK double tax relief; and

29 [Author's note] But what the Court of Exchequer had to say is of no significance since the House of Lords expressed the matter differently.

(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.

### 11.14.4 *Remittances out of mixed capital funds*

Suppose an individual holds in one pre-2008 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.

### 11.14.5 *Remittance of gain or remittance of base cost?*

Suppose a foreign domiciliary purchases a foreign asset for £1m; they sell it for £3m and realises a pre-2008 chargeable gain of £2m. If they remit the entire £3m proceeds, the entire £2m gain is charged to CGT. But what is the position if they remit only £1m and retain the balance abroad? The former Inspectors Manual para.1567 published 9/95 provided:

> 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[30] arising from the disposal transactions. This is because, whilst the income content of any fund is a separate and distinguishable part of that fund, a capital gain is merely part of the whole proceeds of a disposal transaction that has no separate identifiable existence within those proceeds.

The last sentence is correct to say that a capital gain has no identifiable existence. I do not think it even exists as "part of the whole proceeds". It is not a separate or separable item of property existing at all. The gain is merely the result of a computation. The proceeds of a disposal represent

30 The italicised words are a paraphrase of the statutory test, which is not whether the amount remitted includes the gain, but whether it is in respect of the gain. Note how this rephrasing subtly bolsters the HMRC view.

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.

## 11.15 Pre-2008 mixed fund regime: HMRC examples

The RDR manual gives two examples concerning pre-2008 mixed funds. The first example involves a pre-2008 transfer from a pre-2008 mixed fund. One therefore applies the pre-2008 mixed fund rules.

**35320 Mixed Funds: Example 4 - remittances before 6 April 2008**
**Example 4** (Martyn)
The "mixed fund" rules in s809Q do not apply to amounts that are in an account before 6 April 2008 (FA2008/para 89).
M has lived in the UK for many years. He has paid UK tax on the remittance basis for all relevant tax years and has decided that he will do so again for 2008/2009.
M has his UK salary paid into his overseas bank account. He also has a salary for overseas employment and his net salary for that work of £5,000 a month is paid into the account. Dividends from a shareholding in a foreign company are also paid into the account.
On 18 March M sold some of his foreign shares. He deposited the proceeds of £5,000,000 from the sale into his overseas account. This amount is made up of £4m capital and £1m gain (no deduction of foreign tax).

| | | Credit (Debit) | Balance | Note |
|---|---|---|---|---|
| **Tax Year 2007-2008** | | | | |
| | Balance b/f | | £47,000 | 1 |
| 31 Dec | UK salary (net of tax) | £10,000 | £57,000 | |
| 31 Dec | Overseas salary (net of tax) | £5,000 | £62,000 | |
| 3 Jan | Transfer to UK account | (£5,000) | £57,000 | 2 |
| 31 Jan | UK salary | £10,000 | £67,000 | |
| 31 Jan | Overseas salary | £5,000 | £72,000 | |
| 3 Feb | Transfer to UK account | (£12,000) | £60,000 | 2 |
| 15 Feb | Dividend | £2,000 | £62,000 | |
| 29 Feb | UK salary | £10,000 | £72,000 | |
| 29 Feb | Overseas salary | £5,000 | £77,000 | |
| 3 Mar | Transfer to UK account | (£8,000) | £69,000 | 2 |
| 18 Mar | Share Sale £4m capital £1m gain | £5,000,000 | £5,069,000 | 3 |
| 31 Mar | UK salary | £10,000 | £5,079,000 | |
| 31 Mar | Overseas salary | £5,000 | £5,084,000 | |
| 3 Apr | Transfer to UK account | (£10,000) | £5,074,000 | 2 |

**Note 1**
The balance brought forward of £47,000 is made up of £15,000 UK salary,

£25,000 overseas salary and £7,000 overseas dividends all arising in, and credited during that tax year. M has paid the relevant amount of UK tax based upon his UK sources of income and the amounts of foreign income and gains that he has remitted to the UK.

**Note 2**

[This text is discussed in 11.14.2 (Remittance from mixture of capital and foreign income).]

So to establish the taxable amount of remittances made in the example above in 2007-2008 the account must be analysed. In this case the analysis is straightforward. M has brought £49,000 to the UK between December 2007 and March 2008 to meet his day to day UK spending needs. Applying the *Sterling Trust v IRC* practice outlined above, the £35,000 can be regarded as remittances consisting solely of his UK salary that has already been taxed under PAYE. Because he has claimed the remittance basis of taxation in respect of his relevant foreign income or foreign earnings for 2007-2008 he has no further amount of UK tax to pay on these amounts that stay in the Offshore account.

**Note 3**

Although not relevant in this example, for years up to 5 April 2008, where a remittance is made to the UK from a mixed fund into which the proceeds from the sale of an asset (such as a shareholding) has been paid the remittance contains a due proportion of any capital and of any capital gain arising from the disposal.

That is because, unlike income that can be identified separately, a capital gain is merely part of the money received from the sale and has no separate existence within that amount. See Capital Gains Manual CG25380 onwards (and CG25440 in particular).

### 11.15.1 *Transfer from fund with pre- and post-2008 entries*

The next example is a post-2008 transfer from a fund with pre- and post-2008 entries.

**35330 Remittances from mixed funds involving income/gains before 6 April 2008 - Example 4a**

Continuing from the example 4 above, on 5 April 2008 M's Offshore account contains:

| | | |
|---|---|---|
| **2007- 2008** | UK salary | £20,000 |
| | Overseas salary | £45,000 |
| | Overseas dividends | £9,000 |
| | Sale of shares: Capital | £4,000,000 |
| | -ditto- Gain | £1,000,000 |

| **Tax Year 2008-2009** | | **Credit (Debit)** | **Balance** | **Category** | **Note** |
|---|---|---|---|---|---|
| 6 Apr | Balance b/f | £5,074,000 | | | |
| 30 Apr | UK salary (net) | £10,000 | £5,084,000 | Para (a) | |
| 30 Apr | Overseas salary (net) | £5,000 | £5,089,000 | Para (f) | |
| 3 May | Transfer to UK acc | (£5,000) | £5,084,000 | | 1 |
| 15 May | Dividend | £2,000 | £5,086,000 | Para (g) | |

| | | | | |
|---|---|---|---|---|
| 31 May | UK salary | £10,000 | £5,096,000 Para (a) | |
| 30 May | Overseas salary | £5,000 | £5,101,000 Para (f) | |
| 30 June | UK salary | £10,000 | 5,111,000 Para (a) | |
| 30 June | Overseas salary | £5,000 | £5,116,000 Para (f) | |
| 30 June | Direct Debit | (£100,000) | £5,016,000 | 2 |

**Note 1**

Applying the ordering rules in S809Q to the account **immediately before the** transfer:

| | |
|---|---|
| **Step 1** Identify the "amount of transfer" in the relevant tax year (2008-09) | £5,000 |
| Identify the separate amounts of income, gains and capital present for the relevant tax year (2008-09) immediately before the transfer: | |
| **Para (a)** Employment income not subject to a foreign tax | £10,000 |
| **Para (f)** Employment income subject to a foreign tax | £5,000 |
| **Step 2** Identify the earliest paragraph above for the relevant year, which has an amount of income or gain in the mixed fund | |
| **Para (a)** | £10,000 |
| **Step 3** Where the amount of the remittance is less than the amount identified at Step 2 the amount remitted is treated coming entirely from that paragraph. There is no need to continue to step 4. | £5,000 |

The remittance is regarded as coming from the "earliest paragraph", that is para (a), so the £5,000 is UK employment income, so there is no taxable remittance of foreign income nor further tax to pay upon remittance.

**Note 2**

M decided to buy a residential property. He remits £100,000 to pay some legal fees [!] for the purchase on 30 June. Although M considers that this amount has come from the sale of shares in 2007-2008 the ordering rules in s809Q require the remittance to be taken into account first against all income and gains of the year in which the remittance is made.

| | |
|---|---|
| **Step 1** Identify the "amount of transfer" in the relevant tax year (2008-2009) | £100,000 |
| Identify the separate amounts of income, gains and capital present for the relevant tax year (2008-09) immediately before the transfer: | |
| **Para (a)** Employment income not subject to a foreign tax | £25,000 |
| **Para (f)** Employment income subject to a foreign tax | £15,000 |
| **Para (g)** Relevant foreign income subject to a foreign tax | £2,000 |
| **Step 2** Identify the earliest paragraph above for the relevant year, which has an amount of income or gain in the mixed fund: | |
| **Para (a)** | £25,000 |
| **Step 3** Where the amount of the remittance is greater than the amount identified at Step 2 the amount remitted is treated as | £100,000 - £25,000 = |

| | |
|---|---|
| reduced by the amount identified in Step 2. | £75,000 |
| **Step 4** Find the next paragraph/amount for that tax year. In the order of preference listed above repeat Steps 2 and 3. | |
| **Step 4** In the order of preference listed above repeat Steps 2 and 3. | |
| **Step 2** Identify the earliest paragraph: **Para (f)** | £15,000 |
| **Step 3** Where the amount of the remittance is greater | £75,000 less £15,000 = £60,000 |
| **Step 4** In the order of preference listed above repeat Steps 2 and 3. | |
| **Step 2 Para (g)** | £2,000 |
| **Step 3** | £60,000 less £2,000 = £58,000 |

At this stage all of the amounts credited to the account in 2008-09 have been matched against £100,000 remittance transfer in that year. But £58,000 has been brought to the UK that has not been "matched" under the s809Q rules (and cannot be matched because of FA2008/para89).
The remaining £58,000 is regarded as coming from the 2007-08 credits to the account. The ordering rules at section 809Q cannot be used, so instead the general principles outlined in Note 2 of example 4 above will apply.
This £58,000 will usually be regarded as a remittance of M's income and is, first and foremost (Sterling Trust principle) his taxed income and then (Scottish Provident v Allan principle) any other income - that is his foreign employment income or dividends - as he selects.
However in this case M may equally be able to demonstrate that the remaining £58,000 comes from the proceeds of the sale of shares, as he particularly sold the shares in order to fund this house purchase. If that is the case, the remaining remittance will consist of £11,600 foreign chargeable gain (1/5 due proportion – see note 3 in example 4).

How is M to demonstrate that the £58k comes from the proceeds of the sale of shares, given that the fund is mixed? The correct approach is to say that the substance is one of a remittance of capital since the purchase is for the house.

## 11.16 Remittance of nominated income or gains

### 11.16.1 *Outline*

EN FB 2008 provides:

> 14... If, in subsequent years, that "nominated" income or gains upon which the RBC has been paid is, in fact, remitted to the UK, then that income or gains will not be taxed again. However, there are ordering rules to ensure that if "nominated" income or gains is, in fact, remitted when other untaxed income and gains remain unremitted, then that unremitted income and gains is treated as being remitted before the "nominated" income and gains.

The expression "nominated income and gains" is defined in s.809I(3). The drafter thought that this was a section-wide definition only, so repeated the definition in s.809J(3). (If the definitions had been made ITA-wide definitions this repetition would not have been necessary.) The definition provides:

> (3) In this section the individual's "nominated income and gains" are the total income and chargeable gains nominated by the individual under section 809C for the relevant tax year or any earlier tax year.

The definition is discussed in 9.11.2 (Nomination of income and gains).

### 11.16.2 *"Remittance basis income and gains"*

Section 809I(4) ITA gives this term a fairly commonsense meaning:

> An individual's "remittance basis income and gains" are the foreign income and gains of the individual for all the tax years (up to and including the tax year mentioned in subsection (1)(a)) for which section 809B, 809D or 809E applies to the individual, apart from the individual's nominated income and gains.

Nominated income/gains do not count as remittance basis income/gains because they are taxed on an arising basis. The drafter thought that this was a section-wide definition only, so repeated the definition in s.809J(4):

> (4) In step (1) of subsection (1) the individual's "remittance basis income and gains" are the foreign income and gains of the individual for all the tax years (up to and including the relevant tax year) for which section 809B, 809D or 809E applies to the individual, apart from the individual's nominated income and gains.

### 11.16.3 *Nominated income/gains categories*

The taxpayer must classify all their remittance basis income and gains into 8 categories, which I will call **"the nominated income/gains categories"**. The categories are set out in s.809J(2) ITA. These are almost the same as the nine mixed fund categories but:

(1) there are casual differences of wording which do not affect the meaning; and
(2) there are (incredibly) small differences of substance (I do not see why – if any reader can suggest a reason I would be interested to know).

I here set out a table which compares the two (the differences are italicised):

| **Nominated income/gains categories** | **Mixed fund categories** |
|---|---|
| | (a) *employment income (other than income within para (b), (c) or (f))* |
| (a) relevant foreign earnings (other than those subject to a foreign tax) | (b) relevant foreign earnings (Other than income within para (f)) |
| (b) foreign specific employment income (other than income subject to a foreign tax) | (c) foreign specific employment income (other than income within para (f)) |
| (c) relevant foreign income (other than income subject to a foreign tax) | (d) relevant foreign income (other Than income within para (g)) |
| (d) foreign chargeable gains (other than gains subject to a foreign tax) | (e) foreign chargeable gains (other than chargeable gains within para (h)) |
| (e) *relevant foreign earnings subject to a foreign tax* | (f) employment income subject to a foreign tax |
| (f) *foreign specific employment income subject to a foreign tax* | |
| (g) relevant foreign income subject to a foreign tax | (g) relevant foreign income subject to a foreign tax |
| (h) foreign chargeable gains subject to a foreign tax | (h) foreign chargeable gains subject to a foreign tax |
| | (i) income or capital not within another paragraph |

Section 809J(6) ITA defines foreign tax for the purpose of the nominated income/gains categories:

> In subsection (2) "foreign tax" means any tax chargeable under the law of a territory outside the UK.

The same definition is used for the mixed funds categories and I discuss the definition there.[31]

### 11.16.4 *Condition for application of nominated income remittance rules*

Section 809I ITA provides:

> **809I Remittance basis charge: income and gains treated as remitted**
> (1) This section applies if—
> (a) any of an individual's nominated income and gains is remitted to the UK in a tax year, and
> (b) any of the individual's remittance basis income and gains has not been remitted to the UK in or before that year.
> (2) Income tax and capital gains tax are charged, for that year and subsequent tax years, as if
> [a] the income and chargeable gains treated under section 809J as remitted to the UK by the individual in that tax year had been so remitted
> [b] (and income and chargeable gains of the individual that were actually remitted in that year had not been).

So we turn to s.809J ITA, which sets out artificial or fictional remittance rules which I call **"the nominated income remittance rules".** (It would be more accurate to call this "the nominated income/*gains* remittance rules", but for convenience I shall where possible refer to income (rather than income/gains) and leave gains to be understood.)

Section 809J(1) provides:

> **809J Section 809I: order of remittances**
> (1) If section 809I applies, the following steps are to be taken for the purpose of determining the income or gains treated in a tax year ("the

31 See 11.3 (Ingredients of a mixed fund).

relevant tax year") as remitted to the UK by the individual.

The section sets out six steps. It is easier to follow the steps if one has an example in mind.

Suppose T (a remittance basis taxpayer) has remittance basis income and gains of £10k per annum of each of the nominated income/gains categories thus:

| **Category** | **Type of income (in short)** | **Year 1** | **Year 2** |
|---|---|---|---|
| (a) | relevant foreign earnings | £10k | £10k |
| (b) | foreign specific employment income | £10k | £10k |
| (c) | relevant foreign income | £10k | £10k |
| (d) | foreign chargeable gains | £10k | £10k |
| (e) | foreign taxed relevant foreign earnings | £10k | £10k |
| (f) | foreign taxed foreign specific employment income | £10k | £10k |
| (g) | foreign taxed RFI | £10k | £10k |
| (h) | foreign taxed gains | £10k | £10k |

Suppose T has in addition to the above £30k nominated income and gains per annum.

T remits nothing in year 1. In year 2 T remits:
(a) £1k from T's nominated income/gains.
(b) £80k from T's remittance basis income/gains.

This brings the nominated income remittance rules into action. (Even if only 1p of the nominated income/gains had been remitted, that would suffice. There is no de minimis rule.[32])

32 HMRC say they will take this point. March 2009 Qs & As provides:

"**Q13:** Cross-collateralisation of debts. Many banks are currently setting up dedicated accounts (with capital of say £100) which will earn just sufficient income (say £1) to be used as nominated income for the purposes of the £30,000 charge. However, under their standard terms and conditions, the bank will often have a floating charge over every account the individual has with them as support for any lending. If any of that lending is brought into the UK then there is a concern that the £1 income in the nominated account might be said to be 'used outside the UK in respect of a relevant debt' because it is, theoretically at least, capable of being taken in support of the borrowing under the cross-collateralisation. In practice, of course, the £1 in the nominated income account

*Step 1*
*Find the total amount of—*
*(a) the individual's nominated income and gains, and*
*(b) the individual's remittance basis income and gains,*
*that have been remitted to the UK in the relevant tax year.*
*This amount is "the relevant amount".*

In the example the relevant tax year is year 2. Applying the facts of the example, the relevant amount is £81k.

*Step 2*
*Find the amount of foreign income and gains of the individual for the relevant tax year (other than income or chargeable gains nominated under section 809C) that is within each of the categories of income and gains in paras (a) to (h) of subsection (2).*
*If none of sections 809B, 809D and 809E apply to the individual for that year, treat those amounts as nil (and accordingly go to step 6).*

"The amount of foreign income and gains of the individual for the relevant tax year (other than income or chargeable gains nominated under section 809C)" means the remittance basis income/gains. (It appears that the drafter has forgotten to use the term which the drafter has defined (twice) for this purpose; but it does not matter.) The amount in the example is as set out in the table above.

*Step 3*
*Find the earliest paragraph for which the amount determined under*

makes no difference one way or the other to the bank's security. One answer to this, of course, is for the banks to change their standard terms and conditions to exclude the nominated account. However, this is easier said than done and is unlikely in most cases to be done before 6 April 2009. The concern, as you will realise, is that if any nominated income is - as a result of this - deemed to be remitted then this results in re-characterisation under s809I and s809J, spoiling careful account segregation for ever afterwards.
Is there any possibility that we could have some de minimis here so that, say, up to £100 of nominated income would not be treated as remitted in these circumstances?
**A:** No. Whether or not this is an issue will depend on the terms and conditions attached to the accounts and loans held with the bank or other financial institution. If individuals are concerned about this issue then it would make sense to simply open a separate account with a different financial institution."

> *step 2 is not nil.*

The earliest paragraph is para (a).

> *If that amount does not exceed the relevant amount, treat the individual as having remitted the income or gains within that paragraph (and for that tax year).*

The individual is treated as having remitted £10k relevant foreign earning, category (a) for year 2.

> Otherwise, treat the individual as having remitted the relevant proportion of each kind of income or gains within that paragraph (and for that tax year).
> "The relevant proportion" is the relevant amount divided by the amount determined under step 2 for that paragraph.

(Had the total remittance been (say) £5k then the relevant proportion would have been £5k÷£10k = 50% so the transfer would have been treated as containing £5k employment income category (a) for year (1).)

> *Step 4*
> Reduce the relevant amount by the amount taken into account under step 3.

The relevant amount is reduced to £71k.

> *Step 5*
> If the relevant amount (as reduced under step 4) is not nil, start again at step 3.
> In step 3, read the reference to the earliest paragraph of the kind mentioned there as a reference to the earliest such paragraph which has not previously been taken into account under that step.

Following this iterative procedure a total of eight times, the transfer is treated as containing:

| | |
|---|---|
| (a) relevant foreign earnings | £10k |
| (b) foreign specific employment income | £10k |
| (c) relevant foreign income | £10k |
| (d) foreign chargeable gains | £10k |
| (e) foreign taxed RFE | £10k |

| | | |
|---|---|---|
| (f) | foreign taxed SEI | £10k |
| (g) | foreign taxed RFI | £10k |
| (h) | foreign taxed gains | £10k |
| | **Total** | **£80k** |

The relevant amount is by this stage reduced to £1k. We move to the next step:

> *Step 6*
> *If the relevant amount (as reduced) is not nil once steps 3 to 5 have been undertaken in relation to all paragraphs of subsection (2) for which the amount determined under step 2 is not nil, start again at step 2.*
> *In step 2, read the reference to the foreign income and gains of the individual for the relevant tax year as a reference to such of the foreign income and gains of the individual for the appropriate tax year as had not been remitted*[33] *by the beginning of the relevant tax year.*
> *"The appropriate tax year" is the latest tax year which is—*
> *(a) before the last tax year for which step 2 has been undertaken, and*
> *(b) a tax year for which section 809B, 809D or 809E applies to the individual.*

Thus we repeat step 2 a last and ninth time, reading "the relevant tax year" to mean year 1. So the remittance of £81k is treated as being:

| | | |
|---|---|---|
| (a) | relevant foreign earnings | £11k |
| (b) | foreign specific employment income | £10k |
| (c) | relevant foreign income | £10k |
| (d) | foreign chargeable gains | £10k |
| (e) | foreign taxed RFE | £10k |
| (f) | foreign taxed SEI | £10k |
| (g) | foreign taxed RFI | £10k |
| (h) | foreign taxed gains | £10k |
| | **Total** | **£81k** |

33 Section 809J(5) ITA provides:
In step 6 of subsection (1) the reference to income or gains being remitted is—
(a) as respects any tax year before section 809I applies, to income or gains being remitted to the UK, and
(b) as respects any tax year in relation to which that section applies, to income or gains treated under this section as so remitted.

March 2009 Qs & As provides:

> **Q3:** HM Revenue & Customs (HMRC) have indicated that individuals do not have to specify which account the nominated income comes from, and from this it could be inferred that without further disclosure of the particulars of the account the taxpayer may be at risk of "tainting" every other source of income of that type. For example if an individual has an account with one bank in Jersey and another bank in a different jurisdiction, he could nominate bank interest on his Jersey account, so that it would be obvious that if he remitted income from his other account, he might not fall foul of re-characterisation provisions. However, this may not be the case if he had three different accounts with the same bank in Jersey and he wishes to nominate income from one of those accounts without disclosing the account number of that account. Can HMRC clarify what their approach to this will be?
> **A:** It is up to the individual to decide how much information to give HMRC on their Self Assessment returns in order to identify the source of the nominated income or gains; if, as in this example, there is more than one account the individual should provide sufficient detail to distinguish between them and identify the "nominated" account. That might be the entire account number, or the account "name", or some other unique identifying feature of the account.

March 2009 Qs & As makes an obvious point:

> **Q6:** If I use nominated income or gains to pay the remittance basis charge of £30,000 it would appear that does not trigger the provisions in sections 809I and 809J. Is that right?
> **A:** If £30,000 of the nominated income or gains is brought to the UK to pay the remittance basis charge, it is treated as not remitted to the UK under section 809V. Therefore section 809I does not apply because none of the individual's nominated income or gains is regarded as having been remitted to the UK in that tax year. If the £30,000 is repaid by HMRC then it is treated as remitted at that point and so section 809I will be triggered.

### 11.16.5 *Accidental remittance of nominated income/gains*

The RDR Manual provides:

**35140 Remittances of nominated income or gains - miscellaneous**
If an individual accidentally remits any nominated income or gains to the UK then HMRC will allow them to undo their mistake, by reversing the transfer without unreasonable delay and in any event before the end of the tax year, for example by paying the income or gains back to the original account, so that the ordering rules at s809I and s809J will not apply.
HMRC will only use its discretion in such situations as long as there have been no relevant transactions or other benefits conferred on a relevant person in the interim. Otherwise the s809J ordering rules will apply.
For example, if £20,000 is transferred in error from an overseas bank to a UK bank account and two weeks later the account owner realises the mistake and immediately transfers that £20,000 directly back to the overseas bank account, HMRC will accept that s809I and s809J do not apply. However if, for example, the £20,000 was spent in the UK and then £20,000 from another UK account was transferred back to the overseas account then s809I and s809J do apply.

### 11.16.6 *Remittance basis charge and section ITA07/s809V*

The RDR Manual provides:

**35140 Remittances of nominated income or gains - miscellaneous**
If taxpayers use nominated income or gains to pay the remittance basis charge of £30,000 it is treated as not remitted to the UK under ITA07/s809V (see RDRM34020 Remittance basis charge – money paid directly to HMRC). Therefore the "ordering rules" at ITA07/s809I and s809J do not apply because none of the individual's nominated income or gains is regarded as having been remitted to the UK in that tax year. If the £30,000 is repaid by HMRC then it is treated as remitted at that point and so s809I is triggered.

### 11.16.7 *HMRC example*

The RDR Manual provides:

**35150 Remittances of nominated income or gains** [July 2010]
*Example 1* (Alexandria)
... *A has foreign income or gains, and uses the remittance basis as follows*

| | Foreign gains Para (d) | Jersey RFI Para (c) | Jersey RFE Para(a) | Nomination (from Jersey RFI) |
|---|---|---|---|---|
| 2010-11 | £250,000 | £75,000 | £200,000 | £75,000 RFI |
| 2011-12 | £300,000 | £80,000 | £120,000 | £75,000 RFI |
| 2012-13 | Nil | £75,000 | £280,000 | £75,000 RFI |
| 2013-14 | £130,000 | £80,000 | £150,000 | £75,000 RFI |
| Totals | £680,000 | £310,000 | £750,000 | |

*In 2013-14 A actually and identifiably remits*

£30,000 Jersey relevant foreign income that she nominated in 2010-11,
£140,000 foreign chargeable gains from 2011-12 and
£50,000 relevant foreign earnings from 2013-14.

*The ordering rules are triggered. The "relevant year" is 2013-14*

| | | | |
|---|---|---|---|
| **Step 1** Identify nominated income and gains remitted in the relevant year | £30,000 | **Relevant Amount** | £220,000 |
| Identify the remittance basis income and gains remitted in the relevant year | £190,000 | | |
| **Step 2** | | | |
| Find the total amount of the individual's foreign income and gains (excluding those nominated) for the relevant tax year | **Para (a)** Relevant foreign earnings (not subject to a foreign tax) | | £150,000 |
| | **Para (c)** Relevant foreign income (not subject to a foreign tax) | | £5,000 |
| | **Para (d)** Foreign chargeable gains (not subject to a foreign tax) | | £130,000 |
| **Step 3** Identify the earliest of paragraphs (a) to (h) above for which the amount determined in Step 2 is not nil. | **Para (a)** | | £150,000 |
| **Step 4** Where the relevant amount is greater than the amount identified above the relevant amount is reduced by the amount identified | £220k less £150k = £70,000 | | |

**Step 5** If the relevant amount is not nil go back and repeat Step 3. Take the reference to the first of paragraphs (a) to (h) as a reference to the earliest paragraph not previously taken into account under Step 3.

| | | |
|---|---|---|
| **Step 3** repeated | **Para (c)** | £5,000 |
| **Step 4** repeated | Relevant Amount reduced to: | £65,000 |

**Step 5** In the order of preference listed above repeat Steps 3 and 4.

| | | |
|---|---|---|
| **Step 3** repeated | **Para (d)** | £130,000 |

**Step 4** If the relevant amount is less than the amount identified, treat the whole of the remaining amount of the transfer as coming from that item of income or gain.

*So A will be taxed on £220,000 of remittances as if she had actually remitted the following*

| | | 2010-11 | 2011-12 | 2012-13 | 2013-14 |
|---|---|---|---|---|---|
| **Foreign chargeable gains** | Accruing in year | £250,000 | £300,000 | Nil | £130,000 |
| | Actually remitted | £Nil | £140,000 | £Nil | £Nil |
| | Treated as remitted | £Nil | £Nil | £Nil | £65,000 |
| **Relevant foreign income Nominated** | Arising in year | £75,000 | £75,000 | £75,000 | £75,000 |
| | Actually remitted | £30,000 | £Nil | £Nil | £Nil |
| | Treated as remitted | £Nil | £Nil | £Nil | £Nil |
| **Relevant foreign income Not nominated** | Arising in year | £Nil | £5,000 | £Nil | £5,000 |
| | Actually remitted | £Nil | £Nil | £Nil | £Nil |
| | Treated as remitted | £Nil | £Nil | £Nil | £5,000 |
| **Relevant foreign earnings** | Accruing in year | £200,000 | £120,000 | £280,000 | £150,000 |
| | Actually remitted | £Nil | £Nil | £Nil | £50,000 |
| | Treated as remitted | £Nil | £Nil | £Nil | £150,000 |

If in future years she actually remits any of these monies, the ordering rules will treat her as having remitted something else instead (refer to RDRM35160 - example 1 continuation).

**35160 Remittance of "nominated" income or gains** [July 2010]

*Example 1 - Continued*

Moving forward, in 2014-15 A has relevant foreign earnings of £80,000, but no other foreign income or gains. She decides not to use the remittance basis in that year.
In 2014-15 A actually brings into the UK;
£5,000 Jersey relevant foreign income that she did not nominate in 2013-14 (note 1)
£80,000 relevant foreign earnings from 2013-14 and
£80,000 relevant foreign earnings from 2014-15
Although A is not using the remittance basis in 2014-15, the ordering rules at s809J ITA 2007 are still required to determine what she is to be taxed as having remitted in that year. The relevant year is 2014-15.

*Ordering rules at 2014-15*

| | | | |
|---|---|---|---|
| **Step 1** Identify nominated income and gains remitted in the relevant year (2014-15) | £nil | **Relevant Amount** | £85,000 |
| Identify the remittance basis income and gains remitted in the relevant year | £85,000 (see note 2) | | |
| **Step 2** Find the total amount of the individual's | Nil | | |

foreign income and gains (excluding those nominated) for the relevant tax year If the remittance basis was not used in that year (that is sections 809B, 809D or 809E did not apply), treat those amounts as nil and go to step 6

**Step 6**

If the relevant amount is not nil, start again at step 2. Take the reference to "relevant year" to be a reference to foreign income of gains of the individual for the earliest 'appropriate year' previous to the lat tax year from which Step 2 was undertaken.

| | | |
|---|---|---|
| **Step 2** Find the total amount of the individual's foreign income and gains (excluding those nominated) for the appropriate tax year (2013-14) (see note 3) | **Para (d)** Foreign chargeable gains (not subject to a foreign tax) | £65,000 |
| **Step 3** Identify the earliest of paragraphs (a) to (h) above for which the amount determined in Step 2 is not nil. | **Para (d)** | £65,000 |
| **Step 4** Where the relevant amount is greater than the amount identified above the relevant amount is reduced by the amount identified | Relevant Amount reduced to: | £85k less £65k = £20,000 |

**Step 5** If the relevant amount is not nil go back and repeat Step 3. Take the reference to the first of paragraphs (a) to (h) as a reference to the earliest paragraph not previously taken into account under Step 3.

**Step 6**

If the relevant amount is not nil after Steps 3-5 have been completed for the year, start again at step 2. Take the reference to 'relevant year' to be a reference to foreign income of gains of the individual for the earliest 'appropriate year' previous to the lat tax year from which Step 2 was undertaken.

| | | |
|---|---|---|
| **Step 2** Find the total amount of the individual's foreign income and gains (excluding those nominated) for the appropriate tax year (2012-13) | **Para (a)** Relevant foreign earnings (not subject to a foreign tax) | £280,000 |
| **Step 3** Identify the earliest of paragraphs (a) to (h) above for which the amount determined in Step 2 is not nil | **Para (a)** | £280,000 |

**Step 4** If the relevant amount is less than the amount identified, treat the whole of the remaining amount of the transfer as coming from that item of income or gain

So in 2014-15 A is treated as having remitted
£20,000 relevant foreign earnings
£65,000 foreign chargeable gains.
NB – The £80,000 relevant foreign earnings from 2014-15 that she brings in will be taxed on the arising basis in that year.

**Note 1** In 2013-14 A has £80,000 of Jersey relevant foreign income, of which £75,000 were nominated; if this £80,000 were all in the one single account, and there was nothing else in the account then, under the principle of this section the first £5,000 remitted in 2014-15 is accepted as being "not-nominated" income. In this example it is of little practical difference because the s809J ordering rules have already been "triggered" in 2013-14 by her remittance of nominated income (from 2010-11).

But if the ordering rules had not already been triggered, then because, this £5,000 Jersey relevant foreign income in 2014-15 can be accepted as being "unnominated" income first and foremost, so A's remittance of this £5,000 would not, of itself, have triggered the s809J ordering rules in this year.

**Note 2** A's remittance basis income and gains are her total foreign income or chargeable gains for all tax years up to the "relevant tax year (2014-15) in which she used the remittance basis under section 809B, section 809D or section 809E. It therefore excludes her relevant foreign earnings from 2014-15 because she is not using the remittance basis in that year.

**Note 3** the 'foreign income and gains 'for' the appropriate year exclude any:

- 'nominated' income or gains, or
- income or gains that were actually remitted to the UK before the beginning of the appropriate tax year or
- income or gains that were treated as remitted to the UK previously under section 809J before the beginning of the appropriate tax year.

In A's case, the £5,000 Jersey relevant foreign income from 2013-14, and the £80,000 relevant foreign earnings from 2013-14 that she actually remitted in 2014-15 were treated as having been remitted in 2013-14 by the ordering rules (refer to the earlier part of example 1 RDRM35150).

*Summary*

| | | **2010-11** | **2011-12** | **2012-13** | **2013-14** | **2014-15** |
|---|---|---|---|---|---|---|
| **Foreign chargeable gains** | Accruing in year | £250,000 | £300,000 | £Nil | £130,000 | £Nil |
| | Actually brought to UK | £Nil | £140,000 | £Nil | £Nil | £Nil |
| | Treated as remitted | £Nil | £Nil | £Nil | £130,000 | £Nil |
| **Relevant foreign income Nominated** | Arising in year | £75,000 | £75,000 | £75,000 | £75,000 | £Nil |
| | Actually brought to UK | £30,000 | £Nil | £Nil | £Nil | £Nil |
| | Treated as remitted | £Nil | £Nil | £Nil | £Nil | £Nil |
| **Relevant foreign income Not nominated** | Arising in year | £Nil | £5,000 | £Nil | £5,000 | £Nil |
| | Actually brought to UK | £Nil | £Nil | £Nil | £5,000 | £Nil |
| | Treated as remitted | £Nil | £Nil | £Nil | £5,000 | £Nil |
| **Relevant foreign earnings** | Arising in year | £200,000 | £120,000 | £280,000 | £150,000 | £80,000 |
| | Actually brought to UK | £Nil | £Nil | £Nil | £130,000 | £80,000 |
| | Treated as remitted | £Nil | £Nil | £20,000 | £150,000 | £Nil |

## 11.16.8 *De minimis relief from 2012/13*

The remittance consultation paper provides:

> **Nominated income**
> 2.67 Non-domiciles who have been UK resident in at least seven of the past nine tax years are liable to an annual charge of £30,000 if they claim the remittance basis. The rules governing the payment of this charge can be very complicated and result in significant administrative burdens and inconvenience for the taxpayer.
> 2.68 Those who elect to pay the charge are required to nominate an amount of their overseas income and capital gains which is taxable on the arising basis and is deemed to generate an additional tax charge of £30,000.
> 2.69 There are complicated rules to ensure that an individual cannot subsequently remit any of the income or capital gains which they have nominated before other overseas income andcapital gains which would be taxed in the UK when remitted.This must be in addition to the UK tax to which they are otherwise liable on income and capital gains arising in the UK or remitted to the UK. This nomination ensures that the £30,000 is a tax charge on overseas income and gains rather than a standalone levy.
> 2.70 Individuals can encounter significant administrative difficulties where they fail to keep their nominated income and capital gains segregated from other income and capital gains. In such situations, an individual might inadvertently remit some of their nominated income and capital gains to the UK. This will mean that they become subject to complicated identification rules which trace the origin of each payment and ensure that the nominated amounts are always the last to be remitted. In the absence of these rules, it would be possible for an individual to reduce significantly the amount of tax they pay on the income or capital gains which they remit to the UK.
> 2.71 To avoid some of these complexities, it is common for an individual to open an overseas bank account which has the sole purpose of holding funds to generate sufficient income to be nominated for the purposes of the annual charge. Whilst this should allow the individual to avoid the identification rules, the need to set up a special overseas bank account involves additional expenditure and administrative obligations. Moreover, even where an individual has a dedicated bank account for their nomination, it cannot be guaranteed that they would never inadvertently make remittances from the account.
> 2.72 The Government recognises that this can result in excessive and

unhelpful complexity which is hard for the taxpayer to understand. It therefore proposes to amend the legislation to allow individuals to remit the first £10 of income or capital gains which they nominate free of tax and without becoming subject to the identification rules. This will enable them to nominate up to £10 of their foreign income or capital gains for the purposes of the £30,000 charge without having to ensure they do not subsequently remit any part of that nominated amount to the UK. Many individuals only nominate a small amount of foreign income or capital gains and so this simplification would remove the risk of them inadvertently remitting the nominated income and triggering the identification rules.
2.73 This would significantly reduce the need to maintain an overseas bank account solely for the purposes of nominating income and capital gains, whilst making the nomination rules less administratively onerous.
2.74 The remaining rules applying to nominated income and capital gains will remain unaltered.[34]

## 11.17 Nominated income: commentary

In short, the effect of the nominated income remittance rule is that remittances are treated as being made in the nominated income/gains priority order, taking more recent years before earlier years (regardless of the actual remittances). As in the case of the "steps" of the mixed fund rules, one is tempted to ask: why didn't the statute simply say so?

But the drafting is the least of the problems of the nominated income remittance rule. The author of the EN anticipates criticism that this is administratively difficult and offers some tax planning advice:

> 14...The rules dealing with this in sections 809I and 809J will require additional records to be maintained from 6 April 2008 or the first year of residence in the UK, if later.
> 15. The record keeping necessary for sections 809I and 809J can be avoided if individuals ensure that "nominated" income or gains upon which the RBC is paid are not remitted to the UK, or only remitted after the remittance of all other unremitted income and gains since the first year of residence from April 2008. If an individual is confident they will never need to remit that "nominated" income or gains, paying the RBC

34 HMT & HMRC, "Reform of the taxation of non-domiciled individuals: a consultation" (June 2011) accessible *www.hm-treasury.gov.uk/d/consult_condoc_non_domicile_individuals.pdf.*

> will not involve any extra complexity or record keeping.[35]

Even if this advice were correct it would not help the majority of remittance basis taxpayers, but they should not complain about administrative complexity: they are responsible for the problem, which they brought on themselves by making a claim for the remittance basis:

> 16. As mentioned earlier, those eligible can choose whether or not to claim the remittance basis for each particular year, depending on whether it is to their advantage to do so.

But even the administrative inconvenience is not the serious problem of the rule. The effect of the rule is that if the individual remits a penny of their nominated income/gains, one disregards entirely the actual remittances and charges on the basis of the fictional rules. Thus an individual who actually remits gains is taxed as if they remitted income (as long as they also remits a penny of nominated income). It is therefore in principle desirable to take care not to remit any nominated income/gains.

35 The last sentence is not correct. It is not enough that an individual is "confident that they will never need to remit that nominated income or gains". The individual must be able to demonstrate to HMRC that they have not remitted, and that requires record keeping.

CHAPTER TWELVE

# EMPLOYMENT INCOME

## 12.1 Employment income - Introduction

The taxation of employment income is mainly governed by ITEPA 2003. Though now dwarfed by the CTAs 2009 and 2010, ITEPA was for its day a mammoth Act: the table of contents is 36 pages long. At least a dozen volumes would be required for a full discussion of the topic. This chapter focuses on matters closest to the theme of this work but the provisions dealing with foreign domiciliaries and non-residents can only be understood in the context of the UK provisions so I begin with a more general outline.

For benefits in kind see 65.6 (Home owned by company: benefit in kind charge), 65.34 (Chattels held by companies) and 40.5 (Employment-related loans). For NICs see 42.1 (National insurance contributions).

I do not discuss employment-related securities but hope to do so in a future edition.

## 12.2 Terminology

It is helpful to begin with some definitions.

### 12.2.1 *"Employer", "employee" and "employment*"

Sections 4 and 5 ITEPA provides a relatively commonsense definition of these terms. Section 5 extends the concept of "employment" to include offices (because directors need not as a matter of employment law be employees):

> (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.

### 12.2.2 *"Employment income" "general earnings" "specific employment income"*

"Employment income" is the general category which is subdivided into two subcategories: general earnings and specific employment income. "General earnings" and "specific employment income" are somewhat opaque terms. Section 7 ITEPA provides a referential definition:

> (1) This section gives the meaning for the purposes of the Tax Acts of "employment income", "general earnings" and "specific employment income".
>
> (2) "Employment income" means—
>
> (a) earnings within Chapter 1 of Part 3,
>
> (b) any amount treated as earnings (see subsection (5))[1], or
>
> (c) any amount which counts as employment income (see subsection (6)).[2]
>
> (3) "General earnings" means—

1 Subsection (5) provides:
"Subsection (2)(b) or (3)(b) refers to any amount treated as earnings under—
(a) Chapters 7 to 9 of this Part (agency workers, workers under arrangements made by intermediaries, and workers providing services through managed service companies),
(b) Chapters 2 to 11 of Part 3 (the benefits code),
(c) Chapter 12 of Part 3 (payments treated as earnings), or
(d) section 262 of CAA 2001 (balancing charges to be given effect by treating them as earnings)."

2 Subsection (6) provides:
"(6) Subsection (2)(c) or (4) refers to any amount which counts as employment income by virtue of—
(a) Part 6 (income which is not earnings or share-related),
(b) Part 7 (income and exemptions relating to securities and securities options), or
(c) any other enactment."

(a) earnings within Chapter 1 of Part 3, or
(b) any amount treated as earnings (see subsection (5)),
excluding in each case any exempt income.
(4) "Specific employment income" means any amount which counts as employment income (see subsection (6)), excluding any exempt income.

Specific employment income includes payments on termination of employment and employment-related securities. These topics are not discussed in this work so it is not necessary to consider the terms in further detail.

## 12.3 The charge to tax on employment income

One would expect ITEPA to begin with a provision saying that income tax is charged on employment income. In fact this is implied rather than expressed: s.6 ITEPA provides:

**6 Nature of charge to tax on employment income**
(1) The charge to tax on employment income under this Part is a charge to tax on—
(a) general earnings, and
(b) specific employment income.

Still, the imposition of the charge is clear enough. Section 6 continues:

(2) The amount of general earnings or specific employment income which is charged to tax in a particular tax year is set out in section 9.

Thus ITEPA draws a distinction between what is charged (employment income) and the amount which is charged. This is familiar from other types of income.

## 12.4 Amount charged to tax (taxable earnings)

So we turn to s.9 ITEPA which provides:

(1) The amount of employment income which is charged to tax under this Part for a particular tax year is as follows.

> (2) In the case of general earnings, the amount charged is the net taxable earnings from an employment in the year.

"Net" taxable earnings brings in the rules relating to deductions, not discussed here. "Taxable" earnings is a label which brings in a large number of rules, for in the various situations where the statute desires to bring earnings into charge in a year it provides that they are "taxable" earnings from the employment in that year. Section 9 continues:

> (3) That amount is calculated under section 11 by reference to any taxable earnings from the employment in the year (see section 10(2)).
> ...
> (6) Accordingly, no amount of employment income is charged to tax under this Part for a particular tax year unless—
> (a) in the case of general earnings, they are taxable earnings from an employment in that year, ...

Section 9(3) is just a signpost provision; and s.9(6) expresses what would obviously be the case.

## 12.5 Taxable earnings

Section 10 ITEPA provides the starting point of the definition:

> (1) This section explains what is meant by "taxable earnings" and "taxable specific income" in the employment income Parts.
> (2) "Taxable earnings" from an employment in a tax year are to be determined in accordance with Chapters 4 and 5 of this Part.

So we move on to chapters 4 and 5 part 2 ITEPA. The pace is leisurely. Bypassing two more signpost provisions (ss.14 and 20 ITEPA) we find three sections that identify amounts of taxable earnings: ss.15, 26 and 27 ITEPA.

### 12.5.1 *Summary*

The taxation of employment income can be summarised in this table:

| UK Resident | Ord Resident | UK Domicile | Taxable earnings | ITEPA Section | *Prev[3] ITEPA Section* | Part 2 Chap |
|---|---|---|---|---|---|---|
| Yes | Yes | Yes | All earnings: AB | 15 | *15* | 4 |
| Yes | Yes | No | (1) Overseas earnings: RB<br>(2) UK earnings: AB | 22(2)<br>22(7)→15 | 22<br>*21* | 5 |
| Yes | No | n/r | (1) UK duties: AB<br>(2) non-UK duties: RB | 26(2)<br>26(6)→15 | *25*<br>*26* | 5 |
| No | n/r | n/r | (1) UK duties: AB<br>(2) non-UK duties: tax free | 27<br>– | *27*<br>– | 5 |

*Key*
AB: Arising basis
RB: Remittance basis

## 12.6 Earnings "for" a year, "from the employment in a year" and "received in a year"

ITEPA uses three distinct expressions:
(1) it refers to *earnings "for" a tax year*.
(2) it refers to *earnings from the employment in a tax year*.
(3) it refers to *earnings received in a tax year*.

## 12.7 Earnings "for" a tax year

It is clumsy to refer to the year which earnings are "for" so the statute resorts to quotation marks to help the reader grasp the sense. I adopt that usage here as any paraphrase is even more confusing, but sometimes expressions such as earnings "attributed to a year" or "relating to a year" or "earned in a year" are used.

The concept (however expressed) is fundamental as the taxability of earnings depends on the employee's residence and domicile in the year which the earnings are "for".

The concept is (slightly) elucidated in s.16 ITEPA:

> (1) This section applies for determining whether general earnings are

3 I give the pre 2008-ITEPA reference because this makes it easier to follow the EI Manual which has not yet been updated for the FA 2008 reforms. I do not know why the numbers were reshuffled in 2008.

> general earnings "for" a particular tax year for the purposes of this Chapter.
> (2) General earnings that are earned in, or otherwise in respect of, a particular period are to be regarded as general earnings for that period.
> (3) If that period consists of the whole or part of a single tax year, the earnings are to be regarded as general earnings "for" that tax year.
> (4) If that period consists of the whole or parts of two or more tax years, the part of the earnings that is to be regarded as general earnings "for" each of those tax years is to be determined on a just and reasonable apportionment.
> (5) This section does not apply to any amount which is required by a provision of Part 3 to be treated as earnings for a particular tax year.[4]

Since this section only applies for the purposes of chapter 4, it has to be repeated verbatim in s.29 ITEPA for chapter 5. (If there had been an ITEPA-wide definition the duplication would not have been necessary.)

This is only intended to set out the general meaning that would have applied in the absence of a definition. EN ITEPA Note 6 provides:

> Sections 16 and 29 of the Act therefore spell out that general earnings are "for" a particular period consisting of the whole or part of a tax year if they are general earnings earned in or otherwise in respect of that period. It is thought that this reflects the meaning that a court would give to "for" if the point ever arose.

The EI Manual provides:

**40008. The year that earnings are "for"** [August 2009]

...

This question has no relevance when deciding the tax year in which the tax charge arises. Earnings are assessed to tax in the tax year in which they are "received". The definition of "received" is set out in Section 18 (see EIM42200).

***Why is it important to know the tax year that earnings are "for"?***

Section 16 establishes the year that earnings are "for". Once this has been done, the next step is to decide which of the rules in Part 2 Chapters 4 and 5 apply to calculate taxable earnings.

For the majority of UK Resident and Ordinarily Resident (R/OR) and domiciled employees, the question of the year earnings are "for" has little consequence. This is because all of their earnings are chargeable to UK income tax in consequence of their

4 This is a reference to s.72(2) ITEPA; see too s.222(2) ITEPA and 223(4) ITEPA for definitions in specialist circumstances.

residence and domicile status. In addition, most earn and receive their earnings in the same tax year. However, for those employees who are other than R/OR and UK domiciled and who receive earnings in different years from those in which they earn them, the question continues to be relevant.

***Principles from case law***

The absence of statutory provision in ICTA 1988 and earlier enactments resulted in various cases being litigated through the 20th century.

• *Edwards v Roberts* (19 TC 618)
• *Hunter v Dewhurst*, (*Henry v Foster*) (16 TC 605)
• *Draycup v Radcliffe* (27 TC 188)
• *Heasman v Jordan* (35 TC 518)
• *Board of Inland Revenue v Suite* (Privy Council) ([1986] 2 All ER 577)
• *Griffin v Standish* (67 TC 317)
• *Bray v Best* (61 TC 705)

Before 1989, the year that earnings were "for" also dictated the year in which income tax was assessed. "Receipts basis" replaced "earnings basis" in 1989.

The case of *Bray v Best* (61 TC 705), was heard by the House of Lords in 1988. Lord Oliver set out the preferred approach at page 752:

> "The period to which any given payment is attributed is a question to be determined as one of fact in each case, depending upon all of the circumstances, including its source and the intention of the payer so far as it can be gathered either from direct evidence or from the surrounding circumstances."

Lord Oliver's approach to determining the year that earnings are "for" continues to apply. Section 16 simply confirms the recommended approach.

**40009. The year that earnings are "for" - arrangement of guidance** [March 2009]

In 2007 and 2008, HMRC consulted with professional advisers with particular expertise regarding the treatment of foreign nationals coming to work in the UK and UK residents leaving the UK to work abroad. Many of the advisers' clients have complex remuneration packages. Some are members of Long Term Incentive Plans or participants in other deferred remuneration schemes. The aim of the exercise was to establish principles for determining the tax year that earnings, delivered by these arrangements, are "for".

The guidelines set out on the following pages were adopted by HMRC with effect from 28 February 2008. They are intended to be comprehensive but do not claim to cover every plan and set of circumstances that will arise.

... The guidance sets out general principles and indicates the views HMRC is likely to take in specified circumstances. It is intended to aid and inform fact finding and decision making. It is not a substitute for obtaining all of the relevant information and exercising good judgment by applying the principles to the facts. This is not an easy task as you may be required to balance one set of conditions against others. (This text has been withheld because of exemptions in the Freedom of Information Act 2000)

***Transitional arrangements***

HMRC published the following statement on 18 September 2008:

> "For the avoidance of doubt HMRC was able to confirm that where Tax Returns were submitted prior to 18 October 2007 on the basis of the established HMRC position (which regarded conditionality as the determinant factor over any specific performance period) they will not seek to challenge the Returns on that point. Furthermore, if after 18 October 2007 any individual submitted a Tax

Return for 2006/7 (or earlier) in accordance with the HMRC guidance given on 18 October 2007 HMRC will not seek to challenge the Return on this point, but if the individual wishes to change the basis and adopt the position clarified on 28 February2008 HMRC would not object to a taxpayer amendment provided that this is made within the available window."

**40011. The year that earnings are "for" - the approach to take** [March 2009]

Lord Oliver's approach set out in *Bray v Best* (61 TC 705) at page 752 should be observed when determining the year that earnings are "for":

"The period to which any given payment is attributed is a question to be determined as one of fact in each case, depending upon all of the circumstances, including its source and the intention of the payer so far as it can be gathered either from direct evidence or from the surrounding circumstances".

***Finding out the facts***

An essential starting point is to obtain contemporaneous evidence. This may include all or any of the following:

• An understanding of the intention of the employer in developing the incentive programmes
• Bonus plans
• Award letters
• Notes of meetings
• Correspondence between the parties
• Obtain an analysis of amounts paid out
• An explanation of how awards are treated in the employer-company accounts

These documents may indicate the understanding of the parties regarding the performance period that awards are intended to be "for". The intention of the employer as disclosed to the employee and the understanding of the employee are particularly significant.

Unsubstantiated recollections of the employee regarding intention should be considered but given less weight than contemporaneous documented statements.

If Plan documents and contemporaneous information do not provide clarity, it is reasonable to make inferences from available evidence.

You may ask the Large Business Team or CRM dealing with the Corporation Tax affairs of the employer company how the bonus awards have been treated in the employer company accounts. The company may claim a deduction for a single year or may create provisions to spread the deduction over a longer period. This may indicate the period the employer considers the award to be "for". The accounting treatment is not conclusive, but it is significant. In the absence of clear statements in the Plan documents the accounting treatment may be evidence of the employer's understanding of what the scheme was intended to achieve.

Lump sums may be made up of amounts arising from different bonus periods and different deferred remuneration plans. If component amounts are "for" different tax years, different rules within Part 2 Chapters 4 and 5 may apply, to produce different liabilities to income tax.

**40012. The year that earnings are "for" - annual bonuses awarded for meeting corporate, team or personal targets** [August 2009]

Many employers operate annual bonus schemes for their employees. There are usually performance criteria. These may require employees to meet corporate, team or individual targets.

Bonuses may be paid out by the employer or through a trust - usually an employee benefit trust (EBT). The identity of the payer is not relevant when determining the year that the award is "for". However, see the guidance below on "discretion".

In some schemes, particularly those referenced to company performance, employees may accrue entitlement to receive bonuses as the performance period passes. In others, entitlement is conditional on remaining in employment until a specified date (see below). The performance period and therefore the period that the bonus is "for" may be set out in the scheme documents.

If the performance period spans more than one tax year, Section 16(4) ITEPA 2003 applies. The bonus should be apportioned to the relevant tax years on the basis of a just and reasonable apportionment.

Section 16 attributes general earnings to one or more tax years. You should not accept that awards can be "for" a shorter period, even a day, to which the rules in Part 2 Chapters 4 and 5 can be applied. Employers may spontaneously award "spot-bonuses" to all employees in post on a particular date, or entitlement to a performance bonus may crystallise when a particular performance factor is satisfied. Even though these events make take place on a particular day, the resultant awards should be treated as general earnings "for" the tax year in which the event occurred.

Unless there is evidence to the contrary, HMRC takes the view that performance bonuses are "for" the performance period. This may be a calendar year or the company accounting period. In the case of specific projects, it may be the period beginning on the date when work started and ending when the specified outcomes were achieved.

***Impact of Extra Statutory Concession A11 (ESC A11)***

ESC A11 is a non-statutory concession that permits tax years to be split. It is usually relevant to years in which individuals arrive in or depart from the UK. In consequence of arrival or departure, there are discrete periods of non-residence (NR) and ordinary residence (OR) for tax purposes. If the conditions are satisfied, the tax year is split and each part treated as a separate tax year.

Where entitlement to spot bonuses or conditional bonuses arises on a single day the advice set out above indicates that the award is to be treated as earnings "for" the year in which that days falls. In ESC A11 cases this will be that part of the split year in which the relevant day falls.

Evidence suggests spot bonuses and similar payments are relatively unusual and will be seen infrequently. If you suspect that the timing of entitlement has been manipulated to gain a tax advantage from the use of ESC A11, HMRC may decide to set aside the Concession and treat the individual as resident in the UK for the whole tax year.

**40013. The year that earnings are "for" - bonuses and deferred remuneration plans - the effect of conditionality and employer's discretion** [March 2009]

***Conditionality***

Many bonus schemes are referenced to performance periods, but awards will not be paid unless employees are in employment on the date of payment. For example, a bonus is referenced to company profits for year ended 31 December but is not paid until the following 30 June. Employees who worked for the employer during the performance year forfeit their entitlement if they leave employment before 30 June.

Up to 28 February 2008, HMRC took the view that the bonus award could only be "for" the year in which unfettered entitlement to receive it arose. The year that the bonus was "for" was the year in which the employment condition was satisfied. Since 28 February

2008, HMRC has adopted the principles set out in EIM40008 and subsequent pages.

***Good and bad leavers***

Many of the plans with employment conditions identify "good" and "bad" leavers and prescribe different treatments for the two categories. "Good leavers" are employees who cease employment before the bonus payment date through retirement, redundancy or ill-health. "Bad leavers" are those who are dismissed for cause or resign to join a competitor.

It is possible to take various views on the year that such bonus awards are "for" where there is an employment condition:

- The performance period
- The performance period plus the period from the end of the performance period to the date of payment, sometimes referred to as the "vesting period"
- The year in which the date of payment falls

Your decision should take account of what the bonus scheme is intended to achieve. If this is not clear from the documents, you may base judgments on how the employer treats good and bad leavers.

Plans that:

- are designed to provide incentives to employees for performance periods, but,
- do not pay out unless the participants are still in employment at the specified date, but,
- do not specify any additional performance conditions in the period beginning after the original performance period and ending on the payment date,

are likely to pay out awards that are "for" the original performance period. However, if the Plan introduces additional performance conditions for the second period the period that the award is "for" is likely to be the aggregate of both periods.

If "good leavers" are entitled to receive awards; that may indicate that the awards are "for" the original performance period. Entitlement to pro-rated awards may indicate that entitlement is "for" the performance and the vesting periods.

Some schemes provide for deferred bonuses to be paid out when ownership of the company changes hands. This may be an indicator that the bonus is earned by that date and is "for" the relevant performance period.

Even though these contingencies may not occur for all or any of the plan participants, their existence may shed light on the period the bonus is intended to be "for".

It is sometimes argued that the employment condition is never just about being in employment on the specified date; that the intention of the employer in introducing this condition is to obtain satisfactory performance in the period ending on the date of payment. This may well be the case. If evidence can be found to support the contention you should accept that the period the awards from the Plan are "for" is the combined performance and vesting periods.

***Employers' discretion***

Some bonus schemes give the employer absolute discretion to award or refuse to award bonuses. The discretion may lie with the trustees if an Employee Benefit Trust (EBT) pays out the awards. The Courts have held that, whatever the Plan says, an employer's discretion in awarding or withholding a bonus is not unfettered. However wide the discretion appears to be, the employer is required to exercise his discretion rationally and in good faith, and not irrationally or perversely.

There may be a pattern of awards that may indicate the year the awards are "for". Employees may also have an understanding of how the bonus scheme works, and the period awards are referenced to, while accepting the employer's discretion.

A discretionary bonus may therefore be "for" the performance period, the combined performance and "vesting" period or the year in which discretion is exercised and payment is made. It is important to consider all of the relevant information.

**40014. The year that earnings are "for" - Long Term Incentive Plans and Deferred Remuneration** [March 2009]

Various schemes exist to reward and provide incentives to employees. Not all intended outcomes will be the same. The intention of the employer and the intended behavioural effect will influence the design of the scheme. For example, plans may be intended to:

• Tie-in valued employees and create a disincentive for leaving and moving to a competitor, or,
• Motivate and reward outstanding performance by aligning the interests of employees with those of the shareholders

Schemes intended to aid retention may include the following features:

• Bonuses are paid after 3 – 5 years of satisfactory employment
• The employer has discretion to award or deny bonuses for good or bad leavers
• Part bonuses are paid year on year with other entitlement remaining in the Plan
• Part entitlement to bonuses "vests" each year, but is not paid until a later year

Schemes intended to motivate and reward outstanding performance may include:

• Employment targets linked to growth in the company's:
– share price
– turnover
– net profits
– expansion of certain markets
– market share
• Granting employees real stocks and shares or "phantom" shares in the company. (In the phantom schemes, no stocks or shares are assigned to the employees. Bonus entitlement is calculated by reference to a notional share portfolio.)

Payments may be made up of amounts arising from different bonus periods and different deferred remuneration plans. If component amounts are "for" different tax years, different rules within Part 2 Chapters 4 and 5 may apply, to produce different liabilities to income tax.

Awards from both types of schemes are likely to be "for" the whole performance or reference period. If this is greater than one tax year then the final award should be apportioned over the tax years falling into the performance period on a reasonable basis.

**40015. The year that awards from Long Term Incentive Plans and other deferred remuneration arrangements are "for"** [March 2009]

***Entry to Long Term Incentive Plans (LTIPs)***

If employees perform exceptionally well, they may be invited to participate in an LTIP. LTIPs run for pre-determined period that can be as long as 10 years. This process may repeat year after year so that employees are simultaneously members of several Plans. In any particular year they may receive part awards from some and entire awards from others.

The initial investment is often funded by part of the participant's bonus for the previous year. The employee may be obliged to defer all or part of the previous year's bonus or may do so voluntarily. Plans may require a mixture of the two. The initial contribution may be guaranteed, in the sense that it cannot be lost, and/or it may have the potential to increase and decrease dependant on what the Plan tracks, for example, share price or company turn-over.

Other plans, particularly phantom share schemes, may simply award notional stock without any requirement for deferral from an earlier bonus.

In addition to the anticipated growth in the share price that adds value to the participants' awards, employers may make additional awards of stock to increase the value of the notional portfolio. These "matching awards" may be granted throughout the life of the scheme at times specified in the plan document.

***Deferred bonuses and matching awards***

Employers may defer the payment of bonuses and make eventual payment subject to conditions. For example, the employer awards a bonus of £100,000 referenced to a performance period. £75,000 is paid in cash immediately following the bonus year; £25,000 is to be paid three years later in cash or shares, if the employee has not resigned or been dismissed before the vesting date. Such a deferral may be imposed by the employer, or it may be entered into voluntarily by the employee. To develop the example, the £25,000 deferral may be required by the employer but the employee has the choice of voluntarily deferring a further £25,000. In both scenarios, the employer may offer an enhancement or matching award. The matching award may be delivered in the form of shares or cash. The matching award may be added to the LTIP at the beginning of the period. Additional matching awards may be added at specified dates during the deferral or vesting period.

***What year are LTIP awards "for"?***

It is important to consider all of the relevant facts. The deferred bonus may be "for" the original bonus year, or for the whole deferral period. If there is particular emphasis on the employee remaining in service at a future date, it may be for the tax year in which that condition is met. However, this feature is unlikely to exist in isolation as the employer wants to motivate the employee to perform well while remaining in employment. In order to determine the period that the deferred bonus is "for", it is necessary to consider all of the relevant information and weigh the emphasis given to each factor.

In general terms, simple deferred bonuses will remain earnings for the original bonus period, and growth or matching awards will be "for" the deferral period. In more sophisticated schemes where the deferred bonus is "awarded" and "vests" after the bonus year, and especially where there are further performance conditions relating to this period, the deferred bonus may be earnings for the period between award and vest.

There may also be circumstances where "growth" in the value of the fund is treated as being "for" the performance period of the original deferred bonus. This view is likely where no additional performance criteria are imposed during the deferral period or, if there are, the conditions are the same as for the deferred bonus.

If the conditions are significantly different, e.g. the matching awards are conditional upon new performance criteria, the "growth" or matching awards are likely to be "for" the deferral or vesting period itself.

If the conditions of the matching award are referenced solely to the employee remaining in employment on the vesting or payment date in order to receive payment, the matching award is likely to be earnings for the tax year in which entitlement to receive the award matures.

Enhancements or matching awards may be paid out of LTIPs at the same time as deferred bonuses. Awards may be aggregated amounts that are "for" different periods. It is important to understand how sums are calculated and whether different performance periods should be considered.

**40016. The year that earnings are "for" - Long Term Incentive Plans and Deferred Remuneration – staged vesting** [March 2009]

Some Long Term Incentive Plans (LTIPs) pay out awards in tranches. The details of different schemes will vary. For example, an LTIP fund containing deferred bonuses and matching awards may pay out 20% per annum over five years or nothing in Years 1 and 2 and 33% per annum in Years 3 to 5. Entitlement may be conditional upon participants meeting performance conditions and remaining in employment.

The period that each tranche is "for" has to be determined. If the evidence shows that the Plan is intended to reward performance over the period from award to vest, each part of the final payment is "for" the period from the original award date until it vests, calculated as per Section 16(4) on a just and reasonable apportionment. In the first example, 20% is "for" Year 1; 20% is "for" Years 1 and 2, and so on. Alternatively, if there are no performance conditions and the Plan emphasises being in employment at each vesting date, each payment may be treated as earnings "for" the tax year of receipt.

### 12.7.1 *Earnings from the employment in a year.*

This expression is defined in s.15(2), 22(2) and 26(2) ITEPA, which are discussed below. It is important to note that earnings which are “for” one year may be taxable earnings from the employment in a different year.

## 12.8 Pre-commencement and post-cessation earnings

There are special rules to deal with pre-commencement and post-cessation receipts. These apply where:

(1) earnings are received after an employment has ended or before it began and

(2) the earnings are not attributable to any year in which the employment was held.

Section 17 ITEPA provides:

> (1) This section applies for the purposes of this Chapter in a case where general earnings from an employment would otherwise fall to be regarded as general earnings for a tax year in which the employee does not hold the employment.
> (2) If that year falls before the first tax year in which the employment is held, the earnings are to be treated as general earnings for that first tax year.
> (3) If that year falls after the last tax year in which the employment was held, the earnings are to be treated as general earnings for that last tax

year.
(4) This section does not apply in connection with determining the year for which amounts are to be treated as earnings under Chapters 2 to 11 of Part 3 (the benefits code).

Since this section only applies for the purposes of chapter 4, it has to be repeated verbatim in s.30 ITEPA for chapter 5.

The EI Manual provides:

**40005. Special rules for determining the year that general earnings are "for": Pre-commencement and post-cessation earnings**

**...**

It is unlikely the rules will often apply in practice because general earnings can normally be attributed to periods in which the job is held.

**40006. 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 or 27 apply (or Sections 21 and 25 before 6 April 2008) in the last or first year the taxpayer held the job. The same is true if the taxpayer left the job at the time of going abroad.

Extra-Statutory Concession A11 (ESC A11) (see EIM42850), which provides split year treatment, cannot be used to take out of charge earnings which in substance relate to service in the UK. The same principle applies where the taxpayer takes up a new job on becoming resident in the UK.

In some cases however the taxpayer may leave the job after ceasing to be resident in the UK. Equally the job might start before the taxpayer arrives in this country. In these circumstances it may be reasonable to split the post-cessation or pre-commencement payment between the part of the year when the taxpayer falls within the relevant charging provision and the rest of the year. But this split should not necessarily be made on a time basis. For example, the post-cessation receipt may be primarily attributable to the taxpayer's service in the UK. If it is, a split that reflects the facts should be agreed.

If the taxpayer is unable to agree, the alternative is that the earnings are taxable on the strict statutory basis, that is, without the benefit of ESC A11. The entire sum will be taxable under Section 15 or 21 because the taxpayer is resident and ordinarily resident for the whole tax year.

**40007. Effect of non-residence on pre-commencement and post-cessation earnings: Examples** [August 2009]

This page provides examples of how the above sections apply. ...

The first example concerns pre-commencement earnings of an employee who is resident, ordinarily resident and domiciled throughout:

> ***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 2009. She commenced work for the new employer on 1 May 2009. 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 2008/2009 they are earnings "for" the year 2009/10.

The Manual then considers whether domicile makes any difference:

> The result will be the same if the employee is resident, ordinarily resident but not domiciled in the UK.

It is assumed that the earnings are not chargeable overseas earnings.[5] The Manual now considers someone becoming UK resident:[6]

> ***Example 2***
> An employee worked in Singapore for many years for a UK resident company. The employment ceased on 31 December 2008. For 10 years prior to that date the individual was not resident and not ordinarily resident although domiciled in the UK. On 6 April 2009 the employee returned to the UK. 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, 2008-2009. In that year the employee was not resident in the UK and performed all of the duties in Singapore. In consequence, the payment does not fall into any of the charging provisions in Part 2 Chapters 4 and 5 and is therefore not chargeable to tax as general earnings.

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5 See 12.10 (Resident, ordinarily resident and foreign domiciled employee).

6 For the position on becoming ordinarily resident, see 6.14.2 (Employment income).

## 12.9 Resident ordinarily resident and UK domiciled employee

Section 15 ITEPA provides:

> (1) This section applies to general earnings for a tax year in which the employee is UK resident.
> (2) The full amount of any general earnings within subsection (1) which are received in a tax year is an amount of "taxable earnings" from the employment in that year.
> (3) Subsection (2) applies whether or not the employment is held when the earnings are received.

Section 15 sets out the general rule: in short, all earnings are "taxable earnings" and taxed on receipt, on an arising basis. This might be called "the receipts" basis of taxation. "Receipt" is defined in ss.18, 19 ITEPA (not discussed here).

The s.15 rule has two exceptions, for foreign domiciliaries (s.22) and for non-ordinarily residents (s.26). That is not stated expressly[7] but clearly has to be implied.

## 12.10 Resident, ordinarily resident and foreign domiciled employee

### 12.10.1 *Chargeable overseas earnings of ordinarily resident non-domiciled employee*

Section 809F ITA provides:

> (1) This section applies if section 809B, 809D or 809E applies to an individual for a tax year.
> (2) The individual's relevant foreign earnings for that year are charged in accordance with section 22 or 26 of ITEPA 2003.

So we turn to s.22 ITEPA which (somewhat repetitively) provides:

> (1) This section applies to general earnings for a tax year, to the extent that they are chargeable overseas earnings for that year, if—
> (a) section 809B, 809D or 809E of ITA 2007 (remittance basis)

7 It was stated clearly in s.14 ITEPA before the FA 2008 reshuffled the statutory provisions.

> applies to the employee for that year, and
> (b) the employee is ordinarily UK resident in that year.
> (2) The full amount of any general earnings within subsection (1) which are remitted to the UK in a tax year is an amount of "taxable earnings" from the employment in that year. ...

In short, the remittance basis applies to chargeable overseas earnings.[8]

### 12.10.2 *UK earnings of ordinarily resident non-domiciled employee*

I use the term "**UK earnings**" to mean earnings which are not "chargeable overseas earnings". Section 22(7) ITEPA provides:

> General earnings for the employee for the tax year fall within section 15(1) to the extent that they do not fall within subsection (1).

This is not strictly necessary, but it does no harm. The drafter put it in as a signpost, because the scheme of the pre-2008 provisions was different, and the charge on UK earnings of an employee who was ordinarily resident and non-domiciled used to fall under s.22, not s.15.

### 12.10.3 *Transitional rules for pre-2008 earnings*

Suppose:
(1) Chargeable overseas earnings accrue to T before 2008/9 and
(2) The earnings are remitted in 2008/9 or later (when T is still resident).
In the absence of a transitional rule, the earnings would not be taxable under s.22 ITEPA because the condition in s.22(1)(a) would not be met. Sections 809B, 809D or 809E did not apply before 2008. Para 82(2)(a) Sch 7 FA 2008 fills that gap:

> (1) This paragraph applies in relation to an individual's general earnings for the tax year 2007–08 or any earlier tax year ("the relevant tax year") if the individual—
> (a) was UK resident in that year, but
> (b) was not domiciled in the UK, or was not ordinarily UK resident, in

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8 Section 22(6) ITEPA provides: "See Chapter A1 of Part 14 of ITA 2007 for the meaning of 'remitted to the UK' etc."

that year.

(2) Section 22 or 26 of ITEPA 2003 (as amended by this Part of this Schedule) applies in relation to the general earnings as if—

(a) section 809B of ITA 2007 (claim for remittance basis to apply) applied to the individual for the relevant tax year and

(b) section 22(7) or 26(6) of ITEPA 2003 were omitted.

I think para 82(2)(b) is misconceived, though it does no harm. In practice the Courts will hold that UK earnings of an ordinarily resident foreign domiciled employee come into charge under s.15, notwithstanding the lack of the signpost in s.22(7).

## 12.11 Chargeable overseas earnings

The expression "chargeable overseas earnings" is a label which brings in two sets of requirements: the earnings must be "overseas" earnings and they must be "chargeable". The key part of the definition is "overseas earnings". Section 23(2) ITEPA provides the definition:

> General earnings for a tax year are "overseas earnings" for that year if—
> (a) section 809B, 809D or 809E of ITA 2007 (remittance basis) applies to the employee for that year,
> (aa) the employee is ordinarily UK resident in that year,
> (b) the employment is with a foreign employer, and
> (c) the duties of the employment are performed wholly outside the UK.

The concept of "chargeable" overseas earnings brings in the rules for deductible expenses (not discussed here) and associated employments.

### 12.11.1 *Transitional rule for pre-2008 earnings*

Suppose earnings accrue before 2008/09. At first sight the earnings cannot be "chargeable overseas earnings" within the definition of s.23(2) ITEPA since they do not meet the condition in s.23(2)(a): section 809B, 809D, or 809E did not apply before 2008/09. Moreover, para 82 which fills that gap in s.22 does not fill the gap in s.23. Construed strictly, therefore, pre-2008 earnings which were not remitted before 6 April 2008 have fallen out of charge!

However, I expect that the courts will to strive to construe the section avoid that result. After all, it is obvious (and para 82 confirms) that this result was not intended. One way to do that is to say that if income arises before 2008, the question of whether it constitutes chargeable overseas earnings is to be decided by reference to the legislation in the year that it arises and not the legislation in the year that it is remitted. It has to be said that para 82 (3) sch 7 FA 2008 would then not be necessary. The alternative is to read para 82(2) as if it applied to s.23 as well as to s.22 and 26. Neither of these solutions is comfortable reading, but the conclusion that all pre-2008 earnings fall out of charge seems even worse. This is only one of many infelicities in schedule 7: but a modern court will strive to make it work.

## 12.12 Foreign employer

One requirement of "overseas earnings" is that the employment is with a "foreign employer". The definition is in s.721(1) ITEPA:

> "foreign employer" means an individual, partnership or body of persons resident outside the UK and not resident in the UK.

### 12.12.1 *Foreign employer: HMRC practice*

EI Manual provides:

> **40102 Taxable earnings: Employee resident and ordinarily resident in the United Kingdom: "chargeable overseas earnings"**[April 2004]
> An employee may maintain that general earnings are chargeable overseas earnings taxable on remittance under section 22 rather than on receipt ... This is likely to lead to a significant reduction in the amount of taxable earnings. You should examine the facts closely before accepting that earnings are chargeable overseas earnings within section 22. In particular you should find out whether the employer has any place of business in the UK. If you can trace an accounts file for the employer, ask the accounts Inspector for instructions on the employer's residence status.

## 12.13 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:

(1) This section applies if in a tax year an employment is in substance one whose duties fall to be performed outside the UK.
(2) Duties of the employment performed in the UK whose performance is merely incidental to the performance of duties outside the UK are to be treated for the purposes of this Chapter as performed outside the UK.

In other words, UK duties may be ignored if they are "merely incidental" to the performance of the other duties outside the UK. What are incidental duties? HMRC interpret this strictly. HMRC 6 provides:

> If your work is normally carried out abroad but you have to carry out some of your duties in the UK, the work you do in the UK will be part of your duties abroad only when you can show that the work you did in the UK was incidental to the duties of your employment abroad.
> Whether or not duties performed in the UK are incidental to an overseas employment will always depend on the circumstances of each particular case. Any decision has to be based on the work carried out in the UK – not the amount of time spent on it. But if you spend more than 91 days working in the UK in a tax year the work **will not** be incidental as it is reasonable to say that someone who spends such an extended period working in the UK is actually working here rather than undertaking duties which are incidental to an overseas employment.
> If the work you perform in the UK is the same or is of similar importance to the work that you do abroad, it will not be incidental. You will have to show that there is a purpose to the work you did in the UK which enabled you to do your normal work abroad and which you could only do in the UK.
> Examples of work carried out in the UK as part of an overseas employment
> ***Incidental work***
> • time spent in the UK by an overseas representative of a UK company to make reports or receive fresh instructions
> • time spent training in the UK by an overseas employee which does not exceed 91 days in the tax year and provided no productive work is carried out in the UK by the trainee during that time
> ***Non incidental work***
> • time spent in the UK as part of the duties of a member of the crew of a ship or aircraft
> • attendance at director's meetings in the UK by a director of the company who normally works abroad.

The EI Manual provides:

> **Appendix 3: Non domiciled employees: Dual contract arrangements** [March 2007]
> In *Robson v Dixon* 48 TC 527, Pennycuick V.-C. observed that:
>
> > "the words "merely incidental to" are upon that ordinary use 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."
>
> So duties performed in the UK that are of the same type as those performed overseas are not merely incidental, even if performed for only a very short time.

EI Manual provides:

> **40203 Employee resident, ordinarily resident or domiciled outside the United Kingdom: location of duties: "merely incidental" duties** [June 2006]
> The case of *Robson v Dixon* (48 TC 527) involved a pilot, resident and ordinarily resident in the UK, who was employed by a Dutch airline. He flew aircraft from Amsterdam to various parts of the world. There were relatively few take-offs and landings in the UK [on average, seven per annum]. He claimed that the small number of take-offs and landings meant that his duties in this country were "merely incidental" to those performed abroad. The Courts rejected his claim on the grounds that the test is one of quality, not quantity. The Judge commented that the core duties of a pilot include landing and taking off in aircraft. So when the aeroplane landed in the UK the pilot was performing substantive duties of his employment.
>
> *Quality not quantity of duties*
>
> The case of *Robson v Dixon* established that it is the quality not the quantity of duties performed in the UK that determines whether or not they are "merely incidental". However, where the employee works in the UK for more than three months in a year, you should not accept that work can be "merely incidental".
>
> *Statement of Practice A10: airline pilots*
>
> Despite the decision in *Robson v Dixon* a single take off and landing in the UK in any year is disregarded on de minimis grounds in considering whether any duties are performed in this country.[9]
>
> *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.

9 [Author's Note] HMRC Brief 17/09 states that SP A10 is withdrawn from 6th April 2009 though there has been no announcement that HMRC now adopt a different practice.

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** [April 2011]

The following examples illustrate how particular situations should be treated.

*Example 1*

An overseas marketing executive of a UK employer spends the majority of each year working overseas. Visits to the UK total less than three months in a year. While in the UK the representative carries out the following duties:

- reports on trade conditions and results in the territory
- establishes questions of policy
- receives instructions
- collects samples in preparation for the next tour.

The duties performed in the UK should be regarded as "merely incidental". If the employee is not ordinarily resident the duties may be disregarded and the general earnings arising from them not charged under Section 15 [ITEPA]. A charge may arise under Section 26 if the earnings are remitted here (see EIM40301).

*Example 2*

An overseas employee visits the UK for periods of training which do not exceed three months in the year. If no productive work is carried out while in the UK, 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.

Attendance at board/directors' meetings is a fundamental and joint duty of a board of directors to manage the company. Therefore performance of these duties in the United Kingdom can never be "merely incidental" to work done overseas, even if the board member participates from the UK in a board meeting held overseas, for example via a telephone or video conference. Preparation in advance of board meetings (e.g. for a presentation) is also unlikely to be merely incidental to other duties, as preparation is essential to the contribution in the subsequent meeting.

*Example 4*

A courier for a tour operator visits many countries in the course of the employment. Visits to the UK, however few and however short, are of the same importance to the job as visits to other countries and therefore cannot be "merely incidental".

This approach is consistent with the 1955 Royal Commission which gave two examples of incidental duties: "returning for report" and "to collect samples, etc".[10]

## 12.14 Dual contract arrangements

EI Manual discusses dual contract arrangements. The manual first explains the planning:[11]

> **77030 Appendix 3: Non domiciled employees: Dual contract arrangements** [March 2007]
> ... 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 [15] wherever received. An employee may therefore be offered two employment contracts, for example:
> Contract 1 covering the performance of duties in the UK and
> Contract 2 with an associated employer resident overseas covering duties 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

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10 Cmd 9474 para 300.

11 An earlier version of the text was in Tax Bulletin 76 (also classified as RI 273). Alistair Ladkin has written a valuable article on this topic in *Taxation*, Vol. 150, No. 3900, p.632 (27 March 2003).

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 some duties of the "overseas" employment are performed in the UK; see 12.13 (Where are duties performed: incidental duties).
(3) Apportionment arguments (see below).

### 12.14.1 *One contract of employment or two?*

*Enquiries into dual contract arrangements*

HMRC 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 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.

12.14.2 *Are some duties performed in the UK?*

The EI Manual goes on to consider this line of attack:

> 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 EI Manual then considers and dismisses a possible defence:

> *Recent developments*
> In a number of cases, the duties required under each purported employment contract are defined according to where those duties are performed. For example, the UK contract states that the duties of the employment are all those duties performed in the UK whereas the overseas contract states that the duties of the employment are all those duties performed wholly overseas. Employees and their advisers may contend that all overseas duties are duties of the overseas employment and all UK duties are duties of the UK employment. On that analysis, duties performed in the UK in connection with the business of the overseas employer are performed under the terms of the UK contract and are not duties of the overseas employment.
> HMRC does not consider that the existence of separate and distinct employments is determined by the terms of written contracts where the main distinction between the duties required under each contract is geographical. There are concerns that arrangements of this nature artificially divide a single job so earnings attributable to overseas duties

can be treated as chargeable overseas earnings. HMRC has received legal advice that supports a robust challenge to such arrangements.

*The commercial context*

As a result of the legal advice referred to above, HMRC considers that a dual contract arrangement based solely or mainly on a geographical split of employment duties without commercial underpinning is vulnerable to challenge on the grounds that there is in reality a single employment with duties in and outside the UK. In such cases, HMRC offices should fully investigate the facts and circumstances including the commercial rationale and context and assess an employee to tax where the evidence shows that there is in fact a single employment.

HMRC takes the view that a dual contract arrangement is unlikely to work unless there are two distinguishable jobs. For example, a French resident employer 'A' sends employee 'B' who is domiciled outside the UK to establish an office in London for its UK subsidiary 'C'. A requires B to work in its Paris office servicing their existing portfolio of French clients two days per week. On the other three days, C requires B to work in London. This is likely to constitute a proper basis for B holding separate employment contracts with A and C.

In order to decide whether the arrangements create two employments, rather than artificially divide a single employment for tax purposes, it is appropriate to look at the economic advantage that an employer gains from the employee's activity. If the contractual arrangements are to have any meaning, they must be seen in the context of the underlying commerciality of the arrangements. Regardless of there being two written contracts, HMRC would not accept that there were two employments if the risks and rewards relating to work done in the UK and overseas were in fact substantially borne and received by a single employer. Moreover, an arrangement requiring a written contract between an employee and a UK employer which provides only for the performance of duties in the UK would appear artificial if the employer's business extends outside the UK.

An employer's interest does not lie in having the employee work in a defined geographical area but in an economic activity that benefits the employer. An employee may perform duties overseas that directly benefit the business of the UK employer. When performing those duties, the employee is not working for the overseas employer but for the UK employer overseas. If the arrangement were genuine, the employee would not be paid by the overseas employer to work for the UK employer overseas. If that is what the contract requires, it would indicate a lack of commerciality. Conversely, an employee who performs duties in the UK that directly benefit the business of the overseas employer is

> working for the overseas employer in the UK. It is difficult to imagine circumstances in which contracts that can require an employee to work for the benefit of a UK employer whilst being paid by an overseas employer or vice versa would be offered by employers that were not associated.
>
> Various mechanisms exist for allocating costs to another entity that benefits from an employee's services. These include transfer pricing adjustments. It has been suggested that such adjustments restore the commercial equilibrium and thus support the existence of separate employments. However, the fact that such adjustments are necessary indicates that the employer has misjudged the commercial reality of the arrangements. Separate employers do not for sensible commercial reasons pay employees to work for someone else, with or without transfer pricing.
>
> Dual contract arrangements are sometimes used when a UK resident employee holding one employment with worldwide duties first becomes ordinarily resident. Some individuals who are self employed before they arrive in the UK become employees with dual contract arrangements on attaining UK resident and ordinarily resident status without any significant change in the way in which they carry out their professional activities. In other cases, recruitment material suggests that the employer has a single vacancy to fill and a dual contract arrangement is only implemented following the appointment of a non-domiciled individual. In such scenarios, HMRC offices will test whether the facts reflect commercial reality.

This is very doubtful. Whether two contracts of employment exist is a matter of contract law, not of commercial reality. It would be interesting to review the HMRC advice to see on what it is founded. No doubt in the event of a dispute HMRC would be pleased to disclose it, in the interests of the open, frank and transparent enhanced relationship which HMRC would like to have with their customers.[12]

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12 "The minimum amount of openness on the part of revenue bodies that will be necessary for the enhanced relationship to function will include ... a willingness to disclose such information without invoking (except in the very rare case where the public interest requires otherwise) executive and other governmental privileges and immunities to suppress documents and other information reasonably sought by the taxpayer." OECD Tax Intermediaries Study Working Paper 6 - The Enhanced Relationship, July 2007, para 43; see *www.oecd.org/dataoecd/59/61/39003880.pdf*.

> *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 HMRC offices from arguing that the employee has performed duties of the overseas employment in the UK. These arguments are based on the UK duties being "ultra vires".
> HMRC does not consider that the presence of such clauses allows the performance of duties in the UK that clearly benefit the overseas employer to be ignored. 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, HMRC 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, the overseas employer should take it into account when calculating bonus entitlement. It is possible that clauses like this are frequently waived or ignored and may be inserted to create a misleading impression.

This may be correct but it depends on the facts of the case.

> *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.[13] The HMRC view might conceivably be defended on the basis

13 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

of *IRC v Scottish 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 EI Manual 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*
>
> Where for tax purposes the facts indicate that despite the existence of

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outside the UK, the part of his income attributed to the work performed outside the UK being itself taxed on the remittance basis;

*(d)* on the whole income, if he is domiciled in the UK, in respect of income from an employment which is performed partly inside and partly outside the UK.

306. The reason for the special treatment of the non-domiciled resident is that 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)

two written employment contracts, there is a single employment covering UK and overseas duties, there could also be National Insurance consequences. 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.

The first sentence is tentatively expressed; the Manual wisely does not try to grapple with the complexities of NIC.[14]

### 12.14.3 *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.

14 See 42.1 (National insurance contributions).

*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 given by sections 450 and 451 of CTA 2010 (meaning of expressions relating to close companies).

(7) If an amount of chargeable overseas earnings is reduced under step 3 in section 23(3) as a result of applying any limit imposed by this section, the amount of general earnings corresponding to the reduction remains an amount of general earnings within section 15(1).

### 12.14.4 *Implications for employer*

The former Inspectors Manual para 5348 provided:

> Apart from the Schedule E implications there are other questions to consider:-
> [1] Is the cost of remunerating the individual under his contract for overseas duties effectively borne by a UK company and claimed as a deduction in computing profits which are chargeable to Corporation Tax? If so, there is a mismatch which will need to be considered with some care.
> [2] Do the individual's activities under the contract for overseas duties generate income, and if so to whom does it accrue? Is income which would otherwise accrue to a company which is liable to Corporation Tax being routed to an overseas company?
> [3] If the profits of a company which is liable to Corporation Tax are computed on a cost plus basis are the costs being depressed by reason of the split employment?

Point [1] raises deductibility issues; point [2] raises Controlled Foreign Company issues; point [3] raises transfer pricing issues. All these should be considered before entering into dual contract arrangements.

### 12.14.5 *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).[15]

This statement was made before the Tax Avoidance Schemes (Prescribed Descriptions of Arrangements) Regs 2006, but it is still valid under the current law. It is interesting that the statement describes dual contract arrangements as "everyday" and "standard".

## 12.15 Resident but not ordinarily resident employee

Section 26 ITEPA provides:

> (1) This section applies to general earnings for a tax year where section 809B, 809D or 809E of ITA 2007 (remittance basis) applies to the employee for that year and the employee is not ordinarily UK resident in that year, if the general earnings are neither—
> (a) general earnings in respect of duties performed in the UK, nor
> (b) general earnings from overseas Crown employment subject to UK tax.[16]
> (2) The full amount of any general earnings within subsection (1) which are remitted to the UK in a tax year is an amount of "taxable earnings" from the employment in that year.
> (3) Subsection (2) applies whether or not the employment is held when the earnings are remitted...
> (5) See Chapter A1 of Part 14 of ITA 2007 for the meaning of "remitted to the UK" etc.
> (6) General earnings for the employee for the tax year fall within section 15(1) if they do not fall within subsection (1).

In short, a resident non ordinarily resident remittance basis taxpayer pays tax:

(1) on an arising basis on general earnings in respect of duties performed in the UK; and
(2) on a remittance basis on other earnings.

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15 Statement to CIOT accessible *www.tax.org.uk/showarticle.pl?id=2704*.
16 See 12.28 (Overseas Crown employment).

This is better than the remittance basis for UK resident and ordinarily resident foreign domiciliary:

(1) It is not necessary to have a foreign employer.
(2) It is not necessary that duties are performed *wholly* outside the UK. (So it is not necessary to consider dual contract arrangements.)

Much of the wording of s.26 is the same as s.22 ITEPA, and so the reader is referred back to 12.10 (Resident, ordinarily resident and foreign domiciled employee).

## 12.16 Non-resident employee

Section 27 ITEPA provides:

> (1) This section applies to general earnings for a tax year in which the employee is not resident in the UK if they are—
> (a) general earnings in respect of duties performed in the UK, or
> (b) general earnings from overseas Crown employment subject to UK tax.
> (2) The full amount of any general earnings within subsection (1) which are received in a tax year is an amount of "taxable earnings" from the employment in that year.
> (3) Subsection (2) applies whether or not the employment is held when the earnings are received.

This applies regardless of domicile. DTAs often override the charge to UK tax.

There are two requirements here:

(1) Duties performed in the UK; and
(2) Earnings in respect of those duties.

These concepts are both 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 earnings and tax-free earnings.

It is best to consider these separately.

## 12.17 Duties "performed in the UK"

Section 38 ITEPA elucidates the concept of where duties are performed:

**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[17] 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.[18]

EI Manual provides:

**40202 Employee resident, ordinarily resident or domiciled outside the United Kingdom: Location of duties: Absence from duties** [August 2009]

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 0under s.15 [ITEPA][19] that excluded salary attributable to the days of absence.

The Inspector successfully contended that s.38 [ITEPA] applied on the basis that the duties of the employment were normally performed in the UK. The earnings that had been excluded were therefore UK-based earnings within s.15 [ITEPA]

17 S.38 refers to earnings "for" duties performed in the UK, whereas ss.26, 27 ITEPA refer to earnings "in respect of" duties performed in the UK, but the meaning must be the same.

18 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.

19 The reference from 2008/2009 is now s.26 ITEPA.

## 12.18 Earnings "in respect of" duties performed in the UK

The question whether earnings are "in respect of" duties performed in the UK is relevant for non-ordinarily resident employees as earnings in respect of duties performed in the UK are taxed on an arising basis and other earnings are taxed on a remittance basis. SP 1/09 explains how this is applied where duties of a single employment are performed both in and outside the UK:

> 13. Where the duties of a single office or employment are performed both in and outside the UK, an apportionment is required to determine how much of the general earnings are attributable to the UK duties. Apportionment of general earnings is essentially a question of fact, but for many years HMRC has accepted time apportionment, based on the number of days worked abroad and in the UK, except where this would clearly be inappropriate. For example, in the case of an employee with 200 working days in the UK and 50 working days outside the UK, the proportion of general earnings attributable to UK duties would be 200/250. This practice does not, of course, apply where the charge arises under Section 15 ITEPA and relief is due under Part 5 Chapter 6 ITEPA (Deductions from seafarers' earnings).

See too *Coxon v Williams* 60 TC 659. EI M77020 provides:

**77020. Appendix 2: General earnings in respect of duties performed in the UK** [April 2008]
(Adapted from an article in Tax Bulletin 63 – February 2003. The section headed "Practical issues - international business travel" sets out a methodology that first appeared as Appendix 2 to the Minutes of the meeting of the Joint Forum on Expatriate Tax and NICs held on 18 April 2007.)
... Whether general earnings (emoluments) are in respect of UK duties is essentially a question of fact. In *Taylor v Provan* (49 TC 579), the courts agreed that the touchstone must be the wording of the statute. In that case, travel expenses paid to a director to come to the UK in order to perform duties here were considered to be "emoluments in respect of duties performed in the UK". In *Perro v Mansworth* [2001] STC (SCD) 179, a Special Commissioner found that the payment by an employer of an employee's liability to tax on UK-based earnings (Case II Schedule E) was itself "an emolument in respect of duties performed in the UK".
Where an attribution is required, Statement of Practice 5/84 (SP5/84) approves time apportionment according to the number of days worked abroad and in the UK except where this would clearly be inappropriate. The Perro case is an example of where time apportionment is not appropriate. The starting point for the SP5/84 approach to time apportionment is that the employee's contractual right to earnings for the work performed

usually accrues from day to day. Authority for this view comes from *Varnam v Deeble* (58 TC 501), although that case was not directly concerned with attributing earnings to UK duties for the purposes of the charge to UK tax. In *Platten v Brown* (59 TC 408), it was held that correct attribution on a time apportionment basis should employ units of days rather than hours.

The courts have consistently taken the view that time apportionment should not be applied to earnings that can be specifically allocated either to duties performed in the UK or to duties performed elsewhere. So time apportionment would be inappropriate in a case where the contract of employment specifically allocated earnings to periods spent working in the UK or overseas. Provisions in a contract of employment that regulate the amount of time to be devoted to the employment, dealing with matters such as the number of days to be worked, the length of holidays or how to calculate compensation do not amount to an allocation of particular parts of remuneration to particular days of work.

This appendix gives examples of how the time apportionment approach envisaged by SP5/84 applies in practice. Self-Assessment Helpsheet IR211 approaches apportionment by calculating the earnings from the employment that are not taxable in the UK. The total earnings are multiplied by a fraction where the numerator is the number of days worked outside the UK and the denominator is the number of days worked in pursuit of the employment during the tax year. Where there are no UK-based earnings taxable under either section 25 or section 27 ITEPA, the resultant figure will be entered at Box 1.31 on the employment page as foreign earnings not taxable in the UK. Although the amount that is not taxable is sometimes referred to as "overseas workday relief", it is not a statutory relief from tax subject to the claims machinery in Section 42 TMA 1970.

Note 4 to IR211 clarifies what is meant by days worked overseas. They are defined as those days that have been spent outside the UK substantially performing the duties of the employment. "Substantially" should be taken as meaning "for the most part". In *Platten v Brown* there is the example of an employee who 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 earnings for that day were not attributable on a time apportionment basis to duties performed in the UK. It follows that the earnings for a day spent working overseas before returning to the UK in the evening will be attributable to duties performed overseas.

There are two questions of fact to be addressed in order to attribute the earnings for a particular day. These are:

- whether the day has been spent substantially performing the duties of the employment
- where those duties have been performed.

Employees should retain evidence such as travel documents and business diaries to demonstrate how they have calculated the earnings from overseas workdays. The following comprehensive example illustrates some practical issues.

***Example***

Monica is resident but not ordinarily resident in the UK. Her salary of £100,000 is paid directly into an offshore bank account. Her contract of employment provides for a five-day 40-hour working week with 22 days holiday plus public holidays - a total of 230 workdays.

During 2005-06, her employer sent her to work at its branch in India for the whole of October and November, a period of 45 weekdays. She also attended the branch office in India on the first Saturday and Sunday in October and spent three other Saturdays working on her employer's Indian premises. She received a special bonus of £15,000 awarded solely in recognition of her work in India.

In addition, she attended her employer's Munich office on five separate occasions during the year. On four of these occasions, she left the UK after work and stayed overnight before returning to the UK on the following evening. On the final occasion, she left the UK on a Friday evening and spent the weekend in Munich. She spent three hours of the Sunday reading papers relevant to a meeting on the following day. She returned to the UK on Monday evening.

Monica was substantially performing the duties of her employment on the five non-weekdays spent working in India, giving a total 50 workdays in India. The Sunday in Munich was not an overseas workday so her duties in Germany encompassed five workdays. The special bonus was on the facts solely attributable to the performance of duties in India.

Time apportionment produces the following result –

UK duties - Salary 100,000 * 180/235 = 76,595 (Section 25 ITEPA)

Overseas duties - Salary 100,000 * 55/235 = 23,405 plus 15,000 = 38,405

***Example - variation A***

Following her return to the UK, Monica's employer gave her time off in lieu of the weekends spent working in India. The denominator in the fraction would become 230 and not 235.

UK duties - Salary 100,000 * 175/230 = 76,086 (Section 25 ITEPA)

Overseas duties - Salary 100,000 * 55/230 = 23,914 plus 15,000 = 38,914

***Example - variation B***

Facts are as variation A plus Monica spent the whole of Sunday 30 September travelling to India and was granted a further day off in lieu when she returned to the UK. That day should also be counted as an overseas workday increasing the numerator by one to 56.

UK duties - Salary 100,000 * 174/230 = 75,652 (Section 25 ITEPA)

Overseas duties - Salary 100,000 * 56/230 = 24,348 plus 15,000 = 39,348

***Practical issues – international business travel***

The time of departure or arrival and the duration of international business travel can make it extremely difficult to decide whether a particular day should be regarded as a UK or an overseas workday. In these specific circumstances, HMRC is prepared to accept that the following treatment provides a reasonable basis for determining the status of such a day:

International flight or journey lasting no more than seven hours

- Morning arrival – UK workday
- Morning departure – overseas workday
- Afternoon arrival – overseas workday
- Afternoon departure – UK workday

International flight or journey lasting more than seven hours

- Morning arrival – half UK workday and half overseas workday
- Morning departure – overseas workday
- Afternoon arrival – overseas workday
- Afternoon departure – half UK workday and half overseas workday

A morning or afternoon arrival or departure is judged according to the time that the aircraft, vessel or train actually arrives or departs, not the scheduled times.

Where a journey involves more than one international flight, a one hour transfer addition may be added to the actual flight times to determine whether the total flight time lasts more than seven hours. International business travel that takes place on a Saturday, Sunday or Bank Holiday is subject to the same treatment as any other day. Note: HMRC may accept alternative approaches to quantifying overseas workdays if the available evidence indicates that such an approach better reflects the facts.

## 12.19 Relocation expenses

Section 271(1) ITEPA provides a somewhat limited relief for relocation expenses.

> (1) No liability to income tax in respect of earnings arises by virtue of—
> (a) the provision of removal benefits to which this section applies, or
> (b) the payment or reimbursement of removal expenses to which this section applies.

A full discussion of this relief requires a chapter to itself, but one point is relevant here. Section 271(2) disapplies the relief for employees taxed on the remittance basis:

> Subsection (1) does not apply if (disregarding this section) the earnings are general earnings to which either of the following sections applies—
> (a) section 22 (chargeable overseas earnings for year when remittance basis applies and employee ordinarily UK resident), or
> (b) section 26 (foreign earnings for year when remittance basis applies and employee not ordinarily UK resident).

However in the case of non-ordinarily resident employees this is relaxed by informal concession:

> HMRC were asked to clarify whether or not the exemption for relocation expenses within Section 271 ITEPA 2003 was available against earnings taxed on the remittance basis. HMRC confirmed that the current legislation does not provide for relocation exemption to be available where the remittance basis is claimed. However HMRC were aware of existing practice whereby the relocation exemption was applied before apportionment in respect of non-UK workdays. Although this methodology was not consistent with the existing legislation HMRC were content to allow the practice to continue.[20]

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

## 12.20 Remittance after year which earnings are "for"

Suppose:

(1) T receives earnings for year (1); the earnings are taxed on the remittance basis and are not remitted in that year.

(2) the earnings are remitted in year (2).

For a resident and ordinarily resident employee, s.22 ITEPA provides:

> (1) This section applies to general earnings for a tax year, to the extent that they are chargeable overseas earnings for that year, if—
> (a) section 809B, 809D or 809E of ITA 2007 (remittance basis) applies to the employee for that year, and
> (b) the employee is ordinarily UK resident in that year.
> (2) The full amount of any general earnings within subsection (1) which are remitted to the UK in a tax year is an amount of "taxable earnings" from the employment in that year. ...

Similarly, for a resident but not ordinarily resident employee, s.26 ITEPA provides:

> (1) This section applies to general earnings for a tax year where section 809B, 809D or 809E of ITA 2007 (remittance basis) applies to the employee for that year and the employee is not ordinarily UK resident in that year, if the general earnings are neither—
> (a) general earnings in respect of duties performed in the UK, nor
> (b) general earnings from overseas Crown employment subject to UK tax.
> (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.

The earnings are "taxable earnings from the employment in that year" ie year (2). In year (1) the earnings are not "taxable earnings" (as defined).

## 12.21 Remittance after employment ceases

The charge on the remittance basis applies "whether or not the employment is held at the time when the earnings are remitted": ss.22(3) and 26(3) ITEPA.

## 12.22 Remittance of earnings for year that employee is not UK resident

To be "overseas earnings" the earnings must be for a year of assessment in which the employee was resident and ordinarily resident in the UK. Accordingly, any earnings for a year during which the employee was not UK resident can be remitted at any time without a charge to tax.

## 12.23 Remittance when non-resident

Suppose earnings taxable on the remittance basis are remitted in a year when the employee is non-resident. In the HMRC view the earnings are taxable. EI Manual provides:

> **42371. Foreign earnings taxed at time of receipt in UK: *Example***
> An employee is resident but not ordinarily resident in the UK in 2004/05. She has earnings for that year of £10,000 in respect of duties performed outside the UK. She is paid the £10,000 in New York in 2005/06. In 2006/07 she remits £5,000 of those earnings to the UK. The result is that this employee is chargeable under Section 26(2) ITEPA 2003 on £5,000 in 2006/07.
> This employee is likely to be resident in the UK in the year of remittance but she is assessable on the remittance even if she is not. What matters is her residence status in the year when the money was earned (see EIM42201). She will also be assessable on any further remittances out of the £5,000 balance that remains.
> Note that the employee is chargeable on any remittances to the UK even if her employment ceases in 2005/06 (see EIM42370).

Is this correct? It is a surprising anomaly compared to the position for RFI, enforcement may be difficult, but this is the most natural reading of the legislation.

## 12.24 Receipt or remittance after death of employee

Section 13(4) ITEPA provides:

> If the tax is on general earnings received, or remitted to the UK, after the death of the person to whose employment the earnings relate, the person's personal representatives are liable for the tax.

EI Manual provides:

**42380. Basis of assessment for general earnings: Earnings received after the death of an employee or office holder** [April 2004]
When an employee or office holder dies, earnings received (or, if the employee was subject to the special rule for certain foreign earnings, received in the UK) after the date of death are treated as income of the personal representatives and not the income of the deceased. They are assessable on the personal representatives in the same way as if they had been received by the employee or office holder (see generally EIM42201). The earnings will, of course, all have been earned in periods before the date of death even though they are assessable only on receipt. If it is contended that earnings cannot be attributed to any particular period during the lifetime of the deceased employee or office holder, see EIM40005.
So it is the place where duties were performed and the residence and ordinary residence status of the employee when the remuneration was earned that counts. The residence position of the personal representatives at the time the earnings are received (or, where the special rules for certain foreign earnings apply, received in the UK) is irrelevant.
In cases where an employee or office holder has died the employer will follow the instructions at page 16 of the Employer's Further Guide to PAYE. By following those instructions the employer will account for tax in the following way:
• where payments are made in the tax year in which the employee died, and before a P45 is issued, the employer will calculate the tax due using the tax code in use before the employee died
• where payments are made in the tax year in which the employee died, but after the P45 has been issued, the employer will use code BR
• when payments are made in a tax year following that in which the employee died the employer will prepare a new deductions working sheet and will use code BR.
The statutory assessing position for earnings received by personal representatives after the death of an employee or office holder is set out in EIM42390. In many cases, adopting the statutory position would place an additional burden upon the personal representatives and family of the deceased but would not result in materially different overall tax liability. Sensible administrative procedures should be used in this type of case.
Normally, you can take the pay and tax shown on the deceased's P45 as received in the period before the date of death, and follow EIM42410. However you should use the strict basis of assessment, and follow EIM42390, in cases:

• where it is requested, or
• where you know that a substantial amount has been paid after the date of death. For these purposes a substantial amount means a sum in excess of £1,500.

The tax chargeable on the personal representatives is a debt due from and payable out of the deceased's estate.

As regards:

• the strict basis of assessment for the personal representatives of a deceased employee or office holder, see EIM42390
• the time limit for assessments on the personal representatives, see EIM42400
• the treatment of earnings received up to the date of death, see EIM42410.

**42390. Earnings received after the death of an employee or office holder: The charge on personal representatives**

If an employee or office holder dies and earnings are received after the date of death, the personal representatives are charged to tax on them (see EIM42380). They are charged:

• at the basic rate only
• in the year the earnings are received (or, where the special rules for certain foreign earnings apply, received in the UK)
• without any allowances, deductions or reliefs except for the deductions, reliefs and exemptions that would have been due to the employee had they lived.

The personal representatives cannot claim deductions for expenses that they incur separately themselves. The main deductions due are therefore:

• expenses within Sections 336 to 338 ITEPA 2003 incurred by the employee or office holder (see EIM31620 onwards)
• balancing allowances due to the employee or office holder; balancing charges will also fall on the personal representatives (see EIM36500 onwards)
• foreign travel and accommodation expenses within Sections 341, 342 and 370 to 376 ITEPA 2003 incurred by the employee or office holder (see EIM34000 onwards)
• professional fees and subscriptions within Sections 343 and 344 ITEPA 2003 (see EIM32880 onwards)
• where a lump sum is assessable under the "golden handshake" provisions the various exemptions that are available under Sections 404 to 414 ITEPA 2003 (see EIM13500 onwards).

A deduction that is due is not limited to expenses actually paid by the deceased. The personal representatives can have a deduction for an expense that the deceased was due to pay but that the representatives actually settle.

As regards:

• the time limit for assessing personal representatives, see EIM42400

• the treatment of earnings received up to the date of death, see EIM42410.

**42400. Earnings received after the death of an employee or office holder: Time limits for assessments on personal representatives**

The normal 5 year 10 month time limit for making assessments applies where earnings are received after the death of an employee.[21]

This is because the earnings are deemed to be the income of the personal representatives (see EIM42380). So the 3 year 10 month assessing time limit in Section 40 TMA 1970 relating to income arising or accruing up to the date of death does not apply.

The SA manual sets out the procedures relating to personal representatives.

As regards earnings received before the date of death see EIM42410.

**42410. Death of employee or office holder: Earnings received up to the date of death** [May 2010]

When an employee or office holder dies, any earnings received before the date of death are chargeable on the employee in the normal way. But if the employee has died before filing a return for the period in which the earnings were received, the executors or personal representatives will be asked to complete returns to the date of death. In these circumstances the special rules at EIM42380 to EIM42400 do not apply and any assessment on the personal representatives must be made within 3 years and 10 months from the end of the year of assessment in which the employee died.

With effect from 1 April 2010 the time limit is 4 years from the end of the tax year in which the employee dies.

The SA manual sets out the procedures relating to personal representatives.

Where the arising basis applies, there is clearly a tax charge for earnings received after death by the PRs.

Where the remittance basis applies, it is difficult to see how there could be a charge on earnings received in the UK after the death of the employee, since the tax charge only arises on receipt by a relevant person, and there are no relevant persons after the death of an employee.

21 [Author's note: This is out of date from 2010/11].

## 12.25 Remittance from earnings for mixed UK/foreign duties

### 12.25.1 *The statutory position from 2008/09*

This section considers the position where:
(1) an employee who is a remittance basis taxpayer, and who is resident but not ordinarily resident, receives earnings for duties which are performed partly in and partly out of the UK.
(2) The earnings are received abroad.
The earnings are taxed partly on an arising basis and partly on the remittance basis, and the earnings received constitute a mixed fund consisting of what I will call (1) taxed UK earnings and (2) untaxed foreign earnings.

The statutory position is (in short) taxed UK earnings (mixed fund category (a)) are remitted before untaxed foreign earnings (mixed fund category (b)), but later years' earnings are taxed before earlier years'. So employees would need to keep each year's earnings in separate accounts and never remit more than the taxed income in the account.

### 12.25.2 *HMRC practice in 2008/09*

SP 5/84 paras 1 & 2 summarised the taxation of earnings for a resident non-ordinarily resident individual. The SP then explained the practice before 1983[22] and continued:

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22 "3 Where an employee resident but not ordinarily resident in the UK performs the duties of a single office or employment both in and outside the UK and is remunerated wholly abroad, he is permitted, by a broad interpretation of the decision in the case of Sterling Trust Ltd v IRC 12 TC 868, to say that any remittances made to the UK are made primarily out of general earnings for that year in respect of duties performed in the UK assessable under [s.15 ITEPA], and only any balance out of general earnings chargeable under s.26 on remittance. [Author's Note: This is arguably correct in law and not a concession: see 11.14.1 (Remittance from mixture of taxed and untaxed income).]
4 However, where part of the general earnings are remitted to the UK, it has been the practice of the Revenue to regard the proportion of the earnings remitted to the UK, as in respect of duties performed both in and outside the UK, and to treat that proportion of such earnings as is attributable to duties performed outside the UK as remitted to the UK for the purposes of s.26."
I find this difficult to follow (paras 3 and 4 do not seem consistent) but it does not now matter.

5 The practice changed with effect from 6 April 1983 when the Revenue introduced a simplified procedure for employees who—

(a) are resident but not ordinarily resident in the UK;

(b) perform duties of a single employment both in and outside the UK, so that they are potentially chargeable under both ITEPA ss.[15] and 26, in respect of general earnings from that employment; and

(c) receive part of their general earnings in the UK and part abroad.

In such cases, provided the general earnings chargeable under s.[15] are arrived at in a reasonable manner (ie in the absence of special facts, the proportion of the general earnings, including benefits in kind, relating to UK duties is arrived at on a time basis by reference to working days), the Revenue are prepared to accept that a charge under s.26 will arise only where the aggregate of general earnings remitted to the UK exceeds the amount chargeable under s.[15] for that year; and to restrict the charge under s.26 to the excess of the aggregate over the charge under s.[15].

This continues to apply in 2008/09, by concession. The 2nd ed of the RDR Manual provided:

**35240 Remittances from mixed funds - Identifying nature of remittance**

For 2008-09 tax year only HMRC will continue to operate Statement of Practice 5/84 on the same basis as in 2007-08. The statement of practice will operate on a concessionary basis until the end of the tax year 2008-09 and where appropriate apply instead of provisions in Schedule 7 Finance Act 2008 (for example instead of the mixed fund rule). This temporary measure is intended [to] help ensure a smooth transition to the new legislation in 2008-09 for employers and employees who use the statement of practice.

(This was omitted from the online version as it applied only to 2008/09.)

### 12.25.3 *Position from 2009/10*

SP 1/09 provides:

*Transfers made from an offshore account holding only the income or gains relating to a single employment*

4. Sections 809Q ITA onwards set out rules to determine the kinds and amount of income or chargeable gains remitted to the UK from a fund containing more than one kind of income and capital, or income, or capital

of more than one tax year. Such a fund is defined in sections 809Q and 809R as a "mixed fund". Where amounts are transferred to the UK out of a mixed fund, Section 809Q(3) requires that the individual's tax liability is calculated by reference to each individual transfer. This transfer by transfer approach is referred to below as the "mixed fund rule". This is a change to HMRC's previous practice, with respect to employees to whom SP 5/84 applied, which was to allow the tax liability to be calculated by reference to the total amount transferred to the UK during the tax year as a whole.

5. In the circumstances outlined in this statement of practice, HMRC will accept that certain individuals who are resident but not ordinarily resident in the UK do not have to apply the mixed fund rule and can continue to calculate their tax liability by reference to the total amount transferred out of a mixed fund during the tax year as a whole, rather than by reference to individual transfers.

### 12.25.4 *Accounts qualifying for the concessions*

Only certain accounts qualify for the concessionary treatment in the SP:

6. Employees who are resident but not ordinarily resident in the UK and who perform duties of an office or employment both inside and outside the UK, do not have to apply the mixed fund rule in respect of transfers from a particular account where:

[1] The mixed fund is an account held solely by the employee;[23] and

[2] The account only contains employment income from a single

23 This requirement is slightly relaxed in Notes of the Joint Expatriate Forum 19 January 2010 accessible *www.hmrc.gov.uk/consultations/expat-mins-190110.pdf.*

"Joint accounts. These fall outside the SP1/09 procedures. The current view is that when the joint account is with a trailing spouse who has no income or gains in her own right whatsoever then these can now be included within the SP1/09 arrangements. HMRC made it clear however that there were no de minimis levels agreed and that other than a share of any interest credited to the joint account by the bank a trailing spouse could not introduce any other income or gains to the account."

Various other relaxations of SP 1/09 are also mooted in this document. HMRC subsequently said:

Where an account is held in the joint names with a spouse or civil partner who has no income or gains of their own, except a share in any interest that arises on the account, HMRC has agreed that SP1/09 can apply. This responds to concerns expressed by stakeholders and will apply to all accounts that qualify for SP1/09 on or after 6 April 2009: HMRC Notice 4 March 2010 [2010] STI 612 employment plus:

[a] Any interest arising only on that account, and

[b] Any gains arising from foreign exchange transactions in respect of the funds in that account

[c] Any gains arising on employee share scheme related transactions

[d] Any proceeds from employee share scheme related transactions, not otherwise covered at paragraph 7, in respect of amounts paid by the employee in acquiring the shares.

7. The employment income from that employment may include:

[1] Employment income (subsection 809Q(4)(a));

[2] Relevant foreign earnings (subsection 809Q(4)(b));

[3] Foreign specific employment income (including termination payments and the proceeds from employee share schemes) (subsection 809Q(4)(c)), and

[4] Employment income subject to a foreign tax (subsection 809Q(4)(f)).

Take care not to pay any dividend income into the account!

### 12.25.5 *The concessions*

SP 1/09 contains two concessions. First:

8. Employees who are resident but not ordinarily resident in the UK may also choose not to apply the mixed fund rule if the account contains only income or gains of a kind listed at paragraphs 6 and 7 above, but for more than one tax year. Where this is the case, the ordering rules at section 809Q(3) shall be applied—ie on a last in first out basis.

9. Where the employee applies this statement of practice, amounts transferred out of the account to the UK will be treated as comprising the kinds of income and gains in the order set out in section 809Q(4) for the tax year as a whole.

The SP then repeats a point made in para 6:

10. Accounts containing income or gains of more than one employment are not covered by this statement of practice.

11. Accounts containing income or gains of more than one individual are not covered by this statement of practice.

After a comment on apportionment (set out above) the SP then provides:

14. Where an employee resident but not ordinarily resident in the UK

> performs the duties of a single office or employment both in and outside the UK and is remunerated wholly abroad, he is permitted, by a broad interpretation of the decision in the case of *Sterling Trust Ltd v IRC* (12 TC 868), to say that any remittances made to the UK are made primarily out of general earnings for that year in respect of duties performed in the UK assessable under Section 15, and only any balance out of general earnings chargeable under Section 26 on remittance.

This text is copied from SP 5/84 though *Sterling Trust* cannot have any relevance to the ITA remittance basis.

> 15. However, where part of the general earnings are remitted to the UK, it was the practice of HMRC to regard the proportion of the earnings remitted to the UK, as being in respect of duties performed both in and outside the UK, and to treat that proportion of such earnings as were attributable to duties performed outside the UK as remitted to the UK for the purposes of Section 26.
> 16. The practice changed with effect from 6 April 1983 when HMRC introduced a simplified procedure for employees who:
> – are resident but not ordinarily resident in the UK;
> – perform duties of a single employment both in and outside the UK, so that they are potentially chargeable under both Sections 15 and 26 ITEPA 2003 in respect of general earnings from that employment; and
> – receive part of their general earnings in the UK and part abroad.
> 17. In such cases, provided the general earnings chargeable under Section 15 are arrived at in a reasonable manner (ie in the absence of special facts, the proportion of the general earnings, including benefits in kind, relating to UK duties is arrived at on a time basis by reference to working days), HMRC is prepared to accept that a charge under Section 26 will arise only where the aggregate of general earnings remitted to the UK exceeds the amount chargeable under Section 15 for that year; and to restrict the charge under Section 26 to the excess of the aggregate over the charge under Section 15.

This text is also repeated from SP 5/84 (the comment on the pre-1983 position is of no relevance now).

SP 1/09 is classified as a statement of practice (though it is clearly a concession). This is presumably because HMRC are not now supposed to grant concessions (except for minor and transitional matters). It appears that the Government have realised that the SP is an unsatisfactory stop-gap measure:

> When SP1/09 was introduced, the intention was that it would apply for one year, before being legislated in Finance Bill 2010. Since April 2009 HMRC has worked towards this aim, including consultation and meeting with external stakeholders. However, it has not been possible to resolve all the outstanding issues in time to legislate the practice this year.
>
> In these circumstances, the Financial Secretary to the Treasury has agreed that SP1/09 will apply for a further year until 5 April 2011.
>
> HMRC will continue working with stakeholders on the issues which remain unresolved, with the aim being that SP1/09 will be brought into legislation as part of Finance Bill 2011.[24]

That deadline was missed, but the remittance consultation paper proposes action in the FA 2012:

> 2.96 SP 1/09 is very widely used by expatriate employers and employees, and is important to business. The Government is seeking to put this non-statutory practice on a statutory footing to provide expatriate employees and their employers with greater clarity and certainty. This will preserve the features and details of the current practice.
>
> 2.97 There are some specific issues for SP 1/09 on which the consultation process will seek to clarify whether the simplified legislative treatment should apply. These are listed below.
>
> **Employee becomes not UK resident part way through a tax year and continues to deposit money into a bank account**
>
> 2.98 The Government expects that this situation would usually only arise in a year in which an employee was leaving the UK permanently. If this is the case, the provisions which allow the tax year to be split into periods of residence and non-residence in certain circumstances (currently contained in Extra Statutory Concession A11), should apply and there would be no need for separate provision in the legislation that will replace SP 1/09.
>
> 2.99 However, the Government would welcome views on whether there are any other circumstances in which this situation would arise and, therefore, whether specific legislative provision might be necessary.
>
> **Employee holds bank accounts containing employee share scheme transactions in respect of non UK situs assets**
>
> 2.100 The Government considers that such accounts should only fall within the simplified treatment if the employee has little or no control over how the transactions are paid. For example, it is common that, when

24 HMRC Notice 4 March 2010 [2010] STI 612

shares or share options which are acquired by virtue of the employment vest to the employee, the amount treated as earnings at that date will be paid through the payroll into the same account as salary payments. The simplified treatment should apply to such transactions.
2.101 However, the Government does not propose that accounts containing capital gains from share scheme transactions should qualify for simplified treatment because the employee can control when and into which account the transactions are paid after the shares have vested.[25]

## 12.26 Earnings from Ireland

In the following discussion:

**"Irish earnings**" means earnings from an Irish resident employer; it is assumed that the conditions for the remittance basis are in principle all met (duties performed outside the UK, etc).

**"Pre-2008 earnings"** means earnings arising before 6 April 2008.

The UK/Ireland DTA also needs to be considered but it is not discussed here. Similar points arise in relation to RFI; see 9.21 (RFI from Ireland).

### 12.26.1 *Earnings from 2008/09*

The position for earnings from 2008/09 is straightforward. The ITA remittance basis treats Irish earnings in the same way as any other foreign earnings. The FA 2008 repealed the rule of the pre-2008 remittance basis which provided (unlawfully and probably ineffectively) that Irish earnings were taxed on an arising basis.

### 12.26.2 *Pre-2008 earnings remitted from 2008/09*

This change raised the problem of transition. Para 82 Sch 7 FA 2008 provides:

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25 HMT & HMRC, "Reform of the taxation of non-domiciled individuals: a consultation" (June 2011) accessible *www.hm-treasury.gov.uk/d/consult_condoc_non_domicile_individuals.pdf.*

> (1) This paragraph applies in relation to an individual's general earnings for the tax year 2007–08 or any earlier tax year ("the relevant tax year") if the individual—
> (a) was UK resident in that year, but
> (b) was not domiciled in the UK, or was not ordinarily UK resident, in that year...
> (3) In relation to the general earnings, the definition of "foreign employer" in section 721(1) of ITEPA 2003 has effect as if at the end there were inserted "and not resident in the Republic of Ireland".

Amended as para 82(3) directs, s.721(1) ITEPA provides:

> "foreign employer" means an individual, partnership or body of persons resident outside the UK and not resident in the UK *and not resident in the Republic of Ireland*.

Thus (although this might surprise the residents of Eire) an Irish resident employer is not (for this purpose) a "foreign employer" so pre-2008 Irish earnings are not "chargeable overseas earnings" so the remittance basis does not apply to them. Para 82(3) is simply a roundabout way of disapplying the remittance basis charge for pre-2008 Irish earnings.
EN FB 2008 provides:

> 395. Subsection (3) ensures that the existing restriction on the application of the remittance basis in the case of employment income from employers resident in the Republic of Ireland continues to apply in relation to the remittance on or after 6 April 2008 of general earnings arising before that date. This will prevent double taxation as the general earnings have already been taxed when they arose.

In short, if:
(1) Irish earnings arose before 2008/09; and
(2) The earnings are remitted on or after 2008/09
there is no tax charge on remittance.

### 12.26.3 *Why is para 82(3) needed?*

Before 2008, s.721 ITEPA provided:

> *"foreign employer" means*
> *(a) in the case of an employee resident in the UK, an individual, partnership or body of persons resident outside the UK and not resident in the UK* ***or the Republic of Ireland,***

Under this definition, earnings from an Irish resident employer could not have been chargeable overseas earnings so at first it seems that para 82(3) is not needed. It may be that para 82(3) is otiose; it is inserted by mistaken analogy with para 83(3) (which is needed). However para 82(3) is needed on the assumption that where
(1) earnings arose before 2008/09 and
(2) the earnings are remitted from or after 2008/09
the question of whether the earnings qualify as chargeable overseas earnings is to be determined by the legislation as it stands in the year of remittance, and not by the legislation as it stood at the time that the earnings arose.

12.26.4 *Pre-2008 Irish earnings: tax position before 2008/09*

As noted above, according to statute, the remittance basis did not apply if the employer was resident in the Republic of Ireland: pre-2008 Irish earnings were taxable on the arising basis and not the remittance basis. The discrimination against Ireland was contrary to EU law.[26] This work advised that those with pre-2008 Irish earnings should only agree to pay tax on the remittance basis. Where tax has been paid on an arising basis which would not have been paid on a remittance basis, a repayment claim should be made.[27] Under para 82(3) discussed above, pre-2008 Irish source income which was not remitted before 2008/09 escapes UK tax altogether, since unremitted Irish source income was not lawfully taxable when it arose and it is not (from 2008/09) taxable on remittance. I expect that this will not often arise in practice, but occasionally it may be important.

26 The point was discussed in some detail in the 6th edition of this book para 9.51 and 10.4.2.
27 For the limitation period see s.106 FA 2007.

## 12.27 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, they may receive a termination payment after their arrival in this country. This would ordinarily be chargeable as employment income by s.403 ITEPA to the extent that it exceeds £30,000. However, s.413 ITEPA provides a territorial exemption.

A payment satisfying the above conditions can be remitted free of income tax to the UK. It is a moot point why the payment does not give rise to CGT, but in practice HMRC do not take that point.

## 12.28 Overseas Crown employment

General earnings from overseas Crown employment subject to UK tax[28] are taxed on an arising basis, regardless of residence, domicile and place of work. In the case of UK resident and ordinarily resident employees, such earnings are charged in the normal way under s.15 ITEPA and excluded from the remittance basis because the Crown is not a foreign employer. In the case of a UK resident and non-ordinarily resident individual, the earnings are charged in the normal way under s.15 and excluded from the remittance basis by s.26(1)(b) ITEPA.[29] In the case of a non-resident employee, the charge is under s.27 ITEPA.[30] The 1955 Royal Commission Report explains the reason:

> International comity does not permit the salary of the servant of one State to be taxed by another State: consequently a Crown servant, even if spending his whole time on work abroad, is not amenable to the local taxing jurisdiction and, if he is to be taxed at all, must be taxed by the UK taxing authority. No doubt the scale of remuneration for Crown servants abroad is fixed with these considerations in mind.[31]

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28 The expression "general earnings from overseas Crown employment subject to UK tax" is defined in s.28 ITEPA.

29 See 12.15 (Resident but not ordinarily resident employee).

30 See 12.16 (Non-resident employee).

31 Cmd 9474 para 307.

### 12.28.1 *Exception for low paid overseas crown employees*

EIM40209 records that HMRC have made the following orders under s.28(5) ITEPA:

> General earnings from overseas Crown employment in respect of an employee who:
> 1. is not resident in the UK;
> 2. was engaged outside the UK; and
> 3. is employed in a grade the maximum rate of pay of which is less than the maximum rate of pay of an executive officer employed in the same department of the UK Civil Service and working in inner London,
>
> is excepted from the operation of Section 27(2) of the Act.
> With effect from 13 June 2006, the order does not apply to Queen's Gurkha Officers or any other members of the Brigade of Gurkhas who were recruited for that Brigade in Nepal.

This replaces the former concession A25. EN ITEPA provides:

> The concession reflects long-standing practice and is in keeping with international treaty obligations.
> The use of a salary level and grade in the concession is an attempt to focus its benefits on genuinely temporary or unestablished staff. However, enshrining these existing limits in primary legislation is not thought to be desirable. Instead it is intended to preserve the existing flexibility of the Inland Revenue to adapt the concession to new circumstances by enabling the Board of Inland Revenue to make an order which sets out the limits of the new statutory exception: see section 28(5) and (6) of the Act. Section 28(7) and (8) of the Act, which deal with the factors by reference to which the statutory exception may be expressed, are intended to reflect the scope of this existing flexibility. Section 717(2) of the Act means that an order does not need to be made by statutory instrument.
> The new statutory exception will operate on the charges to tax arising by virtue of section 25(2) of the Act (UK-based earnings for year when employee resident, but not ordinarily resident, in UK) or section 27(2) (UK-based earnings for year when employee not resident in UK). It is intended that it should operate at least as widely as the present exception conferred by ESC A25.

## 12.29 Seafarers

The rules relating to seafarers and duties performed on vessels and aircraft are too specialist to be considered here, but reference should be made to s.39(3) and ss.40, 372 and Chapter 6 Part 5 ITEPA. On residence of seafarers, see 3.26 (Seafarers).

## 12.30 Lower-paid employee exemption

BN55 (22 April 2009) provides:

> Individuals with small amounts of foreign employment income
> 5. Individuals employed in the UK are currently required to file a Self Assessment tax return if they have also received income from overseas employment in the same tax year. This is the case even where there is little or no tax to pay in the UK because the overseas employment income has already been subject to tax in the other country.
> 6. This obligation to file a return will be removed with effect from 6 April 2008 where such individuals have overseas employment income of less than £10,000 and overseas bank interest of less than £100 in any tax year, all of which is subject to a foreign tax.

EN FB 2009 provides:

> 11. This clause introduces a new income tax exemption for low-income employees working in the UK who meet certain conditions. Such individuals will typically be migrant workers employed in seasonal work in the agricultural or service sectors in UK and in other countries in the same tax year and whose overseas income is subject to tax where it is earned. Previously they were required to file a Self Assessment tax return, even in situations where there was no, or very little, tax to pay. This exemption removes that requirement in most cases.

According, s.828A ITA provides:

> **Chapter 1A**
> Exemption for Persons Not Domiciled in UK
> **828A Introduction**
> This Chapter provides for an exemption from liability to income tax for an individual for a tax year if-
> (a) the individual is UK resident in the tax year but not domiciled in the

UK in the tax year,
(b) section 809B does not apply to the individual for the tax year, and
(c) conditions A to F in section 828B are met.

I refer to these conditions as "**LPE conditions A to F**" to avoid confusion with the myriad other conditions in ITA.

Section 809B will only apply if the individual makes a claim under s.809B, which where the LPE conditions are satisfied will never happen, so the important requirements are the LPE conditions.

### 12.30.1 *LPE condition A: UK employment*

Section 828B(1) ITA provides:

> Condition A is that in the tax year the individual has income from an employment the duties of which are performed wholly or partly in the UK.

Section 828D ITA defines "employment":

> (1) This section applies for the purposes of this Chapter.
> (2) "Employed" and "employment" have the same meaning as in the employment income Parts of ITEPA 2003: see Chapter 1 of Part 2 of that Act.

If these were income-tax wide definitions it would not be necessary to say this here.

### 12.30.2 *LPE condition B: cap on RFE*

Section 828B(2) ITA provides:

> Condition B is that, if the individual's income for the tax year consists of or includes relevant foreign earnings—
> (a) the amount of the relevant foreign earnings does not exceed £10,000, and
> (b) all of that amount is subject to a foreign tax.

Section 828D(5) defines "relevant foreign earnings":

> "Relevant foreign earnings", in relation to an individual, means what would be the individual's relevant foreign earnings for the purposes of Chapter A1 of this Part if section 809B applied to the individual (see section 809Z7(3)).

Section 828D(4) ITA defines "foreign tax":

> "Foreign tax" means any tax chargeable under the law of a territory outside the UK.

See 50.22 ("Subject to tax").

HMRC say:

> HMRC also confirmed that the £10,000 limit for relevant foreign earnings applied for the full year and was not affected by ESC A11 split year treatment. Therefore, an individual who had already earned more than £10,000 abroad in the UK tax year before he or she arrived would not be eligible.[32]

### 12.30.3 *LPE condition C: cap on RFI*

Section 828B(3) ITA provides:

> Condition C is that, if the individual's income for the tax year consists of or includes income that is relevant foreign income by virtue of section 830(2)(e) of ITTOIA 2005—
> (a) the amount of that income does not exceed £100, and
> (b) all of that amount is subject to a foreign tax.

In order to understand the reference to s.830(2)(e) ITTOIA one needs to read it together with s.830(1):

> (1) In this Act "relevant foreign income" means income which—
> (a) arises from a source outside the UK, and
> (b) is chargeable under any of the provisions specified in subsection (2) (or would be so chargeable if section 832 did not apply to it).

32 Joint Expatriate Forum on Tax and Nics: 29 July 2010 Meeting Note *www.hmrc.gov.uk/consultations/expat-mins-290710.pdf*

(2) The provisions are ...
(e) Chapter 2 of Part 4 (interest),

### 12.30.4 *LPE condition D: no other income/gain*s

Section 828B(4) ITA provides:

> Condition D is that the individual has no other foreign income and gains[33] for the tax year.

This condition will in practice rarely be satisfied if (as is likely) the individual has a foreign currency foreign bank account because any withdrawal from the account is more likely than not sooner or later to give rise to some trivial gain.[34]

### 12.30.5 *LPE condition E: exclusion of higher rate taxpayers*

Section 828B(5) ITA provides:

> Condition E is that the individual would not for the tax year be liable to income tax at a rate other than the basic rate or the starting rate for savings if this Chapter did not apply to the individual for the tax year.

### 12.30.6 *LPE condition F: no tax return*

Section 828B(6) ITA provides:

> Condition F is that the individual does not make a return under section 8 of TMA 1970 for the tax year.

Since a return is due if HMRC choose to require it, the position is that HMRC have a power to withdraw the exemption (by requiring a return). The rule is thus: no tax is due unless HMRC happen to ask for it. This is

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33 Section 828D(3) ITA incorporates the standard commonsense definition of "foreign income and gains":
“"Foreign income and gains", in relation to an individual, means what would be the individual's foreign income and gains for the purposes of Chapter A1 of this Part if section 809B applied to the individual (see section 809Z7(2)).”

34 See 49.11 (Foreign currency bank accounts: CGT).

a new development in tax policy; one hopes it does not become standard.
HMRC say:

> HMRC sought to clarify the intention behind the new legislation which was to remove the obligation on overseas migrant workers on low incomes to file an SA return in cases where there was little or no tax to pay in the UK. It was true that such individuals would no longer qualify for the tax exemption if they filed a return to claim a tax repayment, but the tax exemption was merely the vehicle for delivering the administrative saving. External delegates failed to understand why the exemption should also be lost if the individual filed not a tax return but an R40 to claim repayment of PAYE on UK income.[35]

In fact, the R40 form is not a tax return under s.8 TMA: *Osborne v Dickinson* [2004] STC (SCD) 104.
The RDR Manual provides:

> **32070 - Remittance Basis: Accessing the remittance basis: Claiming the remittance basis: Calculation of income tax liability - exemption for non-domiciles with small amounts of foreign employment income**
> Individuals employed in the UK are usually required to file a Self Assessment tax return if they have also received income from overseas employment in the same tax year. However in many cases there is little or no tax to pay in the UK because the overseas employment income has already been subject to tax in the other country.
> From 6 April 2008 there is no obligation for individuals who are resident but not domiciled in the UK for a tax year to file a return as long as the individual is not claiming the remittance basis under ITA07/s809B and meets all of the following conditions (ITA07/s828A).
> [The Manual summarises conditions A - F and continues:] If all of these conditions apply, the individual receives an exemption from liability to income tax, in so far as that liability is attributable to the individual's foreign income or gains for the tax year (termed the 'relevant amount').
> Broadly, the relevant amount is deducted from what would otherwise be the amount of the individual's liability to income tax for the tax year under ITA07/s23.
> This means that the individual is automatically taxed on the Arising Basis for that tax year, and does not have to complete a return.

35 Joint Forum on Expatriates Tax and NICs 16 July 2009, accessible *www.hmrc.gov.uk/consultations/expat-mins-160709.htm*.

Most individuals who fulfil Conditions A to F are expected to use the Arising Basis and not complete a return. However there may be a small number of non-domiciled individuals who fulfil these conditions but who wish to use the remittance basis in respect of their foreign income and gains and are within the 'below £2,000 threshold' user group (ITA07/s809D). Such individuals will have to complete a return in order to claim the remittance basis under s809D; this will of course mean that Condition F of ITA07/s828A is no longer met, refer to RDRM32110 Unremitted foreign income and gains below £2,000 threshold.

### 12.30.7 *The exemption*

Section 828C ITA provides:

(1) The exemption is given by deducting the relevant amount from what would otherwise be the amount of the individual's liability to income tax for the tax year under section 23.
(2) "The relevant amount" is so much of the amount of the individual's liability to income tax as is attributable to the individual's foreign income or gains for the tax year.

I refer to this as the **"Lower-paid employee exemption**."

### 12.30.8 *Restriction on exemption*

Section 828C ITA provides:

(3) But if for the tax year the individual's total income is reduced by any deductions which fall to be made at Step 3 of the calculation in section 23 from the individual's foreign income or gains for the tax year, subsection (2) has effect as if the individual's foreign income or gains for the tax year were reduced by the amount of the deductions.
(4) And if the individual is entitled under.
(a) sections 2 and 6 of TIOPA 2010(double taxation arrangements: relief by agreement), or
(b) section 18(1)(b) and (2) of that Act (relief for foreign tax where no double taxation arrangements),
to a tax reduction in respect of the individual's foreign income or gains for the tax year, what would otherwise be the relevant amount is reduced by the amount of that reduction.

### 12.30.9 *Administration: avoiding issue of SA return*

HMRC say:

> HMRC stressed that, whilst the exemption was not designed for employees on inter-company transfers, it had become clear that the exemption could be applied to certain assignees, in particular those from India and China.
> 3 The main issue was the difficulty in identifying the relevant individuals. Unless informed that they qualify for filing exemption, HMRC would issue SA returns, thereby preventing them from taking advantage of s828A. HMRC had designed an election letter for Expats to meet this need: agents should submit this letter at the same time as the 64-8, and after the P46 (Expat) had been filed, which would ensure that no SA return is issued.

This is essential as if a SA return is issued, the relief is lost. For the form of the letter, see Fisher, "Expat Exemption", *Taxation* 3 March 2011 p.18.
HMRC continue:

> There was a separate issue with employers using EPM App 6 with a month 12 adjustment to eliminate any residual liability whose employees are required to submit a SA return. However, as some had very simple tax affairs, there was a case for allowing them to use s828A whilst remaining within EPM6. HMRC will seek to engage with such employers to reach a suitable agreement for their employee base. In such cases, the election letter will need to be completed but retained by the employer. If there are individuals who do not qualify, the employer or agent will need to submit an SA1 to request a return.
> A similar case existed for NR individuals who submit SA returns to get personal allowances under DTAs.[36]

### 12.30.10 *Commentary*

Almost every requirement of the lower-paid employee is anomalous. If the aim is to remove obligations to file a return where there is little or no UK tax at stake, why is it so limited? The provision presumably reflects

36 Joint Expatriate Forum on Tax and Nics: 29 July 2010 Meeting Note *www.hmrc.gov.uk/consultations/expat-mins-290710.pdf*

effective lobbying by special interest groups concerned with lower-paid employees rather than a serious attempt to address compliance cost issues.

## 12.31 PAYE

Section 690 ITEPA modifies the PAYE rules for non-resident or NOR employees on the remittance basis:

> (1) This section applies in relation to an employee in a tax year only if the employee—
> (a) is not resident or, if resident, not ordinarily resident in the UK, and
> (b) works or will work in the UK and also works or is likely to work outside the UK.
> (2) If in relation to an employee to whom this section applies and any tax year it appears to an officer of Revenue and Customs that—
> (a) some of the income paid to the employee by the employer[37] is PAYE income, but
> (b) some of that income may not be PAYE income,
> an officer of Revenue and Customs may, on an application made by the appropriate person,[38] give a direction for determining a proportion of any payment made in that year of, or on account of, income of the employee which is to be treated as PAYE income.
> (2A) For the purposes of subsection (2) as it applies in relation to an employee who is UK resident but not ordinarily UK resident in a tax year, the officer may treat section 809B of ITA 2007 (remittance basis) as applying to the employee for that year, even if no claim under that section has been made.[39]

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37 Section 690(3)(b) ITEPA provides:
"any reference to a payment made by the employer includes a reference to a payment made by a person acting on behalf of the employer and at the expense of the employer or a person connected with the employer."

38 Section 690(3)(a) defines "appropriate person":
"In this section—
(a) "the appropriate person" means the person designated by the employer for the purposes of this section and, if no person is so designated, the employer..."

39 For completeness, the section continues:
(4) An application under subsection (2) must provide such information as is available and is relevant to the application.
(5) A direction under subsection (2)—
(a) must specify the employee to whom and the tax year to which it relates,
(b) must be given by notice to the appropriate person, and

HMRC Brief 17/09 provides:

> **Section 690 ITEPA directions**
> Prior to April 2008 non-domiciled individuals and not ordinarily resident individuals were automatically taxed on the remittance basis on their foreign employment income. However since April 2008 individuals have to make an annual claim to the remittance basis. Section 690 ITEPA was amended in Finance Act 2008 to reflect this change for not ordinarily resident employees. Prior to April 2008 employers were able to ask for a section 690 direction which permitted them not to apply PAYE to certain employment income paid to not ordinarily resident employees entitled to be taxed on the remittance basis. These rules have been amended to allow this procedure to continue.

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(c) may be withdrawn by notice to the appropriate person from a date specified in the notice.

(6) The date so specified may not be earlier than 30 days from the date on which the notice of withdrawal is given.

(7) If—

(a) a direction under subsection (2) has effect in relation to an employee to whom this section applies, and

(b) a payment of, or on account of, the income of the employee is made by the employer in the tax year to which the direction relates,

the proportion of the payment determined in accordance with the direction is to be treated for the purposes of PAYE regulations as a payment of PAYE income of the employee.

(8) If in any tax year—

(a) no direction under subsection (2) has effect in relation to an employee to whom this section applies, and

(b) any payment of, or on account of, the income of the employee is made by the employer,

the entire payment is to be treated for the purposes of PAYE regulations as a payment of PAYE income of the employee.

(9) Subsections (7) and (8) are without prejudice to—

(a) any assessment in respect of the income of the employee in question, and

(b) any right to repayment of income tax overpaid and any obligation to pay income tax underpaid.

(10) In a case where section 689 applies—

(a) the references to the employer in subsection (3)(a) are to be read as references to the relevant person, and

(b) any reference to a payment made by the employer is to be read as a reference to a payment treated, for the purposes of PAYE regulations, as made by the relevant person.

In this subsection "the relevant person" has the same meaning as in section 689.

HMRC 6 provides:

> **6.4 What should you do if you have UK Tax Allowances and use the Remittance Basis?**
> From 6 April 2008 onwards, if you have claimed the remittance basis (see Chapter 5) and your unremitted income and/or gains is £2,000 or more you will not be entitled to the allowances listed in paragraph 6.2.
> If you decide during a tax year that you are going to use the remittance basis and you are still receiving personal allowances through the PAYE system, you may not be paying enough UK tax. If you let us know, we can arrange to adjust your PAYE code so that you are not left with a tax bill relating to overpaid personal allowances at the end of the year. Otherwise we shall ask you to pay the additional tax through the Self Assessment system.
> If you want us to adjust your PAYE code you should contact the office which deals with your PAYE and ask for a tax code to be issued which does not give relief for personal allowances. This will reduce the amount of tax you may have underpaid at the end of the tax year. Your employer can't do this for you as your tax affairs are confidential between you and HMRC. Until they receive a new tax code from us, your employer will continue to deduct tax from you based on the code we originally issued before you told us you were claiming the remittance basis.

It is hard to imagine anyone wishing to do this. But HMRC say:

> Employers have expressed concern that the P46 (Expat) does not allow them to operate a 0T code (no personal allowance) even where they are aware that the employee will claim the remittance basis or has income in excess of £100K.
> HMRC said that it was not the responsibility of employers to withdraw personal allowances and, if they did so, the New PAYE System (NPS) might reinstate the allowances when the P14 is filed and make a repayment to the individual.
> HMRC said that, if employers agree with their employee that they will claim the remittance basis or if the individual's earnings will exceed £100K, they should request a formal change of code number from the Expat Team. This would ensure that HMRC records mirror those of the employer when the P14 is submitted.
> HMRC confirmed that the Modified PAYE rules in EPM6 allows PAs to be withdrawn from remittance basis users but it would be sensible for Employers to notify the Expat Team of situations where that applies. They agreed to make the necessary changes to the EPM6 agreement to

make this clear.[40]

The minutes of the Joint Expatriate Forum record:

> Tax equalisation packages and repayments of PAYE
> 2.8 Since the last meeting, HMRC had been giving further consideration to the issue of whether a repayment of overpaid PAYE should be treated as a remittance. This had proved to be a complex matter and HMRC proposed convening a subgroup to take this forward.
> 2.9 The point was made that it would be unfortunate if employees were penalised for operating PAYE properly and that the forum was looking for a practical and sensible solution.[41]

## 12.32 Tax equilisation

The EIM provides:

**77040. Appendix 4: Not ordinarily resident employees: Tax equalisation** [March 2007][42]
... In addition to salaries and benefits, employers may also provide their employees with the benefit of tax equalisation. This usually means that the employer undertakes to meet on the employee's behalf any additional tax payable above the tax that the employee would have paid in his home country. It is well established that such payments made on behalf of employees form part of their earnings. But before 2002, there was a difference of view between the then Inland Revenue and a number of accountancy firms about the extent to which such tax equalisation payments represent earnings in respect of duties performed in the UK.

The issue matters for NOR and NR employees: see 12.16 (Non-resident employee).

The view taken by the Inland Revenue and subsequently by HMRC is that tax equalisation payments represent earnings wholly referable to duties performed in the UK where the underlying tax liability is similarly wholly referable to duties performed in the UK. Therefore, where an employer pays a tax liability arising under section 25 on an employee's behalf, that payment will itself represent earnings wholly chargeable under section 25.
This view was approved by a Special Commissioner in 2001 in the case of *Perro v*

40 Joint Expatriate Forum on Tax and NICS: 26 May 2010 Meeting note *www.hmrc.gov.uk/consultations/260510-epf-minutes.pdf*.
41 Joint Expatriate Forum on Tax and NICs: 10 Feb 2011 Meeting Note
42 The text is derived from Tax Bulletin 59.

*Mansworth* [2001] STC (SCD) 179. The Special Commissioner stated that it was an inescapable fact that the payment of tax by the appellant's employer was an emolument (earnings) in respect of UK duties since that tax was only payable because of the performance of duties in the UK.

Ms Perro's net earnings were time apportioned in accordance with SP5/84 in order to find the net attributable to UK duties as there was no specific attribution of salary or other benefits between UK and overseas duties. Following Perro, it has been accepted practice to gross up this net figure on the basis that the payment of tax on UK-based earnings represents additional earnings wholly referable to duties performed in the UK.

The Special Commissioner did not consider the treatment of reimbursement of tax on income other than employment income chargeable under what is now section 25. The employer of a tax-equalised employee may reimburse UK tax on investment income or capital gains. Employers may also pay foreign tax liabilities on the employee's behalf. Following the decision in Perro, the Inland Revenue was asked to give its view on the treatment of such reimbursements.

When apportioning earnings between sections 25 and 26, it is necessary first to consider whether those earnings are wholly referable to UK or non-UK duties on the facts. Clearly if this is so, there is no need to consider time apportionment. If the earnings are not wholly referable either to UK or non-UK duties, then time apportionment will be necessary in accordance with SP5/84.

If an employer reimburses personal tax liability arising on non employment income[43] such as bank interest, dividends or capital gains, then the first question is whether that reimbursement is a payment of earnings that relates wholly to either UK or non-UK duties. We do not consider that the physical presence of the employee in the UK in order to perform employment duties is sufficient justification for treating such reimbursements as wholly in respect of duties performed in the UK. In the absence of unusual facts, we believe that such earnings should be time apportioned. This will produce net section 25 earnings that will then need to be grossed up. The gross up will be on the basis that the payment of UK tax on earnings within section 25 is itself a payment of earnings wholly chargeable under section 25.

With regard to foreign tax payments, the attribution between sections 25 and 26 will depend upon the facts and circumstances. If the foreign tax relates solely to overseas duties, then the payment of that tax by the employer will comprise earnings wholly referable to duties performed outside the UK that cannot be charged to tax under section 25. Alternatively, the foreign tax may be charged on worldwide income so that time apportionment is likely to provide the only practical mechanism for determining the attribution between sections 25 and 26.

With regard to the treatment of employer payment / reimbursement of tax chargeable under section 26, SP5/84 states that provided the earnings chargeable under section 25 are arrived at in a reasonable manner; HMRC is prepared to accept that a charge under section 26 will arise only where the aggregate of earnings received in the UK exceeds the amount

43 [Author's note]. Employees are likely to claim the remittance basis so the tax charge is only on remitted income and remitted foreign gains. It is not clear that the employee ought to pay the charge on remitted income or gains as remittance is a decision of the employee. However it may be appropriate to do so.

chargeable under section 25 for that year. The amount chargeable under section 26 is therefore restricted to the excess of the aggregate over the amount chargeable under section 25.

Where the employer meets UK tax liability under section 26, the payment of that tax to HMRC will clearly be remitted to the UK. It is logical that the payment of the section 26 liability will itself be a payment of earnings chargeable under section 26 and as the tax payment will be remitted to the UK, the related gross up will also be wholly chargeable under section 26.

There can be significant practical difficulties in identifying whether earnings relate solely to non-UK duties and therefore fall within section 26. In such cases, HMRC would not generally dispute time apportionment between sections 25 and 26 on the basis of working days. If any earnings were allocated solely to section 26 as attributable wholly to non-UK duties, evidence should be available to justify the attribution, in the event of an HMRC enquiry.

***Non resident employees***

Some tax-equalised employees are not resident in the UK. They may perform substantive duties of their employment in this country. Unless the specific terms of a Double Taxation Agreement confer an exemption from UK tax on UK source employment income, such employees will be liable under section 27 ITEPA on earnings in respect of duties performed in the UK. Earnings for duties performed outside the UK will fall outside of the charge to UK tax on employment income. HMRC adopts the same approach to tax equalisation for non-resident employees as for those resident but not ordinarily resident employees whose earnings are apportioned between sections 25 and 26.

The following simple examples are intended to illustrate the basic approach to tax equalisation earnings described in this appendix. It is recognised that many cases will have much more complex facts and that the ensuing calculations will be similarly complex.

***Example (Tanya)***

T has been sent to the UK to work at her employer's UK branch for two years from 1 January 2005. She is resident but not ordinarily resident in the UK from the day of her arrival. In addition to her UK duties, her employer requires her to make regular and extensive visits to an overseas branch of its business in order to monitor an important project. Whilst assigned to the UK, T is subject to her employer's policy on tax equalisation which provides for her to receive the same net salary and benefits as if she had remained in her home state.

During 2005-06, T performed the duties of her employment on 225 days. She spent 158 days working in the UK and 67 days working overseas. Net salary and benefits from her employment were £100,000 of which £60,000 was received in the UK. Her employer was obliged to pay her tax liabilities in accordance with its tax equalisation policy. For simplicity, all calculations assume that T's income is chargeable to UK tax at 40%

***Scenario 1***

T's only tax liability was incurred in the UK on the earnings from her employment.

**Calculation of UK tax for 2005-06**

| | |
|---|---|
| Net salary and benefits | 100,000 |
| Less amount attributable to overseas workdays – 67/225 (30%) | (30,000) |
| Attributable to the performance of UK duties | 70,000 |
| Gross up for UK tax at 4/6 | 46,666 |
| UK-based earnings taxable under section 25 ITEPA | 116,666 |

| | |
|---|---|
| Tax at 40% | 46,666 |
| Remitted to the UK - 60,000 plus section 25 tax of 46,666 | 106,666 |
| Section 26 ITEPA - SP5/84 | Nil |

***Scenario 2***

Facts as above but T's employer also paid UK tax liability of £5,000 on her investment income. As the £5,000 is not directly referable to the performance of duties inside or outside the UK, it falls to be time apportioned in accordance with SP5/84. Therefore, the £5,000 has been added to net salary and benefits before calculating and deducting the amount attributable to overseas workdays.

**Calculation of UK tax for 2005-06**

| | |
|---|---|
| Net salary and benefits | 105,000 |
| Less amount attributable to overseas workdays – 67/225 (30%) | (31,500) |
| Attributable to the performance of UK duties | 73,500 |
| Gross up for UK tax at 4/6 | 49,000 |
| UK-based earnings taxable under section 25 ITEPA | 122,500 |
| Tax at 40% 49,000 | |
| Remitted to the UK - 60,000 plus section 25 tax 49,000 and other UK tax 5,000 | 114,000 |
| Section 26 ITEPA - SP5/84 | Nil |

***Scenario 3***

Additionally, T's employer pays overseas tax liability of £5,000 direct to an overseas tax authority. The overseas tax is referable solely to the performance of duties outside the UK and is therefore excluded from the section 25 calculation.

**Calculation of UK tax for 2005-06**

| | |
|---|---|
| Net salary and benefits | 110,000 |
| Less overseas tax payment | (5,000) |
| Salary and benefits to be time apportioned | 105,000 |
| Less amount attributable to overseas workdays – 67/225 (30%) | (31,500) |
| Attributable to the performance of UK duties | 73,500 |
| Gross up for UK tax at 4/6 | 49,000 |
| UK-based earnings taxable under section 25 ITEPA | 122,500 |
| Tax at 40% | 49,000 |
| Remitted to the UK - 60,000 plus section 25 tax 49,000 and other UK tax 5,000 | 114,000 |
| Section 26 ITEPA - SP5/84 | Nil |

***Scenario 4***

Facts are the same as in Scenario 2 except that £70,000 out of the £100,000 net salary and benefits has been remitted to the UK.

**Calculation of UK tax for 2005-06**

| | |
|---|---|
| Net salary and benefits | 105,000 |
| Less amount attributable to overseas workdays – 67/225 (30%) | (31,500) |
| Attributable to the performance of UK duties | 73,500 |
| Gross up for UK tax at 4/6 | 49,000 |
| UK-based earnings taxable under section 25 ITEPA | 122,500 |
| Tax at 40% 49,000 | |
| Remitted to the UK - 70,000 plus section 25 tax 49,000 and other UK tax 5,000 | 124,000 |

| | |
|---|---|
| Net section 26 ITEPA - SP5/84 | 1,500 |
| Gross up for UK tax at 4/6 | 1,000 |
| Foreign earnings taxable under section 26 | 2,500 |
| Total taxable earnings (sections 25 and 26) | 125,000 |
| Tax at 40% | 50,000 |

## 12.33 Accountancy services benefit

Joint Forum on Expatriates Tax and NICs records a discussion on tax return preparation fee benefits:

> It was made it clear that these discussions and any proposals or guidance based on them will relate only to circumstances where:
> • due to tax equalisation arrangements, the employer pays for accountancy services relating to the preparation and submission of the individual assignees' Tax Returns
> • tax return preparation is part of a wider bundle of services provided by the adviser as negotiated with the employer
> • S9A enquiry services are not included as part of the bundle
> In such circumstances HMRC accept that the level of benefit in kind should be arrived at by apportionment based on the facts. The mechanics of how the apportionment should be calculated are an operational issue and CPTT had already shared with delegates (within the meeting notes of 30 August 2007) an exchange with Ernst & Young LLP on this topic. CPTT did not have authority to agree fixed round sum figures applicable in all cases. Indeed, it was clear from the evidence submitted that there is no 'one size fits all'. However, CPTT were prepared, in due course, to provide some clarity of the level at which they perceive there to be a risk worthy of enquiry.
> The intention therefore would be to:
> • establish a level of tax return preparation benefit which if returned or exceeded will not prompt any enquiry
> • continue to allow for different figures to be reported based on the available facts
> • highlight that where levels of tax return preparation benefits are reported below this level it remains open to HMRC/CPTT to enquire into the precise figures and apportionment methodology to check the accuracy of Returns submitted
> CPTT is still analysing the information provided but Martin Dwyer was able to say that the available evidence suggested that a level of around £600 per head would be reflective of a situation where a home and host country Return was completed.

HMRC remain of the view that any accountancy fees paid in respect of S9A enquiry work should be reported as benefits in kind. HMRC will continue to look for evidence of the payment of such fees and their position will be as clarified within the meeting notes of the Forum held on 30 August 2007, as follows:

> 'Where we find evidence to indicate that the costs of accountancy services related entirely to resolving the S9A enquiry, we will regard these costs as giving rise to a taxable benefit in kind. If your clients are unable to accept this treatment, we will need to refer an appropriate case to the Commissioners.'

Subsequent to the meeting HMRC has now completed its analysis of the information provided. From this we conclude that the levels of benefits which appear both realistic and reasonable are £650 per head where a home and host country Return is completed and £250 per head where only the host country (UK) Return is completed. Under existing circumstances these figures will represent levels which if returned or exceeded will not prompt an enquiry from CPTT. However, it has been recently highlighted by external representatives that the proposed levels of analysis necessary to support access to the remittance basis from 6 April 2008 is likely to lead to increases in the costs charged for UK Tax Return preparation where the remittance basis is claimed. If this proves to be the case there would be a need to recognise this and revise the figures for 2008-09 onwards accordingly.

HMRC reiterate that the sums quoted above are not intended to represent an agreed level of benefits which must be reported across the board. We recognise that there is unlikely to be consistency in the precise make up of the bundle of accountancy services provided across different cases and by the variety of advisers involved. Rather, the aim is to indicate a level at which CPTT perceive the level of risk to be worthy of enquiry.[44]

A subsequent meeting of the forum records:

**Q10:Accountancy fees in regard to partially tax-equalised employees**
It is not clear which partially tax-equalised cases are covered by the agreement announced in the 18 September 2008 forum notes. By 'partially tax-equalised' we mean when the employer agrees to tax-equalise part of the employee's income/gains but not the whole. This is very common, often employers will tax equalise only employment

44 Note of Meeting 18 September 2008, accessible *www.hmrc.gov.uk/consultations/expat-mins-180908.htm*

income and even then might exclude elements such as share options.
The notes mention 'due to tax equalisation arrangements, the employer pays for accountancy services' which perhaps suggests the precise nature of the equalisation arrangements is not in point. However, Appendix 6 of HMRC's Employment Procedures Manual – 'Modified PAYE' arrangements – says that those arrangements may be applied only to tax-equalised employees and, for that purpose, 'tax-equalised' means that:
' ... the employer must equalise liability to UK Income Tax on all general earnings (see note) subject to the rules in part 2 Chapters 4 and 5 ITEPA applying to employees resident, ordinarily resident or domiciled outside the UK.
Note: Where the employee is tax-equalised on all general earnings but not, for example, on taxable awards of securities options or the award of securities at undervalue (which is specific employment income) the employee may still be included within the arrangement as long as all the other conditions are satisfied'.
It would seem rather restrictive to take the same approach in relation to accountancy fees as an employee's tax equalisation computations can be just as (possibly more) complex if only part of the earnings are equalised.
**HMRC Answer:** It is the case that the guidance contained within the Forum meeting notes of 18 September 2008 was intended to relate to 'fully' tax equalised cases including those capable of inclusion within an EP Appendix 6 agreement.
Where partial tax equalisation applies it seems to me that the extent to which the accountancy advice directly benefits the individual rather than the employer must increase and I would expect this to be reflected within the level of benefits reported.
As in the case of tax equalised individuals, where HMRC wishes to check the amounts reported we will look at the amounts paid for the basket of services provided and seek to establish those parts of this basket which directly benefit the employer. It should then be possible to calculate a benefit in kind figure by reference to the balance on a per head basis.
...
HMRC were asked to give clarification regarding whether or not the levels of accountancy fees, clarified at the meeting held on 18 September 2008, could be applied in respect of the 2008-09 SA Tax Returns. Martin Dwyer confirmed that these amounts were intended to reflect levels below which HMRC perceive there to be a risk and above which it was unlikely that HMRC would make an enquiry into the matter of accountancy fees relating to Tax Return preparation. They were not intended to represent mandatory levels of benefits which should be included on Tax Returns as HMRC accept that there will be cases where

> the true level of benefit varies from the figures provided for guidance. Against this background, however, HMRC confirmed that the same guidance could be extended to apply to 2008-09 SA Returns. As was confirmed in the answer to Q10, however, that guidance was intended to relate to fully tax equalised cases, including those capable of inclusion within an EP Appendix 6 agreement. Whilst it was accepted that this would include cases where tax equalisation applied to all employment income other than share based remuneration, the guidance was not intended to apply to circumstances where partial tax equalisation arrangements are in place which can often apply to a small proportion of the overall compensation package.[45]

The figures have not been increased:

> 2.6 HMRC thanked the forum for supplying details of the current level of accountancy fees. Based on this information, HMRC would continue not to enquire into benefits in kind reported for fees for preparing tax returns of £650 for UK and home country returns and £250 per head for UK only returns. This would only apply for fully tax equalised employees and does not cover the cost of section 9A enquires which should be reported in full.
> 2.7 The level of fees would be reviewed again in 2013/14 and HMRC would be seeking views from the forum at the end of 2012.[46]

## 12.34 Double Taxation Relief

Article 15 OECD Model provides:

> 1. Subject to the provisions of Articles 16, 18 and 19, salaries, wages and other similar remuneration derived by a resident of a Contracting State in respect of an employment shall be taxable only in that State unless the employment is exercised in the other Contracting State. If the employment is so exercised, such remuneration as is derived therefrom may be taxed in that other State.

The DTR Manual provides:

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45 Note of meeting 16 July 2009, accessible *www.hmrc.gov.uk/consultations/expat-mins-160709.htm*

46 Joint Expatriate Forum on Tax and NICs: 10 February 2011.

> **1920 Employment** [April 2007]
> The employment Article in our double taxation agreements is normally called the Dependent Personal Services Article. In most of the United Kingdom's agreements the Article is based on Article 15 (Dependent Personal Services) of the OECD Model Convention (see DT153) and the terms of this Model Article are summarised below. It must, however, always be checked that the Article in the particular agreement with which you are concerned follows the OECD Model Article before reliance is placed upon the guidance below.
> Paragraph (1) of the OECD Model Article sets out the general principle that salaries, wages and other similar remuneration may be taxed in the country where the employment giving rise to that remuneration is exercised.
> The words 'salaries, wages and other similar remuneration' should be understood in the broadest sense as covering all income from an employment, including benefits and share option gains chargeable under Section 135 ICTA 1988 (see DT1925).

In *Kljun v HMRC* [2011] UKFTT 371 (TC) the Judge said:

> [18] What does exercised mean? The English is clear and it is where the employee is physically present when performing the activities for which the employee is being paid.

This takes us to Art. 15(2) OECD Model:

> 2. Notwithstanding the provisions of paragraph 1, remuneration derived by a resident of a Contracting State in respect of an employment exercised in the other Contracting State shall be taxable only in the first-mentioned State if:
> a) the recipient is present in the other State for a period or periods not exceeding in the aggregate 183 days in any twelve month period commencing or ending in the fiscal year concerned, and
> b) the remuneration is paid by, or on behalf of, an employer who is not a resident of the other State, and
> c) the remuneration is not borne by a permanent establishment which the employer has in the other State.[47]

47 For completeness, article 15(3) continues: "3. Notwithstanding the preceding provisions of this Article, remuneration derived in respect of an employment exercised aboard a ship or aircraft operated in international traffic, or aboard a boat

The DTR Manual provides:

> It follows from the terms of Paragraph (1) that, in general, an individual can be taxed on the income arising from duties performed in the United Kingdom whether or not he is resident in the United Kingdom under our domestic law. Our double taxation agreements provide, however, that such income may, in certain circumstances, be exempted from United Kingdom tax.
> Paragraph (2) of the OECD Model Article provides that, notwithstanding paragraph (1), employment income may, if certain conditions are fulfilled, be exempt from tax in the country where the employment is exercised. Consequently it is this paragraph which forms the basis of most claims for exemption from United Kingdom tax under this Article. To qualify for exemption, the taxpayer has to demonstrate that he is a resident of the other country for the purposes of the agreement (see DT310) and three further conditions, explained at DT1921 - DT1923 below, must all be met.
> ...
> For years of assessment 1996-97 onwards, claims to exemption from UK tax in respect of employment income are made as part of the taxpayer's self assessment on the claim form attached, depending on the circumstances, to either Help Sheet IR302 (Dual-Residents) or Help Sheet IR304 (Non-Residents - Relief under Double Taxation Agreements). Both forms require the taxpayer to establish the fact of his residence in the other country for the purpose of the agreement (see DT310) and to declare that the relevant provisions of the particular agreement are considered to have been fulfilled. All claims under Article 15(2) should be checked carefully by reference to terms of the agreement and, where appropriate, to the guidance at DT1921 - DT1923, and enquiries raised in suitable cases. See also DT1924 about certain types of cases which must always be referred to Employment Income Technical, before a claim is accepted.
> ...

### 12.34.1 *Article 15(2)(a): limited days of presence*

The DTR Manual provides:

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engaged in inland waterways transport, may be taxed in the Contracting State in which the place of effective management of the enterprise is situated."

**1921 Short term visitor exemption 183 day rule** [May 2009]
The first condition for exemption under Article 15(2) is that the employee must not be present in the United Kingdom for more than 183 days either 'in the tax year concerned' (as in Article 15(2)(a) of the 1980 United Kingdom/USA agreement) or 'in any period of 12 months' (found in Article 15(2)(a) of the 1985 United Kingdom/Norway agreement). It is important to distinguish between these formulae. The latter formula is a much tighter test than that used in the agreement with the USA.
For example, a US resident seconded to work in the United Kingdom for a two year assignment arrives here on 15 October 1990 and leaves the United Kingdom on 1 October 1992. Depending on all the circumstances, he could be taxable in the United Kingdom only for the year 1991-92. For the years 1990-91 and 1992-93 he could meet the condition in Article 15(2)(a) because in both periods he was not present in the United Kingdom for 183 days 'in the tax year concerned'.
By contrast, a Norwegian resident working in the United Kingdom would be taxable here throughout the period 15 October 1990 to 1 October 1992 under the test in the agreement with Norway.
Our agreements with Azerbaijan, Belgium, Bolivia, Denmark, Estonia, France, Ghana, Guyana, Iceland, Indonesia, Ivory Coast, Kazakhstan, Korea, Latvia, Malta, Mexico, Mongolia, Pakistan, Papua New Guinea, Sweden, Uganda, Ukraine, Uzbekistan, Venezuela and Vietnam also use the wording of the Norwegian agreement; and the agreement with New Zealand is similar. Most of the United Kingdom's agreements, however, use the tax/fiscal year formula.
Up until 5th April 2009, when counting to 183 days under Article 15(2)(a),a part day counts as a part day and days of arrival and departure and all other days spent inside the country of activity should be included in the calculation.
From 6th April 2009 onwards, when counting to 183 days under Article 15(2)(a), any part of a day, day of arrival, day of departure, and all other days spent in the UK such as Saturdays, Sundays, national holidays, holidays before during and after the period of work, short breaks (training, strikes, lock-out, delay in supplies), days of sickness (unless they prevent the individual from leaving and he would otherwise have qualified for the exemption) and death and sickness in the family should be included in the calculation as a day the person is present in the country of activity.
Days spent in the UK in transit in the course of a trip between two non-UK points should be excluded form the computation.
From 2008/09 onwards (this overlaps for a year with the previous day counting method), days during which the tax payer is a resident of the

UK should not be included in the calculation. The conditions in the treaty are for remuneration derived by a resident of a Contracting State in respect of an employment exercised in the other Contracting State and does not apply to a person who is resident and works in the same State. For example if a person is a resident of the UK but is hired by an employer in another State, moves to that State where he becomes resident and is subsequently sent to work for a short period in the UK by his employer, we would only include days in the UK after the taxpayer became a resident of the other State for the purposes of computing whether they had exceeded 183 days in the UK. Days in the UK when the taxpayer was a resident of the UK should not be included.

Similarly if a non-resident taxpayer is seconded to the UK for a short period by their employer and subsequently moves to and becomes a resident of the UK, days in the UK after they became a resident here should not be taken into account for the purposes of the calculation of the 183 days.

### 12.34.2 *Article 15(2)(b): payment by non-resident employer*

The DTR Manual provides:

**1922 Employment** [April 2007]

The second condition for exemption under Article 15(2) is that the remuneration which is the subject of the claim must be paid by, or on behalf of, an employer who is not United Kingdom resident.

The fact that an individual remains an employee of an overseas company does not on its own satisfy the test in Article 15(2)(b). Not only must the claimant remain an employee of the overseas company but the remuneration in respect of which the exemption is claimed must be paid by the overseas employer and not, for example, by a United Kingdom subsidiary company to whom the employee may have been seconded. Any statement on this aspect of a claim should be checked to ensure that it is consistent with

i) other information in the papers (for example what does the return show?) and
ii) the position in other similar cases involving the same United Kingdom employer.

If there is any doubt you should ask the agents to provide a statement from the United Kingdom company or the overseas employer, to confirm the extent to which, if at all, the overseas employer has continued to pay the claimant's remuneration either directly or by reimbursing the United Kingdom company.

Cases where remuneration continues to be 'paid by' the overseas employer, but there is a recharge of the cost of that remuneration to the United Kingdom company to whom the employee has been seconded, are frequently a cause of difficulty. The Inland Revenue has in the past accepted claims made in these circumstances on the footing that the remuneration continues to be 'paid by' the overseas employer even though it is a United Kingdom company which finally economically bears its cost.

This approach is not consistent with that adopted by a number of the United Kingdom's treaty partners, nor with guidance in the OECD Model Commentary. The June 1995 edition of Tax Bulletin announced that this approach would not be adopted in dealing with future claims. The following approach should be adopted.

When dealing with

- claims from employees who commence a work assignment in the United Kingdom after 1 July 1995 and
- all claims for 1996-97 onwards

claims should not be admitted where

- the employee remains formally employed by a company which is not resident in the United Kingdom and
- he is seconded to work for a United Kingdom resident company and
- the United Kingdom company for practical purposes functions as his employer during the United Kingdom assignment and
- the United Kingdom company bears the cost of the employee's remuneration, either by a direct recharge or as part of a management charge made by the non- resident employer.

Subject to fulfilment of the other conditions for relief and the guidance below concerning avoidance cases, claims for earlier periods should normally be accepted where the overseas employer pays the remuneration but this is subsequently recharged to a United Kingdom company.

*When does a United Kingdom company function as an employer?*

Guidance on the criteria for identifying the employer for the purposes of the Article is to be found in paragraph 8 of the Commentary on Article 15 of the OECD Model Double Taxation Convention which should be considered in cases of difficulty. In short, where an employee works in the business of a United Kingdom company and that company obtains the benefits and bears any risks in relation to the work undertaken by the employee then that company is treated as his employer.

The mere fact that the United Kingdom company has borne the cost of the employee's remuneration is not alone sufficient for that company to be treated as the employer. A United Kingdom company would not be regarded as the employer where the employee continued to work in the business of a non-resident company even though working at the premises of the United Kingdom company - for instance, an employee sent to the United Kingdom company to service equipment supplied by a non-resident company.

The following guidance may also be of assistance in practice. In the case of very short term secondees it is unlikely that an employee would be sufficiently integrated within the business of the United Kingdom company for that company to be regarded as his employer. For that reason it may be accepted that a United Kingdom company with whom an employee does not have a formal contract of employment should not be treated as the employer for the purposes of Article15 where that employee is in the United Kingdom for less than 60 days in a tax year and that period does not form part of a more substantial period when the taxpayer is present in the United Kingdom.

*Avoidance cases*

Even in the case of work assignments beginning before July 1995 claims should not be admitted where payment by an overseas company forms part of an arrangement to avoid United Kingdom tax. Employment Income Technical will advise in cases where, for example, the overseas employer is based in a tax haven or the employee is nominally employed by a company which exists to provide his services to the United Kingdom user of those services. Cases where an employment which existed prior to the employee's assignment to the United Kingdom continues during that assignment usually do not cause difficulty. Cases where the employee has taken up a new formal employment with an overseas company at the time of assignment should be reviewed critically.

*'On behalf of'*

Payments may be made 'on behalf of'a non-resident employer in cases where the payment is physically made by a United Kingdom company. It may be accepted that remuneration has been paid or benefits provided 'on behalf of' a non-resident employer if that non-resident ultimately bears the cost of such remuneration and benefits. Claims should not be admitted where a United Kingdom company pays remuneration or incurs the cost of benefits and does not receive reimbursement from the overseas employer. Such payments and costs are incurred in the interest of the United Kingdom company and not on behalf of the overseas employer.

Unless the claimant offers evidence that the United Kingdom company was reimbursed the cost of the taxpayer's remuneration and benefits by the non-resident employer (and this can be checked with the District dealing with the United Kingdom company's Corporation Tax affairs) a claim under Article 15(2) should be resisted.

> Where it is argued that remuneration has been paid 'on behalf of' an overseas employer, even though a United Kingdom company has paid the individual's remuneration and the overseas employer has not reimbursed the cost, it should be pointed out that it is unlikely that, in these circumstances, the cost of the remuneration could be regarded as wholly and exclusively incurred for the purposes of the United Kingdom company's trade and that, therefore, no deduction should be claimed for the cost of the remuneration in computing the United Kingdom company's taxable profit. Reference should be made to the tax case of Robinson v Scott Bader and Co Ltd (54TC757) which considers the inadmissibility of remuneration paid on behalf of another employer.
>
> The decision in the Scott Bader case makes clear that the object of the person making the payment is decisive in determining whether or not a deduction is permissible in accordance with Section 74 ICTA 1988.
>
> In relation to seconded employees there are three possible situations
>
> - the payment to the employee is made solely in the interests of the overseas company;
> - the payment is made partly in the interests of the United Kingdom company and partly in the interest of the overseas company or
> - the payment is made solely in the interests of the United Kingdom company.
>
> Only in the third case is a deduction available to the United Kingdom company in computing its profits.
>
> *Benefits*
>
> Even where basic remuneration continues to be paid by the overseas employer it is common for benefits (for example, the use of a flat) to be provided at the cost of the United Kingdom employer to whom the employee has been seconded. Subject to the other conditions in the Article, the basic remuneration may be exempt from United Kingdom tax but the condition in Article 15(2)(b) is not satisfied in relation to benefits in these circumstances because they are not 'remuneration paid by, or on behalf of,' the overseas employer (unless the cost of the benefits is borne by the overseas employer through a recharge).

*Kljun v HMRC* [2011] UKFTT 371 (TC) offers an illustration of a case within art 15(2)(b).

### 12.34.3 *Article 15(2)(c): PE in other state*

The DTR Manual provides:

**1923 Employment**

The third condition for exemption under Article 15(2) is that the remuneration of the employee must not be borne by a permanent establishment or fixed base which the employer has in the United Kingdom –see DT1710 onwards and DT219 for general guidance concerning the meaning of these terms.

This condition should be considered carefully in all cases where the employee has not apparently been assigned to work in the United Kingdom for a United Kingdom-resident company. If an employee has simply been seconded by his overseas employer to work here for a United Kingdom-resident company it will not usually be necessary to consider this condition.

A subsidiary company in the United Kingdom is not generally a permanent establishment of its overseas parent company (see DT1714). The subsidiary is not in law part of its parent company but is a distinct legal person. A permanent establishment is simply a part of an overseas company which is transplanted in the United Kingdom. Customers and employees all contract with the overseas company rather than with a separate legal person in the United Kingdom. Company letter-paper often indicates how the United Kingdom operations are organised; the registered number and place of registration of a United Kingdom company are often given at the head or foot of the paper.

If operations in the United Kingdom are carried out through a permanent establishment, it should be assumed in the absence of evidence to the contrary that the cost of remuneration of an employee seconded to the permanent establishment is a deduction in computing the profits of the permanent establishment. This will be the normal basis of allocating costs in accordance with international tax principles. The permanent establishment should therefore be regarded as bearing the cost of that individual's remuneration unless there is evidence that the overseas Head Office continues to pay the employee and the cost is not allocated to the United Kingdom permanent establishment for United Kingdom tax purposes. A permanent establishment cannot be said to 'bear the remuneration' unless it is charged against its profits without a corresponding credit, for example by way of a management charge. In doubtful cases advice may be sought from the Inspector dealing with the accounts of the permanent establishment.

Sometimes dealing with the PAYE District may be the first contact which an overseas company has with the United Kingdom Revenue and it may not yet have been established whether or not the company has a permanent establishment in the United Kingdom. If the company has had no prior contact with the Revenue the Corporation Tax District which would have responsibility for the company (the District dealing with the area where the business premises of the company are located) should be asked to advise whether or not a permanent establishment exists in the United Kingdom (see DT1715 in cases of difficulty).

**1924 Employment** [April 2007]

Refer to Employment Income Technical all claims to the exemption of employment income from United Kingdom tax (DT1920 onwards) where

- the tax at stake in that case exceeds £50,000, or
- the company claimed to be the employer is apparently based in a tax haven, or
- difficulty is experienced in applying the guidance at DT1920 onwards in a particular case.

As the instructions in DT410 explain, a claim to exemption under an agreement is a claim to the Board by virtue of Section 788(6) ICTA 1988 and a notice of decision on a claim may not be given by an Inspector. If you reach the point where you are unable to reach agreement with the taxpayer please send the case to Employment Income Technical.

*Kljun v HMRC* [2011] UKFTT 371 (TC) offers an illustration of a case within art 15(2)(c).

### 12.34.4 *The 60-day rule*

Tax Bulletin 68 provides:

**Non-Residents Working In The UK For Short Periods: The "60-Day" Rule**

Most of the United Kingdom’s double taxation agreements contain a provision which may enable an employee who comes to work here on a short-term basis to be taxed only in his or her home country. An employee must show that he or she fulfils a series of conditions specified in the agreement to make a valid claim to exemption from UK tax. One of those conditions will be that the employee’s remuneration must be ‘paid by or on behalf of an employer’ who is not resident in the United Kingdom .In many cases, it is clear that the employer is the non-resident company for whom the taxpayer was working before he or she came to the UK. In other cases, the employee may have been seconded by his or her overseas employer to work for a UK company, or the overseas employer may carry on a business of hiring out staff to other companies. A formal contract of employment remains with the overseas employer, but the employee works in the business of the UK company, which obtains the benefits and bears any risks in relation to the work undertaken by the employee. In economic terms, this state of affairs is recognised by the overseas employer recharging the cost of the employee’s earnings to the United Kingdom and the UK company might be described as the ‘economic employer’. In such a case, the exemption from UK tax for short-term visitors will not be available. This was explained in Tax Bulletin 17, published in June 1995.

However, the position of very short-term visitors caused concern, and Tax Bulletin 25 dealt with this in October 1996. This reproduced a statement by the Financial Secretary to the Treasury (FST) that the Inland Revenue would not consider that a short term business visitor was sufficiently integrated into the business of a UK company for it to be regarded as the employer where:

- the employee concerned is in the UK for less than 60 days in a tax year; and
- that period does not form part of a more substantial period when the taxpayer is present in the UK.

This has become known as the "60-day rule". This article gives further guidance on common situations where it may be an issue.

**Does the worker have to be from a country with which we have a full double tax agreement for the 60-day rule to apply?**

The 60-day rule is framed in terms of accepting without enquiry that the conditions in a DTA for short-term business visitors to be solely taxed in their country of residence have been satisfied. That exemption, and consequently the 60 day rule, is therefore only relevant if the person is resident in a country with which we have signed a comprehensive double tax agreement. If not, domestic legislation will apply in full.

**Is the 60-day exemption available if the employee is on the UK payroll?**

No. The FST's statement was made in the context of workers who were paid via a non-resident employer's payroll but whose economic employer might be in the UK.

**How do you count the days for the 60-day rule?**

It is based on physical presence in the UK in the same way as the 183 days are counted for the purposes of Article 15(2) of the OECD model Tax Convention.

**Is the 60 days a fixed limit? For example, an employer has a succession of people who work for him and he bears their wages, but they may be in the UK up to 90 days.**

The 60-day rule represents a balance between a loss of tax revenue which may be due to the UK and the compliance costs to both employers and the Revenue of ascertaining and collecting such tax for very short-term visitors. There are no plans for it to be altered. However individuals working in the UK may be exempt under the relevant DTA anyway, for example if their earnings are paid by an overseas company, not recharged in any form to a UK company or permanent establishment and no UK company acts as their employer.

**Is the 60-day rule available where the earnings have been recharged to a UK permanent establishment rather than a UK-resident company?**

Although not covered in the actual wording of the 1996 statement, the Revenue accepts the 60-day rule should apply in these circumstances also.

**How should the phrase "part of a more substantial period" be interpreted?**

The aim is to provide consistency:

- Between very short-term workers, regardless of the particular dates involved; and
- Between short-term workers seconded from overseas and the normal workforce of the UK employer.

The most obvious example met is where less than 60 days are worked up to 5th April and less than 60 days after, but the overall period is more than 60 days. In these circumstances, the 60-day exemption will not be available, to be consistent with periods of more than 60 days worked over, say, November to January.

What if there is a gap between two shorter periods of employment?

To consider whether the 60-day period has been exceeded, the following factors may be relevant:

- Is there an expectation that the employee will return to the UK when they depart initially?
- How long is the gap between visits in comparison to the length of those visits?
- How frequently does the employee return to the UK?
- How integral to the business are the duties performed?

It is impossible to give an exact formula that will cover all circumstances. However, the following examples should assist in seeing how the Revenue will approach this question.

**Example 1: Alain visits the UK for 35 days in Feb/March 2003, then returns to Austria for a fortnight's holiday, and returns again to the same contract for 40 days in April/May.**

The 75 days would be regarded as one period. The gap here is insignificant compared to the two periods either side and liability to UK tax would be consistent with a person who works for 75 days here continuously. As the periods are part of the same contract, the employer would be expected to operate PAYE from day one. If there had been no expectation of returning during the first 35 days we would expect PAYE to be operated only for the second period even though liability to UK tax would exist for both for Alain. This is because the 60 days is an objective test whilst PAYE is based on "reasonable expectation" that payments are liable to UK tax.

**Example 2: Beatrice visits the UK for 35 days in Year 1. She returns to Belgium but unexpectedly is asked to return in Year 2, after a 7 month gap, and does so for 40 days.**

Each episode in the UK would be regarded as separate periods of less than 60 days. Beatrice's return was unexpected, and after a relatively long gap. So there is no UK liability for either and no PAYE is due.

**Example 3: Cedric is the financial controller for a Canadian group. Each year he visits the UK subsidiary for 55-59 days.**

Once there is an expectation that this will be the work pattern, the Revenue would consider that the episodes of work here were part of a more substantial period. A financial controller will be significantly integrated into the business, whether this is of the UK subsidiary or possibly a permanent establishment of the parent company. PAYE will apply from when it is clear that visits will recur as part of a regular and integrated pattern, although Cedric may have to consider whether he is also liable under self assessment to UK tax for an earlier period of work, as for Alain in Example 1. Cedric and the group will then be able to decide the duration and timing of visits to the UK on business grounds rather than for individual tax considerations.

**Example 4: Danielle spends 50 days working in UK between 10 April and 15**

**January, with visits averaging 3 days each. Then from 1 June to 6 October a further 15 days are spent visiting UK for business meetings on the same piece of work.**

Although Danielle is taxable from the very start, we would not expect either her or the company to be able to recognise this. However, the Revenue would expect PAYE to be operated in Year 2.

HMRC say:

HMRC were asked to clarify the way in which the economic employer test applies in a number of scenarios in which employment costs are recharged to a UKemployer. In each scenario, an individual has a formal employment contract with a person resident outside the UK and is seconded to work in the UK.

The economic employer test is set out in the commentary to Article 15 of the OECD Model Tax Convention on Income and Capital which, subject to certain conditions, enables an overseas employee who comes to the UK to work on a short-term basis to be taxed only in his or her home country. HMRC confirmed that it is not practice to restrict this test for UK resident employers.

This means that, where an employee is present in the UK for less than 60 days and is not on the payroll of a UK resident employer, the 60-day rule set out in Tax Bulletin 68 will normally apply: the individual will not be considered to have an economic employer without any further consideration of the facts being necessary. In other situations, it will be necessary to examine the facts to determine who has the rights on the work produced and bearing the relative responsibility and risks. Where the employee is a resident in another contracting State and is seconded to the UK for a short period, the economic employer will not depend on whether the UK employer is entitled to a Corporation Tax deduction for the remuneration costs: the UK employer might be entitled to a deduction even where they are not the economic employer.

HMRC referred to the recent publication on 21 May 2010 by the OECD of proposed revisions to the Model Treaty Commentary on employment relationships for the purposes of Article 15.[48]

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48 Joint Expatriate Forum on Tax and NICS: 26 May 2010 Meeting note *www.hmrc.gov.uk/consultations/260510-epf-minutes.pdf.*

CHAPTER THIRTEEN

# TRADING INCOME

## 13.1 Trading income- Introduction

A full discussion of the taxation of trading income would require many volumes. In this chapter I focus on matters closest to the themes of this book.

See too 39.11 (When is there a trade in financial assets?); 14.7 (Border between trading income and property income).

## 13.2 Charge on trading income

Section 5 ITTOIA provides:

> Income tax is charged on the profits of a trade, profession or vocation.

Section 5 applies to all trading[1] income, but s.6 ITTOIA distinguishes between trading income of residents and of non-residents; these need to be considered separately.

## 13.3 Trading income of UK resident

Section 6(1) ITTOIA provides:

> Profits of a trade arising to a UK resident are chargeable to tax under this Chapter wherever the trade is carried on.

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1 In this chapter, reference to a "trade" includes a profession or vocation as there is no relevant distinction between them. Section 6(3) ITTOIA provides:
"This section applies to professions and vocations as it applies to trades."

Section 7 ITTOIA provides:

> (1) Tax is charged under this Chapter on the full amount of the profits of the tax year. …
> (4) This section is subject to Part 8 (foreign income: special rules).

This brings in the remittance basis rules if the trading income arises from a source outside the UK. It is therefore necessary to identify the source. Section 7(5) ITTOIA states the test of source of trading income:

> And, for the purposes of section 830 (meaning of "relevant foreign income"), the profits of a trade, profession or vocation arise from a source outside the UK only if the trade, profession or vocation is carried on *wholly* outside the UK.

This is a statutory statement of the pre-ITTOIA case law.[2] It is a wide and strange test of source. Applying this test, if a trade is carried on partly in country A and partly in country B, the source of the income is in country A *and* country B. For the same income to have a source in two different countries is contrary to the natural meaning of "source" and contrary to the purpose of the concept which is to locate a source in one jurisdiction in order to identify one state with jurisdiction to tax. (Similarly an individual can have only one domicile.)

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 commonwealth countries 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 not even a *de minimis* rule; contrast the incidental duties disregard which applies to employment income.[3]

The former ITH discussed the old case law, which still holds good under ITTOIA:

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2 See John Avery Jones, "Taxing Foreign Income from Pitt to the Tax Law Rewrite – The Decline of the Remittance Basis", *Studies in the History of Tax Law* (Vol 1 2004) p.26 accessible *www.kessler.co.uk*.

3 See 12.13 (Where are duties performed: incidental duties).

**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 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 their trading income has a foreign source. Section 7(4)(5) ITTOIA is dead letter law. The former ITH recognised 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. ...

For completeness: s.95 ITA restricts loss relief for trades carried on wholly outside the UK, but since it is almost impossible to arrange that, the section is dead letter law.

### 13.3.1 *Planning for UK resident sole trader*

If a remittance basis taxpayer carries on a trade partly in and partly out of the UK, the individual will be taxed on the arising basis and not under the remittance basis. In these circumstances the individual may be able to divide up their activities into two spheres – those in and those out of the UK. The individual will then be carrying on two separate activities, of which at least one will yield foreign source income and qualify for 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

## 13.4 To whom does trading income arise?

Since different rules apply depending on whether trading income arises to a UK or non-UK resident, it is necessary to identify the person to whom the income arises.

Suppose a non-resident trust is carrying on a trade. If the trading income accrues to the trustees, they are taxed in accordance with the rules relating to *non*-residents, 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 residents: ie on an arising basis unless the strict condition is satisfied that the trade is carried on wholly outside the UK.[4]

Suppose a non-resident settlor-interested trust with a settlor who is a remittance basis taxpayer. One might think that the settlor would be taxable on an arising basis only on the part (if any) of the trading income

4 This may need to be reviewed when *R on the application of Huitson v HMRC* [2010] EWHC 97 (Admin) is final, because of the somewhat novel dicta of that case, but I do not anticipate any changes are likely.

attributable to carrying on the trade in the UK. The balance of the profits one might think taxable only (if at all) under the s.624 remittance basis. But this is not the case. Since the trust income is deemed to be that of the UK resident settlor, the settlor is taxed in accordance with the rules relating to UK residents: ie theirs are taxed on an arising basis unless the strict condition is satisfied that the trade is carried on wholly outside the UK.

What if the trade is carried on by a non-resident company within s.720 ITA? The transferor is treated as receiving income which in the HMRC view is not trading income. However, the s.720 remittance basis applies only to income which would be RFI if it were the individual's.[5] So for the purpose of the s.720 remittance basis one must apply the rules relating to UK residents: ie the transferor is taxed on an arising basis unless the strict condition is satisfied that the trade 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.

## 13.5 Trading income of non-resident

An entirely different rule applies to trading income arising to a *non*-resident person. Section 6(2) ITTOIA provides:

> Profits of a trade arising to a non-UK resident are chargeable to tax under this Chapter only if they arise—
> (a) from a trade carried on wholly in the UK, or
> (b) in the case of a trade carried on partly in the UK and partly elsewhere, from the part of the trade carried on in the UK.

The pre-ITTOIA wording imposed a charge on non-residents on income arising:

> from any trade, profession or vocation exercised within the UK.[6]

The meaning was the same so pre-ITTOIA case law is still relevant.

5 See 26.14 (Section 720 remittance basis).

6 Section 18 ICTA 1988 (repealed). It was accepted (though not stated in statute) that where a trade was exercised partly in the UK, income was apportioned and only the UK part was taxable.

Section 6(2) raises two issues: (1) When is a trade carried on wholly or partly in the UK? and (2) If a trade is carried on partly in the UK, how does one identify the profits from that part?

This is sometimes paraphrased by asking the question whether (or to what extent) the source of the trading income is in the UK. There seems nothing wrong with that; it is the correct and natural meaning of the word "source". Since s.7(5) ITTOIA uses the word "source" in an artificial sense in the rules relating to trading income UK residents, I have wondered whether it would aid clarity to avoid the word "source" in the context of the rules for non-residents. But in practice it is not possible to avoid the use of the word "source" here[7] so one simply needs to remember that source has two distinct meanings.

The UK case law is mostly antique, because in practice double taxation treaties often apply and then the issues may not arise. But of course that is not always the case. The former ITH is erudite and still helpful.[8] There are two other sources of guidance: cases on foreign tax credit and non UK tax cases. I should comment briefly on these.

### 13.5.1 *Foreign tax credit cases*

Section 9 TIOPA provides foreign tax credit relief where the foreign tax is:

> calculated by reference to income arising ... in the territory.[9]

Thus for the purposes of foreign tax credit it is similarly necessary to identify the locality of the source. The issue arose in *Yates v GCA International*[10] where *Smidth* principles (ie the rules for trading income of non-residents) were applied. The former ITH para 827 provided:

> The *Gaffney Cline* case [*Yates v GCA International Ltd* 64 TC 37], ... 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

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7 Since relevant case law and foreign statutes regularly use the word "source".

8 Tax Bulletin 18 provides a brief summary, not set out here.

9 See 50.5 (Foreign tax credit relief).

10 64 TC 37.

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.

### 13.5.2 *Non-UK tax 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 whether the test is the same, ie whether the Commonwealth cases have any relevance in the UK (and vice versa).

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 ...
> Their Lordships have no criticisms to make of any of those decisions, but they desire to point out that
> [1] decisions on the words of one statute are seldom of value in deciding on different words in another statute, and that
> [2] different business operations may give rise to different taxing results.

Point [2] is obviously correct but we are here concerned with point [1]. The Privy Council continue:

> [3] If the charging words of the English statute are looked at,
>> "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";[11]
>
> 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.

11 I have corrected a slight misprint in the law report. This is only a rough summary of the statutory wording, later s.18 ICTA, now rewritten in ITTOIA.

> [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*,[12] 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.[13]

Lord Atkin correctly states at [4] that the Commonwealth legalisation and case law has no relevance to the (artificially wide) test of location of source of trading income for UK residents.[14] It is considered that the Commonwealth legislation does apply the same test as s.6(2) ITTOIA (trading income of non-resident). For this purpose the Commonwealth cases *are* persuasive authorities in the UK. For the object of the rules for non-residents 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 former ITH referred to *Kirk*.

The same applies to Hong Kong, where the charge is on profits "arising in or derived from Hong Kong".[15] *Smidth* is the basis of the Hong Kong case law.[16] The Hong Kong Revenue have issued useful guidance **"the Hong Kong guidance note"**. It is suggested that its status in an English court should be the same as that of a respected textbook. The Hong Kong guidance note provides:

> 4. Though the word "source" is not used in section 14, it has always been accepted by the courts that the words "arising in or derived from" raised the concept of source. Cases from other common law jurisdictions with

12 3 TC 407.
13 [1940] AC 774 at p.788–9.
14 See 13.3 (Trading income of UK resident).
15 Section 14 Hong Kong Inland Revenue Ordinance.
16 *IRC v HK-TVB* [1992] STC 723 at p.728.

> legislation using the specific word "source" are therefore relevant and have been used in assisting the interpretation of the words used in section 14. In *IRC v. Philips Gloeilampenfabrieken* [1955] NZLR 868, Barrowclough CJ at 874 said that the concept of derivation seems necessarily to imply the concept of a source.[17]

In an Indian statute, the charge was on profits "accruing or arising in British India". This was held to be substantially the same as in Hong Kong.[18]

Unfortunately the Commonwealth cases are remarkably inconsistent.[19]

## 13.6 Place where contract made

The former ITH provided:

> **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

17 Inland Revenue Department Hong Kong, Departmental Interpretation and Practice Notes No. 21 (Revised) Locality of Profits December 2009, accessible *www.ird.gov.hk/eng/pdf/e_dipn21.pdf*.

18 *IRC v Hang Seng Bank* [1990] STC at p.739 though "it may be that there is some marginal difference in the shades of meaning conveyed by the two phrases".

19 See Michael Littlewood's scholarly article "The Privy Council, the Source of Income and *Stare Decisis*" [2004] BTR 121 and Robert Venables QC, "The Territorial Source of Income" OTPR, Vol 7, p.177.

to Denmark. It was making the point that some of the profit arose from the transmission along other cables which had absolutely nothing to do with the UK. The first thing the judgments in the Court of Appeal make clear is that the matter is wholly one of fact. The judgments then separate two questions for decision. First, is there trading in the UK? Brett LJ says this on page 425. His words are important because it is here that the significance of contract – place of contract – begins.

> "Now, I think it would be first of all nearly impossible and second wholly unwise to attempt to give an exhaustive definition of when a trade can be said to be exercised in this country. The only thing that we have to decide is whether upon the facts of this case it can be said that this company is carrying on a profit earning trade in this country. Now I should say that wherever profitable contracts are habitually made in England by or for a foreigner with persons in England, because those persons are in England, to do something for or supply something to those persons, such foreigners are exercising a profitable trade in England, although everything done by or supplied by them in order to fulfil their part of the contract is done abroad. The profit arises to them from the contract which they make. The profit which they derive can only be derived from the payment which is to be made to them by the person with whom they contract. In the given case they would not have any such contract as they are in the habit of making unless it was a contract made in England with a person who is in England because he is in England. Observe, if the person or someone acting for him were not in England he would not be wanting to send a telegraph message from England".

The language is now over 100 years old and while it may perhaps look a little old fashioned today its meaning seems plain. The Court was saying: "You, the customer, are in England and because you are here you want goods here (or in the case in point, you want a message sent from here). The profit comes from the contract, the contract is here and there is trading in England and it is nonetheless trading in England even though the goods come from abroad or the service is provided through electric cables which are partly abroad". ...

**815. First champagne cases**

*Erichsen v Last* was followed by the so-called champagne cases. There were three leading champagne cases. In the first two, the Revenue succeeded in a claim that the French champagne houses concerned were trading in the UK through agents in London. In the Pommery case [*Pommery and Greno v Apthorpe* 2 TC 182] there was no express finding as to where contracts were made but most orders were met from stock held in the UK. In the Werle case [*Werle v Colquhoun* 2 TC 402] the Court of Appeal made it clear that they considered the contracts to be made by the agents here on behalf of their principal.

These two houses were producers of champagne as well as sellers of champagne and it is reasonably clear that the Revenue did not claim to tax the producer's profit. In the Pommery case at page 189, the Judge specifically referred to the difficulty of calculating the profit; he said that there might be some difficulty as to the manner of calculation in deciding what amount of expenditure to put against the profits and wondered whether it would be proper to look at the goods sent over to England and to put a fair valuation upon them as they arrived. That he said was a matter of quantum, a matter for the consideration of persons skilled in such things.

In the Werle case on page 413 Fry LJ had a similar approach, he said

> "A small shopkeeper... is plainly carrying on a trade in the place where the shop is ... The question, however, becomes more difficult when the trade is carried on, as in the present case, in a far more complicated manner ... when the contract may be in one place, the goods in another, the principal in another and the goods may be delivered in some other place. We have, however, simply to do this, to take all the relevant facts and the mode in which the business is carried on, and to ask ourselves whether that business be or be not carried on within the UK. It appears to me that the same business may in some sense be carried on in many places. The Head Office of a firm, the place where the goods are manufactured, the place where the contracts are made, may all of them be places in which the business or parts of the business is or are carried on. Now, in the present case what we find is this, that the appellants reside in France, carrying on there the business of vineyard proprietors, champagne makers and champagne merchants, no doubt a large portion of that business is carried on within France, but a portion of that business is that of champagne merchants. Now, that means, as I understand, the selling of champagne and that business they carry into effect in England through the intervention of a firm of agents in this country."

**816. Contracts abroad**

The last of the champagne cases is *Grainger v Gough* [3 TC 311 and 462] and it is a very significant case. The Court of Appeal made no distinction between this and the earlier cases and found that the champagne house was liable on its trading here. ...

But Lord Esher and his fellow judges were overruled by the House of Lords on the question of whether there was liability at all. That was on the basis that in this particular case, contracts were not made in the UK. Although to the customer there may have been little difference between buying through the agents in the first two cases and buying through the agents in the third, there was a difference in the arrangements which the House of Lords saw as vital in determining the non-resident's liability to UK tax. In finding that the contracts were not made in the UK the House of Lords drew the now classic distinction between trading in the UK which involves liability and trading with the UK which does not. Non-residents with customers here commonly rely on this distinction.

The House of Lords may well have had it in mind that if we sought too strenuously to tax foreigners who sold goods here, we might be faced with hostility by countries to which we were exporters and which might seek to tax those exporters in parallel circumstances. The thought is not directly expressed but there is a hint of it at the end of Lord Herschell's judgment on page 468.

## 13.7 Rejection of place of contract test

The former ITH provided:

> **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?"

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 former ITH gave one further quote to drive the point home:

> In one of the few fairly modern[20] cases on this subject, the Firestone case [*Firestone Tyre & Rubber Ltd v Lewellin* 37 TC 111 at p.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

20 I guess that this passage in the former ITH was written in the 1980s.

determining factor if there are other circumstances present that outweigh its importance or unless there are no other circumstances that can."

This approach is adopted in the Privy Council. The Hong Kong guidance note provides:

> 7. Lord Bridge explained the "broad guiding principle" in *Hang Seng Bank* at 322H to 323A in the following terms: "But the question whether the gross profit resulting from a particular transaction arose in or derived from one place or another is always in the last analysis a question of fact depending on the nature of the transaction. It is impossible to lay down precise rules of law by which the answer to that question is to be determined. The broad guiding principle, attested by many authorities, is that one looks to see what the taxpayer has done to earn the profit in question."
> 8. The "operations test" was further elaborated by Lord Jauncey in *HKTVBI* at 407C-D:
>
> > "*F. L. Smidth & Co. v. Greenwood* [1921] 3 K.B. 583 was cited in Hang Seng Bank case and their Lordships do not doubt that Lord Bridge has in mind the judgment of Atkin L. J. in that case and in particular the passage when he said, at p. 593: 'I think that the question is, where do the operations take place from which the profits in substance arise?' Thus Lord Bridge's guiding principle could properly be expanded to read 'one looks to see what the taxpayer has done to earn the profit in question and where he has done it.'"[21] ...
>
> 21. When Lord Bridge said in *Hang Seng Bank* that profits from buying and reselling of commodities were derived from the place where "the contracts of purchase and sale were effected", he could not merely mean legally executed (as this would depend on formal legal rules of offer and acceptance). The Department agrees with the approach in *Magna* and will contemplate all the relevant operations carried out to earn the profits, including the solicitation of orders, negotiation, conclusion, trade financing, shipment and performance of the contracts.
> 22. The Department does not merely look at the place of contract to determine the geographical source of profits. Where the contract is made by exchange of letters, by fax, or by e-mail, the application of contract

21 Similarly Lord Jauncey in *HK-TVBI* at 409D-E:
"The proper approach is to ascertain what were the operations which produced the relevant profits and where those operations took place."

law and of private international law as to where the contract is made may result in conclusions that are entirely fortuitous. In *Firestone Tyre and Rubber Co Ltd v. Lewellin* [1957] 1 WLR 464 (HL) at 471, Lord Radcliffe said such an approach under the conditions of international business and modern facilities of communication was capable of proving a somewhat ingenuous one. Hunter J shared the same view in *Sinolink Overseas Ltd v. CIR* 2 HKTC 126 at 131.[22]

## 13.8 Where profits in substance arise

So we turn to the question of where profits in substance arise. The short answer is that there is no short answer. The former ITH provided:

> **820. NRs: profits in substance**
> It is consistent with the words of Brett LJ at the start of the quotation in ITH813 to say that no neat formula to decide what is, and what is not, trading in the UK can be devised. ...

Circumstances vary so widely that it is not possible to devise a single test that fits all cases.[23] The Hong Kong guidance note provides:

> 11. The broad guiding principle has been followed in subsequent cases before the Court of Final Appeal. In *Kwong Mile*, Bokhary PJ summarised the broad guiding principle at 174I to 175E:
>
> > "The ascertainment of the source of a profit is not hindered by technical rules, but is helped by the broad guiding principle that one looks to see what the taxpayer has done to earn the profit and where he has done it. ... In *CIR v. Orion Caribbean Ltd* [1997] HKLRD 5 924, Lord Nolan emphasised (at p.931F) that '[n]o simple, single, legal test can be employed' when ascertaining the source of a profit. ... The situations in which the source of a profit has to be ascertained are too many and varied for a universal judge-made test. Apart from the words of the statute themselves, the only constant is the need to grasp the reality of each case, focusing on effective causes without being distracted by antecedent or incidental matters."[24]

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22 *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".

23 "No simple legal test can be employed"; see *IRC v Orion Carribean.*

24 *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".

It is not, of course, an answer to say that the question is just a question of fact. The comments made at 17.2.10 (Unsatisfactory approaches) apply here too.

## 13.9 Trading in UK: preparatory and auxiliary activities

The former ITH Manual para 849 provided 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;[25]
> e) the maintenance of a fixed place of business solely for the purpose of carrying on, for the enterprise, any other activity of a preparatory or auxiliary character;
> f) the maintenance of a fixed place of business solely for any combination of activities mentioned in subparas a) to e), provided that the overall activity of the fixed place of business resulting from this combination is of a preparatory or auxiliary character.[26]

The Hong Kong guidance note provides:

> ANTECEDENT OR INCIDENTAL ACTIVITIES
> 14. In *ING Baring* at 428, Ribeiro PJ when discussing the legal principle also emphasised the need to grasp the reality of each case, focusing on effective causes without being distracted by antecedent or incidental matters. The focus is on establishing the geographical location of the taxpayer's profit-producing transactions as distinct from activities

25 See 13.10 (Buying from UK sellers).

26 For similar discussion, see 74.7 (PE: preparatory and auxiliary activities).

antecedent or incidental to those transactions.
15. Whether an act is an antecedent or incidental activity is a question of fact and would depend on the nature of the transaction. In *CIR v. The Hong Kong & Whampoa Dock Co Ltd* [1960] 1 HKTC 85, the initial business contact in Hong Kong which set in motion a chain of operations that ultimately led to the salvaging of the vessel was rejected as the relevant operation.
16. Comments in a similar vein can be found in *Hang Seng Bank* at 320F-G:

> "The activities of the bank from which the income arose was the buying and selling of this property in overseas market places and not the decision making process in Hong Kong or any other activities in Hong Kong. Likewise the income arose from the trading in property situate outside of Hong Kong and not the moneys of customers situate in Hong Kong."[27]

## 13.10 Buying from UK sellers

The former ITH provided:

> **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 of the trade carried on in New York, where the main business is conducted".

Maintaining a purchasing office is also included in the list of auxiliary activities which do not amount to trading in the UK.[28]

The Hong Kong guidance note provides:

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27 *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".

28 Model convention para 5(4)(d); see 13.9 (Trading in UK: preparatory and auxiliary activities).

BUYING OFFICE
29. A trading company, carrying on business outside Hong Kong, may set up a branch in Hong Kong to act as a buying office for the purpose of purchasing goods or merchandise or of collecting information. The activities of the branch are confined to the purchase of goods or merchandise or of collecting information in Hong Kong and it is not involved in their sale, either in Hong Kong or elsewhere. In such a situation, a liability to Hong Kong profits tax would not arise. The functions of a buying office may also be carried out by a subsidiary company or by an agent (either related or unrelated). However, as for a branch, the subsidiary company or agent must not be involved in the sale of the goods. On the other hand, any commission or other remuneration earned by the subsidiary company or agent for performing its services in Hong Kong will be fully taxable.

## 13.11 Buying and selling to UK purchasers

The former ITH para 820 provided:

But we do attach much importance to Lord Atkin's approach to the question of "trading in" in the *Smidth v Greenwood* case quoted in ITH817 above – "where do the operations take place from which the profits in substance arise".
We have come to adopt this test as the principal criterion for determining whether there is "trading in". But it should be borne in mind that the Smidth company was found not to be trading in the UK. Although it had an agent in the UK to advise prospective purchasers and assist with the installation of machinery, the profits in substance arose from the sale of that machinery under contracts made abroad. ...
**821. Merchanting: Place of sale**
The decision in the *Smidth* case supports the conclusion that in the case of merchanting business (buying and selling goods for profit), the trade is normally exercised at the place where the contracts for sale are made – that is where the operations take place from which the profits in substance arise.
It may help, in considering why that should be the relevant place, to put the decided cases aside and to ask what sort of facts could possibly be significant in leading to an answer to the question of whether there is trading in the UK. Where merchanting is concerned – buying and selling – there will often be a central office where questions of policy are considered and finance is arranged. There is the buying of the goods and perhaps the holding of a stock of goods. Then there is the search for customers and there is the actual contract for sale. That contract may be at a price laid down in a distant Head Office or it may be for a price negotiated with some skill on the spot. Finally there is delivery involving the question where does the lawful property in the goods pass from seller to buyer.
Few if any of the elements described above necessarily call for a presence in this

country and the functions involved can be located where the trader wishes. Most countries take the same view as we do about buying. The Court in *Sulley's* case simply said "It would be most impolitic thus to tax those who come here as customers." The place of sale, as identified by the place of contract for sale, is a reasonable means of determining the location of trading; trading profit becomes measurable only when there is a sale and without a sale there can be no profit.

**822. Place of sale unreliable**

But the place of sale, like other elements, can be moved. Even where the trade is that of buying and selling some qualification is needed to the assertion that there is trading in the UK if the contracts for sale are made here. It is generally taken for granted that it must be so if the sales are to people who are here. But, as is apparent from ITH830–ITH834 below which look at the place of contract, just when and where a contract is concluded can depend on fine distinctions and may even be a matter of chance. If, for example, a non-resident advertises goods for sale in a newspaper here and the customer responds by a telephone call to the non-resident during which agreement is reached or there is an exchange of telexes, the contract may technically be made in the UK even though the non-resident does very little here at all. We do not know what view the Courts would take of that though they have certainly not ruled out the possibility that while there may be contracts here there may nevertheless be no trading here [See *Belfour v Mace* 13 TC 558].

There may be similar doubt when sales are to people who are not resident here. The problem can be illustrated by a simple example. A New York art dealer has a picture which a Frenchman is interested in. The American and the Frenchman happen to meet in London which both are visiting for a few days holiday. In their hotel they agree on a price for the picture and conclude the deal. The contract is made here. Is the American trading in the UK? The matter is considered further on in chapter 9 (ITH947).

One may devise improbable examples of this kind without doing more than to highlight the difficulties which absolute reliance on the place of contract as a test would involve. Other cases of difficulty are those where there is reason to believe that, although contracts are formally made abroad, everything is really done here short of signing a piece of paper. In such cases we would say that there is trading here. The problem in such a case is largely one of proof. See, for example, the comments in chapters 9 (ITH914) and 10 (ITH1017).

The Hong Kong guidance note provides:

18. In *CIR v. Magna Industrial Co Ltd* [1997] HKLRD 171 at 178, Litton VP recognised that in case of a trading profit the purchase and the sale were the important factors. He further included in his deliberation all of the relevant operations and not just the purchase and sale of the products. When applying the operations test, Litton VP said at 176G:

> "In other words, one looks to see what the taxpayer has done to earn the profits and where he has done it. Obviously the question where the goods

were bought and sold is important. But there are other questions: For example: How were the goods procured and stored? How were the sales solicited? How were the orders processed? How were the goods shipped? How was the financing arranged? How was payment effected?”

19. The obtaining of the buyer’s order in Hong Kong and the placing of the order with the seller from Hong Kong are the foundations of a trading transaction since the differential between the selling price and the buying price (i.e. the mark-up) generates the profit. In *Exxon Chemical International Supply SA v. CIR* 3 HKTC 57, having decided that the obtaining of the order from the buyer and the placing of the order with the seller, took place respectively in and from Hong Kong, Godfrey J concluded that the profit arose in or was derived from Hong Kong.

20. In *CIR v. Euro Tech (Far East) Limited* 4 HKTC 30, Barnett J doubted that there should be some particular level or threshold of activity on the part of the taxpayer in Hong Kong, such as by bringing the products into Hong Kong and re-exporting them. He observed that in many trading companies the taxpayer was doing no more than bringing together the complementary needs of sellers and buyers. He said if the bringing together was done in Hong Kong the trading profit was sourced in Hong Kong....

23. On the basis of the various court judgments discussed in paragraphs 18 to 22 above, the Department’s views which are reflected in its assessing practice on the locality of profits derived from trading in commodities or goods by a business carried on in Hong Kong can be summarised as follows:

(a) Where both the contract of purchase and contract of sale are effected in Hong Kong, the profits are fully taxable.

(b) Where both the contract of purchase and contract of sale are effected outside Hong Kong, no part of the profits are taxable.

(c) Where either the contract of purchase or contract of sale is effected in Hong Kong, the initial presumption will be that the profits are fully taxable. Matters, such as those mentioned in paragraph 18 above, will be examined to determine the issue.

(d) Where the sale is made to a Hong Kong customer (including the Hong Kong buying office of an overseas customer), the sale contract will usually be taken as having been effected in Hong Kong.

(e) Where the commodities or goods are purchased from either a Hong Kong supplier or manufacturer, the purchase contract will usually be taken as having been effected in Hong Kong.

(f) Where the effecting of the purchase and sale contracts does not require travel outside Hong Kong but is carried out in Hong Kong by telephone, fax, etc., the contracts will be considered as having been effected in Hong Kong.

(g) The purchase and sale contracts are important factors but all the relevant operations that produce the trading profits must be looked at to determine the locality of the profits. Persons who are merely trading with Hong Kong by either selling goods to customers in Hong Kong or buying goods from suppliers in Hong Kong will not fall within the ambit of this paragraph. Nor will this paragraph applies to a buying office referred to in paragraph 29 below.

24. Having regard to the points expressed above, it will be apparent that, in the Department’s view, the question of apportionment does not arise in relation to

trading profits. Trading profits will be either wholly taxable or wholly non-taxable. There is no room to substitute a mixed source for a Hong Kong source even though there might be some overseas activities.

### 13.11.1 *Situs of assets sold*

In *IRC v HK-TVB* the Privy Council said:

> profits accruing to a resident taxpayer from the sale of foreign immovable property are likely to arise in the country where that property is situated although both the contracts of purchase and sale thereof are made in the country of residence of the taxpayer: *Liquidator, Rhodesia Metals Ltd. v. Commissioner of Taxes* [1940] AC 774.[29]

The Hong Kong guidance note provides:

> 45. Subject to specific provisions, the Department regards the locality of the following types of profits to be as follows:
> (a) Rental income from real property. *Locality:* Location of the property.
> (b) Profits derived by an owner from the sale of real estate. *Locality:* Location of the property.
> (c) Profits from the purchase and sale of listed shares and other listed securities. *Locality:* Location of the stock exchange where the shares or securities in question are traded. Where the purchase and sale took place over-the-counter, the place where the contracts of purchase and sale are effected.
> (d) Profits from the purchase and sale of unlisted shares and other unlisted securities. *Locality:* Place where the contracts of purchase and sale are effected, except financial institutions in instances where section 15(1)(l) applies.

### 13.11.2 *Buying and selling through an agent*

SP 1/01 provides:

> 22. If a non-resident carries on a financial trade outside the UK, any transactions carried out through a UK investment manager are likely to amount to trading in the UK. That is so whether there is a discretionary

29 [1992] STC 723 at p.729.

agreement or whether the manager acts on the instructions of the non-resident.

Whether or not this is right does not much matter as in most cases the investment manager exemptions apply, but (even allowing for the qualification in the use of the word "likely") it is too widely expressed. The Hong Kong guidance note provides:

> 25. Cases may arise where it is claimed that contracts of purchase and of sale have been effected wholly outside Hong Kong by employees of the Hong Kong business travelling abroad or by overseas agents. In this context, no operations are carried out in Hong Kong to give effect to the trading transaction; and the employee or overseas agent habitually exercises a general authority to negotiate and conclude contracts on behalf of his principal.
> 26. Normally the activities of an agent and an employee are accorded the same weight if it can be shown that the employee has full authority to conclude contracts without reference to the business in Hong Kong. In considering claims that contracts have been wholly effected outside Hong Kong by employees, Assessors will, in addition to facts in paragraph 18 above, require details of travelling, hotel and subsistence expenses in respect of each individual transaction. Where it is claimed that contracts are effected by overseas agents, it will be necessary to provide agency agreements or other evidence to support the claim.

## 13.12 Services

The former ITH continued:

> **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.[30]

The Hong Kong Guidance Note adopts the same approach:

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30 The former ITH para 826 continued:
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.

> 20. The Department regards the locality of the following types of profits to be as follows -
> (e) Service fee income. *Locality*: place where the services are performed[31] which give rise to the fees.

This is consistent with the statutory rule for foreign tax credit relief. Section 9(1) TIOPA provides relief where foreign tax is

> (b) calculated by reference to income arising ... in the territory, and

Section 9(3) TIOPA provides:

> For the purposes of subsection (1), profits from, or remuneration for, personal or professional services performed in the territory are to be treated as income arising in the territory.

This raises the question of where the services are provided or performed. Where the services involve physical work, the answer is obvious. In *Brackett v Chater*[32] a surveyor contracted himself to a Jersey company (owned by a Jersey trust that he had made although this was not material). He became its employee. Clients contracted with the Jersey company but the surveyor did all the work in the UK using facilities available to them at the offices of the firm in which they were previously partners. The Jersey company was held to be trading in the UK.

The Hong Kong guidance note provides:

> It should be noted that in the case of an investment adviser whose organisation and operations are located only in Hong Kong, profits derived in respect of the management of the clients' funds are considered to have a Hong Kong source. Included in chargeable sums are not only management fees and performance fees but also rebates, commissions and discounts received by the adviser from brokers located in Hong Kong or elsewhere in respect of securities transactions executed on behalf of clients.

31 The ITH refers to the place where services are *provided* and the HK guidance refers to the place where services are *performed* but in the context the meaning is the same.
32 60 TC 134 & 639.

In *Yates v GCA International*[33] a UK resident company provided services (an investigation into oil fields in Venezuela). Some of the work was done in Venezuela and some in the UK. The company (being UK resident) was in principle taxable on all trading income, but subject to foreign tax credit relief for Venezuela tax on income arising in Venezuela.[34] The *Smidth* principles were applied and so (unsurprisingly) part of the profits were held to arise in Venezuela.

### 13.12.1 *Commissions*

The Hong Kong Revenue guidance provides:

> RE-INVOICING CENTRE
> 27. The Department's view is that if a profit is derived from services rendered in Hong Kong, the profit is clearly taxable. Commission income or profit that accrues to a "re-invoicing centre" for services rendered is chargeable to profits tax. Profits derived from the buying and selling of goods are not service income. The transaction involves the taking of commercial risks (e.g. product risks, inventory risks, credit risks, exchange risks, capital risks, etc.) different from those attached to a service. Confirmation of sales and issue of purchase orders are indications that it is a trading transaction. The source of trading profits depends on the locality of the trading operations. Paragraphs 18 to 26 are relevant.
> 28. It is not possible to categorise the circumstances under which income or profit derived by a "re-invoicing centre" would be regarded as a service income and not as a trading profit. In each case, the Department would examine the nature of the operations and the type of risks in question to determine whether they constitute the provision of services or trading. The label "re-invoicing centre" clearly does not in itself provide the answer as it can mean different business structures.
> *Example 1*
> Company A, incorporated in Hong Kong, is a re-invoicing centre of a group of companies with a holding company incorporated in the United States, as more particularly described below. It manages in Hong Kong all foreign currency exposures from intra-company trade, guarantees the exchange rates for future orders and manages intra-affiliate cash flows, including lead and lags of payments. Manufacturing affiliates in Mainland China sell goods to Company A, which in turns resells to the distribution affiliates in North America and Europe. Company A resells at cost plus a mark-up for its services. The mark-up covers the cost of the re-invoicing centre and a reasonable return on the services

33 64 TC 37.
34 See 13.5.1 (Foreign tax credit cases).

> provided. The profits accrue to Company A are service income derived from Hong Kong. The mark-up earned by Company A, which acts as a re-invoicing centre, is chargeable to profits tax.

## 13.13 Construction and engineering works

The former ITH para 826 continued:

> 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].

## 13.14 Manufacturing

The former ITH para 826 continued:

> 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 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.[35]

The Hong Kong Revenue guidance note provides:

MANUFACTURING PROFITS

30. Lord Jauncey in *HK-TVBI* at 410F has commented on the source of manufacturing profits. He explained:

> "If a manufacturer in Hong Kong sells his goods to a merchant in Manila the payment which he receives is no doubt sourced in Manila but his profit on the transaction arises in and is derived from his manufacturing operation in Hong Kong."

Where goods are manufactured in Hong Kong, the profits arising from the sale of such goods will be fully taxable because the profit making activities are considered to be the manufacturing operations carried out in Hong Kong, which should include the procurement of raw materials, the employment of labour, the design of products and the use of machinery and plant, etc.. The following examples illustrate the Department's views on this subject:

*Example 2*

Company B manufactures goods in Hong Kong and sells them to overseas customers. The fact that Company B has sales staff based overseas does not give a part of the profits an overseas source. This is not a case for apportionment. The whole of the profits are liable to profits tax.

*Example 3*

Company C manufactures in Mainland China and sells the finished goods through a retailing branch in Hong Kong. The retailing branch has sales staff and a fixed place of business, and has registered for business in Hong Kong. Company C is both a manufacturer and a retailer. Profits are derived from the manufacturing operations in Mainland China and the retailing operations in Hong Kong. It is necessary to apportion the profits derived by Company C. Profits attributable to the Hong Kong retailing branch are chargeable to profits tax.

32. In Mainland China, two types of processing trade normally involve Hong Kong companies: contract processing and import processing. They are two different forms of transaction and require an accurate legal analysis.

CONTRACT PROCESSING

33. In contract processing, the document that governs the contractual relationship among the parties is the processing agreement. It sets out the rights and responsibilities of the Hong Kong company and the Mainland processing

35 [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.

enterprise. The Hong Kong company is responsible for the supply of raw materials and machinery without consideration and to provide technical and managerial know-how while the Mainland processing enterprise is responsible for the provision of factory premises, utilities and labour force. 34. In return for the processing service, the Hong Kong company pays a subcontracting charge to the Mainland enterprise. The legal title to the raw materials and finished goods remains with the Hong Kong company. In the Department's view, the Hong Kong company's operations in Mainland China complement its operations in Hong Kong. Recognising the operations of the Hong Kong company in the Mainland, an apportionment of profits on a 50:50 basis is usually accepted.

35. In *D132/99* 15 IRBRD 25, the taxpayer contended that all of its profits were offshore in nature. The Board of Review held that its operations in Mainland China were not dominant operations that overshadowed the activities in Hong Kong and the operations in Hong Kong could not be disregarded.

36. In *D145/99* 15 IRBRD 91, the Board found that the taxpayer was not privy to the processing agreements, which had been entered into by its fellow subsidiaries and the taxpayer should be assessed for profits tax on 100% of its profits for the years of assessment after the processing agreement lapsed. The Board found that the taxpayer's business was the procurement of toys to satisfy sale and purchase contracts and that important operations took place inside Hong Kong: the reaching of purchase agreements; the determination of price; the issue of invoices; the procurement of raw materials and the shipment of finished products.

37. If the Hong Kong company has restricted involvement in the processing arrangement with the Mainland enterprise, the apportionment of profits could not be appropriate. For example, a Hong Kong company has contracted out the assembly work to various contractors in Hong Kong and the Mainland. The jobs are numerous, small in value and of short duration and the Hong Kong company has minimal involvement in the assembly work. Given that the Hong Kong company does not carry out any manufacturing operations outside Hong Kong, its profits should be fully chargeable to profits tax without any apportionment.

38. The apportionment contemplated in paragraph 34 above will also apply to cases where manufacturing activities are undertaken under a similar arrangement in other places.

IMPORT PROCESSING

39. In import processing, the manufacturing operations are carried out by a foreign investment enterprise (FIE) related to the Hong Kong company. An FIE is often a separate legal entity incorporated in the Mainland. The Hong Kong company sells raw materials to the FIE and buys back the finished goods from the FIE. The Hong Kong company engages in the trading of raw materials and finished goods whilst the FIE manufactures the finished goods. The legal title to the raw materials and the finished goods passes to/from the FIE.

40. In import processing, the gross profits arise from trading transactions whereby the Hong Kong company purchases finished goods from an FIE and sells them for a profit. The manufacturing operations of the FIE in the Mainland are not performed on behalf of, or for the account of, the Hong Kong company even though the Hong Kong company and the Mainland enterprise might be

within the same group of companies.

41. In *ING Baring*, Lord Millet NPJ said that the source of profits had to be attributed to the operations of the taxpayer which produced them and not to the operations of other members of the group. In D36/06 21 IRBRD 694 which was a typical import processing case, the Board held that the taxpayer's profits were fully chargeable to profits tax. It was ruled that the FIE was not part of the taxpayer and was not an agent of the taxpayer. Hence the FIE's operations were not relevant in determining the source of profits of the taxpayer. The Board of Review rejected the contention of "substance over form" and disagreed with the suggestion that a leasing agreement of production facilities was similar to a contract processing agreement.

42. The Department holds the view that profits which accrued to the Hong Kong company from "trading transactions" carried out in Hong Kong cannot be attributed to the manufacturing operations of the FIE carrying on business in Mainland China. The source of the trading profits must be attributed to the operations of the Hong Kong company which produced them. In *Consco Trading Co. Ltd v. CIR* [2004] 2 HKLRD 818, To Deputy J said that it was correct to consider factors such as the finance arrangements, the payment of raw materials and processing fees, the arrangement for receipt of payment from purchasers for the finished product and pre-contract negotiations and the Board was entitled to conclude that, on the evidence, the preponderance of the activities which earned the profits were performed in Hong Kong. The Court of First Instance said the Board correctly excluded the processing activity of the Mainland Chinese entity as not being relevant to the determining of the taxpayer's source of profits which were derived through the sale of processed goods.

43. In *CIR v. Datatronic Limited* [2009] 4 HKLRD 675, where the arrangement between Datatronic and the FIE was an import processing arrangement, the Court of Appeal held that the profit-producing transactions were the purchase of goods from the FIE by Datatronic and subsequent sale and that these activities took place in Hong Kong. Thus, the profits were derived from Hong Kong. The Court of Appeal further held that the fact that the FIE, although a wholly-owned subsidiary of Datatronic, is a separate legal entity and that its dealings with Datatronic were not at arm's length would not detract from the reality of the legal effect of the transactions. It is also worth to note the Court of Appeal's concurrence with the Board's findings that the manufacturing was done by the FIE in the Mainland is substance and not form and that Datatronic's activities (i.e. assisting the FIE in preparing the goods and supplying them to Datatronic) in the Mainland were merely antecedent or incidental to the profit-generating activities.

44. The Department has noticed that a Hong Kong company is sometimes interposed between an overseas company and a Mainland manufacturing enterprise in order to comply with or circumvent the trade barriers imposed by the overseas jurisdiction. In D7/08 23 IRBRD 102, the Board of Review recognised that making the Hong Kong company a customer of the overseas company and of the Mainland enterprise freed the overseas company from the trade barriers. Applying what the Court of Final Appeal held in the Kim Eng case on the effective cause of the production of the profits in question, it was

held that the Hong Kong company's relevant activity in Hong Kong however limited was what was done to earn the profits in question and the Hong Kong company did it in Hong Kong.

## 13.15 Use of UK commodity markets

The former ITH provided:

**929. Is use of the markets "trading in"?**

It is a good thing for this country that these markets exist. There are all sorts of spin-off advantages. Big business has to be financed and insured and there are shipping services and all sorts of peripheral activities which are good both for the people who are involved in them and for the country's balance of payments. Looking at the physical markets the produce concerned may or may not come to this country. A Brazilian plantation owner may sell his cocoa in London although the buyer may be in France. A broker here will sell to another broker acting on behalf of the buyer and the contract will be made here. So the question arises – is the Brazilian producer trading in London and until the end of the last century it never occurred to anybody that this might be so.

Then came clarification by the Courts on the meaning of trading in the UK and the possibility that the fact of a contract being made by an agent in London could involve the principal in UK tax. It appeared open to the Revenue to contend that the principal was carrying on the selling part of his trade in London or even carrying on the whole trade in London. The Revenue had contended neither of those things; to have done so would have frightened off the foreign users of our markets. In any event, in those early days, the non-resident principal could have arranged that his London brokers did not receive the profits or gains.

But in 1915 everything changed because it was then provided that the receipt of the profits or gains would no longer count and the business world was worried. The Revenue said that it had always regarded business done on our markets through brokers as trading with the UK rather than trading in the UK. But the business world was not satisfied. The difficulty was clear enough. If, as some of the early cases might suggest, the bare making of a contract here is such a vital matter, there is a risk that anybody using our markets might be held to be trading here. The Revenue's former view that in normal circumstances that constituted trading with rather than in the UK is not easily defensible.

**930. Pt VIII TMA 1970: Trading in: Can there be any profit?**

But accepting that a primary producer, a Brazilian plantation owner selling cocoa in London, is trading in the UK, where is the profit? Such commodities have a world market price at any time; it is an essential function of the market to decide exactly what that price is. If it is decided that the Brazilian producer is trading in the UK he must be charged either as a seller of cocoa or as a cocoa grower. If he is not charged as a grower and, to put it no higher it would be stretching things rather to do so, it is hard to see how any profit can be said to arise in London as a seller of cocoa. The position is entirely different from that of the French champagne grower of the type referred to in ITH815 of chapter 8, who

> may at least be regarded as making a merchanting profit here. In that situation one would look at the market value of the champagne in bulk and then at the price (wholesale or retail) actually realised in this country. But where commodities like bulk tin or rubber or cocoa are concerned, the position is otherwise. These things are traded in our markets precisely to determine what their market value is and to dispose of them at that price.
>
> **931. Dealer**
>
> In some cases the primary producer may not sell directly in London but sell to an intermediary in the producing country who in turn sells on the London market. The trade here is then clearly that of selling and if the intermediary does not purchase at world prices – there may, for example, be a reserve price – it may be possible to identify a profit or a loss. But if the intermediary sells through a broker within the exemption described in the following paragraphs then the exemption runs just the same. But it sometimes happens that, although the contracts are made through a broker, the seller has a presence here – a branch or an agent – which plays some part in the selling process. It may, for example, instruct the brokers. The question then is whether what is done is sufficient to enable us to say that the non-resident is trading also through that branch or agent. The terminal markets may be used by a non-resident dealer in commodities simply to hedge purchases or sales of raw materials which take place outside the UK. The hedging transactions may amount to trading here but, again, the broker exemption may apply unless the non-resident has a presence here, other than the broker, which is involved with the hedging transactions. If the exemption does not apply, there is then the question of the extent, if any, to which the results of the related transactions outside the UK should be taken into account in measuring the taxable profits. This is an area of difficulty and International Division should be consulted in such a case.

In practice the point is not important because the broker exemption applies.[36]

## 13.16 Leasing and licensing tangible property

The position for property income from land is governed by statute and trading case law is irrelevant for UK tax.[37]

What about leasing[38] chattels (eg pictures)? It is helpful to consider trading and non-trading cases separately.

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36 See 39.1 (Investment Manager exemptions).

37 See 14.1 (Property income).

38 References to leasing in this paragraph include licensing: there is no material distinction for our purposes.

### 13.16.1 *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 letting property ... the profit will have arisen in or derived from the place where the property was let ...[39]

But this was tactfully "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.[40]

Although the comment was made in the context of immoveable property, it is considered that the same applies to chattels.

It is true that the chattel may be moved, but most chattels do not move often. If a picture was moved permanently, it is unclear whether the source changes. It is tentatively suggested that the source changes.

If the chattel were a mobile asset (a plane or yacht) then it is suggested that one should not adopt the rule that the source is where the asset is situated. It is rational to have a separate rule for ships and aircraft. The IHT/CGT situs rules are also different for such assets.

### 13.16.2 *Leasing as part of trade*

If the leasing is a trade, then the income is trading income and the source is the trade not the assets of the trade. The question whether the trade is partly carried on inside the UK can be addressed looking at wider factors than just where the asset is situate. But in practice it is suggested that the situs of the assets will often be determinative (unless the trade involves

39 [1990] STC 733 at p.740b.
40 [1992] STC 723 at p.729e.

assets situate in more than one country).[41]

### 13.16.3 *When is chattel leasing a trade?*

Finance Leasing Manual provides:

> **20.10. Schedule D Case I: whether trading**
> In general, where chattels are leased, it should be accepted that the leasing is by way of trade. In exceptional cases, however, where the evidence of trading is extremely slight, for example if only one asset has been acquired for leasing and there is no personal involvement by the taxpayer or any semblance of a trading organisation, the taxpayer's activities are more likely to be in the nature of an investment, with the income assessable Case VI, than trading. Case I treatment should not be refused where, although there is no personal involvement by the taxpayer, there is trading activity by a manager as agent for the taxpayer.[42]

Business Leasing Manual takes a similar line and gives a little more detail:

> **315. Whether lessor trading**
> In general, where chattels are leased, you should accept that the leasing is by way of trade.
> In exceptional cases, however, where the evidence of trading is extremely slight, for example if only one asset has been acquired for leasing and there is no personal involvement by the taxpayer or any semblance of a trading organisation, the taxpayer's activities may be special leasing within Section 19 CAA 2001.
> You should not seek to deny trading treatment where, although there is no personal involvement by the taxpayer, there is trading activity by a manager as agent for the taxpayer.
> The same principle applies to special purpose vehicle lessor companies set up by groups that carry out leasing activities. In such cases it is not unusual for the company to own only one (or a few) assets and be managed by a group member.

This is an oversimplification. For instance, when the chattel is acquired by way of gift (not purchase), and when the taxpayer is an individual or

41 See 13.11.1 (Situs of assets sold).
42 The same text is found in BI Manual 61190.

trust rather than a commercial company, then trading is much less likely.

A conclusion of trading will usually suit a non-corporate taxpayer and so not be challenged. A conclusion of trading would be a concern to a corporate taxpayer only if it were carrying on that trade in the UK through a permanent establishment, which would move it from income tax to the more onerous corporation tax regime.

## 13.17 Research division and shop windows

The former ITH provided:

> **827. Profit producing activities**
> Early in this chapter (ITH811) an illustration was given of the hypothetical maker of refrigerators making them in various places in the world and selling them in those places. One way of describing the split of that trade is as a vertical split with a vertical slice here and other similar vertical slices in other countries. We would wish to tax only the vertical slice of the trade carried on here. The other way in which a trade may be split may be thought of as horizontal, the sort of situation we have just discussed, one horizontal slice of the trade, manufacturing say, being here and another slice, the selling, abroad.

The horizontal/vertical terminology seems strange. The metaphor is also used in competition law but the other way round.[43] The former ITH continued:

> 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 unhelpful metaphor. What does it mean? The former ITH explained:

43 "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.

> There may be a research section here with computers and the other paraphernalia of a modern trade of that sort. The branch gives advice to would be customers and when they decide to buy a particular American stock, it tells its head office in New York and there the actual deal is done. If the London branch really is only a shop window and really does take no part in the contracting process then the conclusion is that that is not trading within the UK; there is only one trade which is providing the service of buying or selling stocks and that is done in New York. It is quite possible for a non-resident trader to have an office here employing a substantial number of people and yet not to be exercising the trade here.
> Another example might be the manufacturer on a very large scale in America, which has a research division in this country. The work of the research division may be absolutely vital to the trade but if that trade consisted for example in the making and sale of television sets, one could not say that research on, let us say, conductivity constituted a distinct profit producing part of that trade. That is reasonably clear.

This is right because it is difficult to allocate the profits, so they should be regarded as merely auxiliary.[44]

> 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.

## 13.18 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[45] 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

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44 See 13.9 (Trading in UK: preparatory and auxiliary activities).

45 Further consideration is needed if the applicable law is not English law.

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 circumstances which may not lend themselves to that analysis.[46]

There is no case law on email acceptance.[47] 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.

The former ITH discussed this issue:

> **The making of a contract**
> **830. General**
> There have been many references in this chapter to the making of a contract and to the place where a contract is made. If two people agree specifically on a sale by word of mouth that is the making of a contract and the place of their agreement is the place where the contract is made. A great deal of business is done in that way daily and the place of contract is not changed by the signing of a piece of paper in a tax haven sometime afterwards. The difficulty is one of proof as we have already seen in ITH822. But putting difficulties of that sort on one side, if the question where a contract is made becomes of central importance it is one on which we should rely on legal advice – it is pre-eminently a question for the Solicitor and what follows is very general guidance.
> **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

46 Some academic writers have suggested abandoning the "offer and acceptance" analysis and replacing it by a contract theory based on reliance. (There is more than a hint of this in Lord Denning's judgment in *Gibson v Manchester City Council.* This decision was reversed by the House of Lords but even Lord Diplock accepted that there would be times when offer and acceptance would be difficult to identify and the "normal analysis of a contract as being constituted by offer and acceptance" might not be appropriate. However that would be exceptional. See [1979] 1 WLR 294 at p.297).

47 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.

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.[48]

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48 There is also a brief comment (not worth setting out here) in NI Manual 29013.

## 13.19 Trade partly in UK: apportionment

I turn to the question of how to apportion where part of the trade is in the UK. Of course this overlaps with the question of whether there is a trade partly in the UK. If there are activities in the UK which do not involve trading in the UK there is nothing to apportion.

Tax Bulletin 18 provides:

> It is perhaps less obvious how the profits from the part of the trade carried on in the UK should be measured. They are required to be measured on the arm's length principle set out in the [OECD model tax convention] where a DTA applies which includes the relevant provisions. It is considered that it also follows from the main rule in Schedule D that the same principle applies even if there is no treaty.
>
> There is support for this principle in the early tax cases on non-residents trading in the UK. For example, in *Pommery & Greno v Apthorpe* at 2 TC 189, Denman J said, with regard to the profits chargeable in the UK from merchanting champagne produced in France, that:
>
>> It may be that there may be some difficulty in some respects as to the manner of calculating the amount of expenditure to be put against the profits, whether it would be a proper course to look at the goods sent over to England and then to consider what profit they make, putting a fair valuation on them as they arrive, and as the money is transmitted, or whether it would be necessary in such a case to look more minutely into the profits and losses upon the whole trade carried on partly in France and partly in England. I do not think it is necessary at all at this stage of the case to decide that. That is a matter of quantum, a matter for the consideration of persons skilled in dealing with such matters as assessing profits of trade.
>
> This can be seen as an early description of the arm's length principle and as a recognition of the need to develop methods to apply that principle in practice. Such methods were developed in the OECD 1979 Report on "Transfer Pricing and Multinational Enterprises" and have been reaffirmed and clarified in the recently published 1995 revision of that report by OECD "Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations".[49]

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49 [Author's Note] 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 17 July 2008 accessible

The former ITH also touched on this issue:

> **814. Measure of profit in *Erichsen v Last*[50]**
> 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 deduct 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.

## 13.20 DT relief for trading income

### 13.20.1 *Treaty relief for trading income*

Article 7 OECD model treaty provides:

> 1. The profits of an enterprise of a Contracting State shall be taxable only in that State unless the enterprise carries on business in the other Contracting State through a permanent establishment situated therein. If the enterprise carries on business as aforesaid, the profits of the enterprise may be taxed in the other State but only so much of them as is attributable to that permanent establishment.

"Enterprise of a Contracting State" is defined in article 1:

> 1. For the purposes of this Convention, unless the context otherwise requires:
> c) the term "enterprise" applies to the carrying on of any business;
> d) the terms "enterprise of a Contracting State" and "enterprise of the other Contracting State" mean respectively an enterprise carried on by a resident of a Contracting State and an enterprise carried on by a

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*www.oecd.org/dataoecd/20/36/41031455.pdf.*

50 [Author's Note] For facts of *Erichsen v Last* 4 TC 422 see 13.6 (Place where contract made).

> resident of the other Contracting State;

A discussion of this topic requires a book to itself, and is not attempted here.

### 13.20.2 *Treaty override for trading income*

Section 130 TIOPA provides:

> (1) Subsection (4) applies if double taxation arrangements make the provision, however expressed, mentioned in subsection (2).
> (2) The provision is that the profits of an enterprise within subsection (3) are not to be subject to UK tax except so far as they are attributable to a permanent establishment of the enterprise in the UK.
> (3) An enterprise is within this subsection if the enterprise—
> (a) is resident outside the UK, or
> (b) carries on a trade, or profession or business, the control or management of which is situated outside the UK.

Section 130(3)(a) is misworded as an enterprise does not have a residence: only a person can have a residence and an enterprise is not a person.

Section 130(3)(b) is also misworded as an enterprise does not carry on a trade, profession or business (hereafter abbreviated to "trade"). Only a person can carry on a trade. This is however the wording used in the OECD model.

But reading purposefully and somewhat charitably, the meaning of s.130(3) is that s.130 applies if:
(a) the person carrying on the enterprise is resident outside the UK; or
(b) the enterprise consists of a trade the control or management of which is situated outside the UK.

Assuming we have such an enterprise we move on to s.130(4) which disallows treaty relief:

> The provision does not prevent income of a person resident in the UK being chargeable to income tax or corporation tax.

Treaty relief is only allowed for a person resident outside the UK. Section 130(6) TIOPA defines residence:

> A person is resident in the UK for the purposes of this section if the person is resident in[51] the UK for the purposes of the double taxation arrangements.

Section 130 is headed: *Interpreting provision about UK taxation of profits of foreign enterprises.* This rule is however not interpretation or even misinterpretation: it is a treaty override. This section simply disapplies the relief for business profits. Breach of treaty agreements has ceased to concern HMRC when on the tax avoidance warpath.

Section 130 applies where an enterprise is carried on by a trust or company which is a resident in a treaty state with a standard business income article; and a UK resident is taxable on the income as life tenant of the trust, or under s.624, or under s.720. The UK resident person does not qualify for DT relief.

For completeness: s.130(5) TIOPA provides an exception:

> Subsection (4)—
> (a) does not apply in relation to income of a person resident in the UK if section 858 of ITTOIA 2005 (UK resident partner is taxable on share of firm's income despite any double taxation arrangements) applies to the income, and
> (b) does not apply in relation to income of a company resident in the UK if section 1266(2) of CTA 2009 (UK resident company that is partner in a firm is taxable on share of firm's income despite any double taxation arrangements) applies to the income.

Section 130 is not needed here as s.858 ITTOIA does the same job; see 36.9 (DTA relief for partnership).

51 The treaty wording is: "a resident *of* the UK", see 5.2 (Starting point: residence under art. 4.1), but it does not matter.

CHAPTER FOURTEEN

# PROPERTY INCOME

## 14.1 Property income - Introduction

ITTOIA uses the term "**property income**" to mean income from land.[1] The taxation of property income is governed by Part 3 ITTOIA. A full discussion requires a book to itself. I chapter focuses on matters closest to the themes of this book.

I do not consider the position of UK resident companies (subject to CT rather than to IT).

I do not consider deduction of tax at source and UK agents, under the non-resident landlord regulations (on which HMRC have written 88 pages of guidance notes) though I would like to cover this in a future edition.

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1 A note on terminology. The commentary to TLR Exposure Draft No. 13 provides: "*Finding a suitable name*

223. Letting income has long been referred to as 'Schedule A income' by tax professionals. But that is not an informative label for the non-specialist and we are removing references to the Schedules.

224. We considered several possible new names for this type of income including 'land income', 'letting income', 'rental income', 'property business income' and 'property income'. We concluded that 'property income' offered the best compromise because:

- it matches the names that are proposed for the other types of income: 'trading income', 'employment income' and 'savings and investment income';
- for most people, it is likely to appear the most appropriate name; and
- it links directly with what we think is the most appropriate name for the business activity ('property business'): 'land business' and 'rental business' might be particularly misleading.

225. The disadvantage is that it might appear to go wider than income just from land; that is, strictly, 'property' means more than just land and buildings. But we do not think that most people will find this confusing as the proposed use corresponds broadly to the popular use."

## 14.2 Property income terminology

### 14.2.1 *"UK property business"*

Section 264 ITTOIA provides:

> A person's UK property business consists of—
> (a) every business which the person carries on for generating income from land[2] in the UK, and
> (b) every transaction which the person enters into for that purpose otherwise than in the course of such a business.

At first sight (b) is puzzling. ITTOIA EN explains why it is there:

> 1049. … the concept of the "property business" is, to a certain extent, an artificial one. Unlike the term "trade" it may not always correspond to an activity organised in a way that the proprietor would necessarily describe as a business. As such, the term has to cover:
>
> - "real" businesses where the lettings are organised in a professional way;
> - lettings which are not so organised; and
> - casual and one-off transactions which may have very little of the qualities normally associated with a business.
>
> Then all of these lettings of different types must be treated as part of the same, single business.

### 14.2.2 *"Overseas property business"*

ITTOIA continues:

> A person's overseas property business consists of—
> (a) every business which the person carries on for generating income from land outside the UK, and
> (b) every transaction which the person enters into for that purpose otherwise than in the course of such a business.

ITTOIA EN explains:

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2 The expression "generating income from land in the UK" is defined in ss.266, 267 ITTOIA.

> 1056. The definition is identical to that of "UK property business" except that the land from which the income arises is outside the UK. That is the only difference between a UK and an overseas property business: income from land outside the UK can arise only in an overseas property business; income from land in the UK can arise only in a UK property business.
> 1057. For the purpose of deciding whether there is an overseas property business, overseas land law is interpreted in accordance with section 363.

See 14.4 (Losses of overseas property business) for a refinement to this definition.

### 14.2.3 *"Property business"*

Section 263(6) provides a commonsense definition:

> In this Act "property business" means a UK property business or an overseas property business.

## 14.3 Taxation of income from property business

The charging provisions are in Chapter 3 Part 3 ITTOIA. Sections 268–270 provide:

> **268 Charge to tax on profits of a property business**
> Income tax is charged on the profits of a property business.
> **269 Territorial scope of charge to tax**
> (1) Profits of a UK property business are chargeable to tax under this Chapter whether the business is carried on by a UK resident or a non-UK resident.
> (2) Profits of an overseas property business are chargeable to tax under this Chapter only if the business is carried on by a UK resident.
> **270 Income charged**
> (1) Tax is charged under this Chapter on the full amount of the profits arising in the tax year.
> (2) Subsection (1) is subject to Part 8 (foreign income: special rules).

Section 270(2) ITTOIA feeds into s.832 which incorporates the remittance basis rules.

## 14.4 Losses of overseas property business

### 14.5 *Losses from 2008/09*

Chapter 4 Part 4 ITA provides loss relief for a property business. There are three classes of loss relief:

(1) Carry forward against subsequent property business profits: ss.118–119 ITA.

(2) (a) Capital allowance losses and
(b) agricultural estate losses.
Sections 120–124 ITA.

(3) Post-cessation property relief: ss.125–126 ITA.

In this chapter I consider only the first of these reliefs. Section 118 ITA provides:

> **Carry forward against subsequent property business profits**
> (1) Relief is given to a person under this section if the person—
> (a) carries on a UK property business or overseas property business (alone or in partnership) in a tax year, and
> (b) makes a loss in the business in the tax year.
> (2) The relief is given by deducting the loss in calculating the person's net income for subsequent tax years (see Step 2 of the calculation in section 23).
> (3) But a deduction for that purpose is to be made only from profits of the business.[3]

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3 For completeness, the ITA continues:
"(4) In calculating a person's net income for a tax year, deductions under this section from the profits of a business are to be made before deductions of any other reliefs from those profits.
(5) No relief is to be given under this section so far as relief for the loss is given under section 120.
(6) This section needs to be read with section 119 (how relief works).
**119 How relief works**
This section explains how the deductions are to be made.
The amount of the loss to be deducted at any step is limited in accordance with section 25(4) and (5).
Step 1 Deduct the loss from the profits of the business for the next tax year.
Step 2 Deduct from the profits of the business for the following tax year the amount of the loss not previously deducted.
Step 3 Continue to apply Step 2 in relation to the profits of the business for subsequent tax years until all the loss is deducted."

The Property Income Manual correctly summarises:

> **4705 CT**
> *Losses*
> As part of the changes made by FA 1995, the taxable profits and losses of overseas let property were ring fenced for IT purposes. The effect was that:
> · losses of an overseas property business cannot, for IT purposes, be set against profits of a UK property business carried on by the same individual,
> · similarly, losses of UK property business cannot for IT purposes be set against profits of an overseas property business carried on by the same individual.

The definitions of UK property business and overseas property business in ITTOIA were only ITTOIA-wide definitions (they do not apply for all the income tax Acts) so the drafter of the ITA had to repeat them. Section 989 ITA extends them to the income tax acts:

> The following definitions apply for the purposes of the Income Tax Acts—
> "overseas property business" has the meaning given by Chapter 2 of Part 3 of ITTOIA 2005,
> "UK property business" has the meaning given by Chapter 2 of Part 3 of ITTOIA 2005

At this point we need to consider s.263(4)(5) ITTOIA which restricts the meaning of "overseas property business":

> (4) References in this Act to an overseas property business are to an overseas property business so far as any profits of the business are chargeable to tax under Chapter 3 (as to which see, in particular, section 269).
> (5) Accordingly, nothing in Chapter 4 or 5 is to be read as treating an amount as a receipt of an overseas property business if the profits concerned would not be chargeable to tax under Chapter 3.

I refer to this provision as **"the non-chargeable overseas property business rule".** This rule applies for the purposes of "this Act" (ITTOIA). However it is suggested that this applies for the purposes of loss relief in the ITA, s.989 ITA incorporates the s.263 rule, because it incorporates the definition of Chapter 2 Part 3 ITTOIA, and s.263 is in Chapter 2.
Suppose T carries on an overseas property business and:

(1) Year 1: T is non-resident and realises losses;
(2) Year 2: T is UK resident and realises profits.

The losses of Year 1 are disallowed since the profits of that year are not chargeable under Chapter 3 (or at all) so there is no overseas property business. In short, losses of non-residents are not relievable. *Quaere* whether this would apply if T were resident in an EU member state.

What about an overseas property business carried on by a remittance basis taxpayer? An overseas property business which is taxed under the remittance basis is (from 2008/09) taxed under Chapter 3 (even though the amount of income taxed is determined by s.832 ITTOIA which is not in chapter 3.) So the non-chargeable overseas property business rule does not disallow loss relief. Presumably this change was intentional as it was not desired to introduce an equivalent of the incomprehensible CGT loss rules into this context.[4]

## 14.6 *Losses before 2008/09*

The position was different before 2008/09. This is still relevant in relation to the question of whether pre-2008 losses can be carried forward and set against post 2008 profits. The relevant legislation in ITTOIA provided:

> **268 Charge to tax on profits of a property business**
> Income tax is charged on the profits of a property business.
> **269 Territorial scope of charge to tax**
> (1) Profits of a UK property business are chargeable to tax under this Chapter whether the business is carried on by a UK resident or a non-UK resident.
> (2) Profits of an overseas property business are chargeable to tax under this Chapter only if the business is carried on by a UK resident.
> *(3) But, in the case of an overseas property business carried on by a UK resident to whom the remittance basis applies, the only profits of the business chargeable to tax under this Chapter are those in respect of land in the Republic of Ireland.*
> *(4) For a UK resident to whom the remittance basis applies, see also Chapter 11 (charge to tax on overseas property income other than income arising in Republic of Ireland).*

4 See 48.8 (Loss accruing to remittance basis taxpayer).

(Words in italics repealed by the FA 2008.) Thus for a remittance basis taxpayer, and ignoring the special case of land in Ireland,[5] the charge was not under Chapter 3. Instead it was in Chapter 11 (also repealed in the FA 2008). This provided:

> ***357 Charge to tax on overseas property income***
> *Income tax is charged on the overseas property income of a person to whom the remittance basis applies.*
> ***358 Meaning of "overseas property income"***
> *In this Chapter "overseas property income", in relation to a person to whom the remittance basis applies, means amounts which*
> *(a) are not brought into account in calculating the profits of any overseas property business of the person, but*
> *(b) would be if section 269(3) (charge to tax on profits of an overseas property business of a person to whom the remittance basis applies only in respect of land in the Republic of Ireland) were omitted.*
> ***359 Income charged***
> *Tax is charged under this Chapter on the amount specified by section 832 (relevant foreign income charged on the remittance basis).*

So before 2008, the remittance basis taxpayer did not have an "overseas property business" so there could not be loss relief. In the 2007/08 edition of this book I commented:

> This is consistent with the CGT treatment of losses. It may be desirable for a foreign domiciliary not to claim remittance basis treatment in the year that a loss accrues in order to obtain that loss relief. Though the cost of that claim must be set against the benefit of the remittance basis in that year. Suppose the loss is allowable in the year it accrues but in a subsequent year the owner claims remittance basis treatment. The loss is not allowable in that year. However, it is suggested that the loss can be carried forward and set against profits of other years if the arising basis applies to those years.

It is suggested that a loss which did not qualify for relief in the year that it accrued cannot be carried forward to 2008/09 or subsequently. HMRC may well agree. The Property Income Manual provides:

5 I do not discuss Irish property income here, but note that the pre-2008 legislation was in breach of EU law; see 9.21 (RFI from Ireland).

**4702. IT cases up to 2004-05** [February 2007]
No loss can ever arise on income taxed on the remittance basis.

Offshore property business losses from before 1998/99 are allowable under ESC B25, but it seems unlikely that any such losses will still be available to be carried forward to the present time.

## 14.7 Border between trading income and property income

A receipt may in some cases be both a trading receipt and a receipt of a property business. Sections 4 and 261 ITTOIA deal with the overlap.

Section 4(1) ITTOIA provides:

> Any receipt or other credit item, so far as it falls within—
> (a) Chapter 2 of this Part (receipts of trade, profession or vocation), and
> (b) Chapter 3 of Part 3 so far as it relates to a UK property business,
> is dealt with under Part 3.

Section 261 ITTOIA provides:

> Any receipt or other credit item, so far as it falls within—
> (a) [i] Chapter 3 of this Part so far as it relates to an overseas property business or
> [ii] Chapter 8 or 9 of this Part (rent receivable in connection with a UK section 12(4) concern or for UK electric-line wayleaves), and
> (b) Chapter 2 of Part 2 (receipts of a trade, profession or vocation),
> is dealt with under Part 2.

ITTOIA EN explains:

> 1058. The priority rules in the trading income Part of this Act (section 4) make it clear that a charge under Part 3 of this Act as UK property income has priority over a charge under Part 2 as trading income. This reflects the rule in Schedule D Case I (section 18(3) of ICTA). The sort of receipt to which this rule might apply is rent received by a property developer from the temporary letting of land awaiting development. The rent is taxed as property income, even if it could properly be regarded as a trade receipt.
> 1059. In the case of a foreign trade and foreign property, the rule in section 65A(1)(b) of ICTA is the reverse of that in section 18(3) of

> ICTA. An overseas property business does not include "income to which section 65(3) of ICTA applies (income immediately derived from carrying on a trade ..)". So the priority rule in section 261 preserves this position.

Perhaps the reason for this apparent anomaly is to maximise income classified as UK source. Under these rules, if UK property income is a receipt of a foreign trade, it is classified as UK property income (and so taxable even in circumstances where foreign trading income may not be); whereas if foreign property income is part of a UK trade it is treated as UK trading income (and similarly taxable).

CHAPTER FIFTEEN

# DEDUCTION OF INTEREST IN COMPUTING PROPERTY INCOME

## 15.1 Deduction of interest in computing property income

This chapter considers the deduction of interest in the computation of UK property income.

A great deal of tax and a great deal of tax planning depends on obtaining that deduction. See *Langsam v Beachcroft LLP* [2011] EWHC 1451 (Ch) for an interesting negligence action where a dissatisfied remittance basis taxpayer obtained some damages against his advisors for failing to advise him on the tax avoidance possibilities dignified with the label of an "equity release arrangement".

For the questions of the location of the source of interest, and deduction at source, see 17.1 (interest income).

Section 272(1) ITTOIA provides:

> The profits of a property business are calculated in the same way as the profits of a trade.

Section 272 gives a long list of provisions which apply, including s.29 ITTOIA:

> For the purpose of calculating the profits of a trade, interest is an item of a revenue nature, whatever the nature of the loan.

Interest is in principle a deductible expense if incurred wholly and exclusively for the purpose of the property business.

The Property Income Manual provides:

> **Introduction** [January 2009]
> ... For IT, interest payable on loans used to buy land or property which

is used in the rental business, or on loans to fund repairs, improvements or alterations, is deductible in computing the profits or losses of the rental business in the same way as other expenses.

Similarly, interest payable under hire purchase agreements or on an overdraft is deductible where the asset is used for business purposes.

The normal rental business rules apply, see PIM2000 onwards, including the 'wholly and exclusively' rule and the rules governing the timing of relief (see PIM1100 onwards). A taxpayer cannot, for example, deduct interest on a private loan, such as a loan used to buy their private residence. Where part of the taxpayer's own residence is let see PIM2120.

Similarly, the interest on a loan or overdraft may not be allowable, or only part may be allowable, where the taxpayer, for example, uses the borrowing:

- to buy non-rental business investments (which may be shown in the balance sheet as assets),
- to buy private assets or assets for their family,
- for the provision of private funds to be taken out from the rental business.

Deciding what interest, if any, can be deducted may be difficult, particularly where the taxpayer's account with the business is overdrawn. That is, where the taxpayer has drawn out more money than the profits of the rental business. The loan may have, for example, partly financed the rental business and partly met private living expenses. Interest on a borrowing that is used to fund private living expenses or other non-business expenditure isn't allowable.

For advice regarding the incidental costs of loan finance see PIM2050.

Interest on a partner's capital account with the business isn't deductible. It is merely an allocation of the rental business profit and is taxed as property income.

For more detailed guidance about the deduction of interest see BIM45650 onwards.

*Interest payable on property only partly used for rental business*

A property may be let for short periods in a tax year or only part of it may be let throughout a tax year (or both); the rest of the time the property is used for private or non-business purposes. Here the interest charged on a qualifying loan on that property has to be split between the rental business use and the private or non-business use. The split is done in whatever way produces a fair and reasonable business deduction, taking account of both the proportion of business use and the length of business use.

You don't have to split the interest if the taxpayer is genuinely trying to let the property but it is empty because they have not been able to find a tenant. In this case the interest will meet the 'wholly and exclusively' test. It won't meet this test if they have not been trying to let the property or they have been using it for private or non-business purposes .

*Interest and rent-a-room*

Interest paid on a loan used to buy a property cannot be claimed as a deduction in the rental business if rent-a-room relief has been claimed. There is more information about rent-a-room relief at PIM4000 onwards.

*Legislation*

The profits of a rental business are calculated in the same way as the profits of a trade. Therefore interest may be deducted in computing the profits of a rental business provided that it meets the following criteria.

- It must be payable wholly and exclusively for the purposes of the rental business.
- If it is paid to a person not resident in the UK, the deductible element must not be at more than a reasonable commercial rate - see PIM2110.
- It must not be within MIRAS - see PIM2120.

Remember that under the rental business rules, relief is given for interest payable on the accruals basis (not interest paid unless, exceptionally, the cash basis is used - see PIM1101).

The guidance on interest as a trade expense at BIM45650 onwards applies equally to interest as a rental business expense.

*Interest rate hedging instruments*

Where an interest rate hedging contract such as a swap or cap is taken out to hedge interest payments which are deductible in computing the profits or losses of a rental business, then profits or losses on that contract will normally be taxed or relieved as receipts or deductions of that rental business. This is because trading principles are imported into the property income computation rules. Profits and losses on such instruments should normally be computed on an accruals basis so that payments and receipts are allocated to the periods to which they relate, without regard to the periods in which they are made or received or become due and payable, in accordance with normal accounting practice. For more on the tax treatment of swaps held by IT payers see PIM2140.

## 15.2 Tax relief schemes and arrangements

Section 809ZG(1) ITA provides the general rule:

> Relief is not to be given under any provision of the Income Tax Acts to a person in respect of a payment of interest if
> [a] a tax relief scheme has been effected, or
> [b] tax relief arrangements have been made,

> in relation to the transaction under which the interest is paid.

Section 809ZG(2) is a small point:

> Subsection (1) applies whether the tax relief scheme is effected, or the tax relief arrangements are made, before or after the transaction.

I do not see how a transaction could take place before the scheme is effected, but it does not matter.

Section 809ZG(3) defines tax relief scheme:

> A scheme is a tax relief scheme in relation to a transaction for the purposes of subsection (1) if it is such that the sole or main benefit that might be expected to accrue to the person from the transaction is the obtaining of a reduction in tax liability by means of relief under the Income Tax Acts.

Section 809ZG(4) defines tax relief arrangements in the same way:

> Arrangements are tax relief arrangements in relation to a transaction for the purposes of subsection (1) if they are such that the sole or main benefit that might be expected to accrue to the person from the transaction is the obtaining of a reduction in tax liability by means of relief under the Income Tax Acts.

Section 809ZG(5) provides a commonsense definition of relief:

> In this section "relief" means relief by way of—
> (a) deduction in calculating profits or gains, or
> (b) deduction or set off against income.

Corporate Finance Manual provides:

> **39030. Artificial payments of interest: Sole or main benefit**
> [The manual summarises the legislation and continues:] The sole or main benefit test is an objective, rather than a subjective test: the subsection focuses on the result to be expected from the transaction rather than its purpose. (See *The Crown Bedding Co Ltd v CIR* 34 TC 107 at pp 115, 118-120, followed in *Ackland & Pratten Ltd v CIR* 39 TC 649 at p662, and approved in *CIR v Brebner* 43 TC 705 at p718).
> Ordinary borrowings involving funds, which are genuinely invested or

re-lent, are not affected because the tax relief on the interest paid is incidental to the transaction.

International Manual provides:

**509120. Section 787 ICTA 1988** [March 2007]
Part XVII ICTA 1988 includes various anti-avoidance provisions including Section 787. This restricts relief for interest paid under a scheme from which the sole or main benefit which might be expected to accrue is the reduction of tax resulting from the relief, including group relief. Although this appears to be a far reaching section which could be used against many avoidance schemes, its usefulness is somewhat restricted.
The provision was introduced to counteract a specific domestic avoidance scheme to get relief on 'manufactured' interest by paying interest in advance on a borrowing which was effectively immediately repaid. It is necessary to distinguish between an out-and-out avoidance scheme and a judiciously arranged borrowing scheme. The section is not, therefore, easily invoked but it may still be legitimate to use it in some cases involving intra-group funding transactions.

HMRC's reluctance to use the section goes back to an assurance given in Parliament:

**Mr. Robert Sheldon (financial secretary to the Treasury)**: The hon. Member for Guildford (Mr. Howell) rightly asked for some assurance that there would be no problems for innocent parties seeking arrangements whereby they undertook to pay interest for genuine business purposes. I can give the hon. Gentleman the assurance that those paying true interest for genuine business purposes will not be caught by this scheme. To give him the definition, which I think also deals with the question put by the hon. Member for Cirencester and Tewkesbury (Mr. Ridley), in a genuine commercial scheme the main benefit is to secure finance. If that is applicable, those people will not be caught by the main benefit test and they will be perfectly free to go about seeking and undertaking any transactions which fall within that definition.
The natural anxiety of the hon. Member for Guildford is that these matters are closely watched. I can give him that assurance. That is to the advantage of the kind of people mentioned in this debate so that we do not entrap those perfectly legitimate and proper cases where people are prepared to pay the interest and get it allowable against tax. We are

concerned about people who resort to some of those very peculiar devices of the kind which show an immense amount of ingenuity and, as the hon. Member for Guildford said, with such unfortunate results.[1]

## 15.3 Transfer pricing and thin capitalisation

The transfer pricing rules are in part 4 TIOPA, supplemented by the OECD transfer pricing guidelines which are nearly 400 pages long. That is a vast topic, and a full discussion would need many volumes. I focus on matters closest to the themes of this book. I only consider income tax and not corporation tax issues.

Assuming interest is paid at market rates, one would not expect any transfer pricing issues to arise. However the effect of some deft deeming provisions is that transfer pricing rules also serve as thin capitalisation rules, ie rules which restrict the deduction of interest by companies funded primarily by borrowing, having limited share capital or net value. It is therefore necessary to consider these rules in some detail.

The International Manual explains the background as it appears to HMRC:

> **542005. Definition of thin capitalisation** [March 2011]
> In the commercial world, a company is said to be thinly capitalised when it has more debt than equity. In transfer pricing, this definition is widened, though the issue may often be much the same. Many cases boil down to a company with more debt than it could and would have borrowed on its own resources, because it is borrowing either from or with the support of connected persons, but thin cap work extends to other terms and conditions of lending and borrowing such as the interest rate, the duration of loan, repayment terms, etc. Financial transfer pricing is a more appropriate term for the work described in this chapter. It is important to note then, that the amount of interest payable may be excessive for a combination of reasons - interest rate, excessive duration of lending, restrictions on repayment, etc - so all terms and conditions should be considered under the banner of thin capitalisation. Other less obvious issues are the appropriateness of the currency (e.g. forex risk) and the possible presence of guarantees. For HMRC, thin cap is shorthand for financial transfer pricing, looking at every aspect of lending and borrowing.

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1 Hansard, 13 July 1976.

**Other legislation on finance**

There is other legislation - and this is not an exhaustive list - which may result in a restriction of the interest deduction, including:

- Arbitrage provisions - see INTM590000
- Unallowable purpose legislation - Section 441–442 CTA 2009 - see CFM38010
- Remaining provisions of Section 209 ICTA 1988 - now around Section 1000 CTA 2010 - such as interest in excess of a commercial rate of return - see below and CTM15502
- World-wide debt cap - Part 7 TIOPA 2010 - see CFM90100

The first two represent anti-avoidance legislation, so the choice depends on the facts and circumstances of the particular case. Section 155(6) TIOPA 2010 says that the Section 1000 CTA 2010 list and the world-wide debt cap legislation shall be disregarded when calculating the transfer pricing tax advantage. The debt cap applies after any transfer pricing adjustment has been made.

These provisions concern corporation tax only and are not discussed here. The Manual continues:

**Section 1000 CTA 2009 onwards (Section 209 ICTA 1988) - distributions in the form of interest**

While the main thin cap provision at Section 209(2)(da) ICTA 1988 was repealed in 2004, much of the section remains, dealing with payments which are interest in form but distributions in substance. These provisions are useful: they require no connection between borrower and lender, and are matters of substance and form rather than pricing. The legislation is now in the form of a list at Section 1000 CTA 2009, under the heading of "Meaning of Distribution", which is followed by a schedule at Section 1001 which lists subsequent sections that explain or supplement these summaries. Included are:

interest in excess of a commercial return - previously at Section 209(2)(d) ICTA 1988

- securities that are convertible into shares - previously at Section 209(2)(e)(ii) ICTA 1988
- interest that is dependent on the results of the borrower’s business - previously at Section 209(2)(e)(iii) ICTA 1988
- securities that are connected with shares - previously at Section 209(2)(e)(vi) ICTA 1988
- interest payable on an equity note issued to an associated company - previously at Section 209(e)(vii) ICTA 1988

These are covered in the Company Tax Manual. Links within INTM to other manuals may not be "live", but will work as search terms on the HMRC website, and possibly on internet search engines.

**How thin capitalisation arises**

When a company operates at arm's length from its sources of funding, commercial considerations drive the decision to raise funds either through debt, equity, or a mixture of the two. There is a marked difference in tax treatment between debt finance and equity, in that interest on debt is deductible from profits, whereas dividends on shares are not. This is explored in more detail in the Practical Thin Cap Guidance from INTM570000 onwards.

When a company borrows from or with the support of other group companies, funding decisions may not be driven by commercial considerations alone. The connection between the parties involved might allow them to change the way in which the funding is obtained in ways unavailable to the borrower at arm's length or to take on funding risks which an independent borrower would avoid. Factors such as group policy, strategy, and tax planning will sit alongside commercial considerations.

As a result of the differences in tax treatment between interest and dividends, a company which increases its indebtedness, and thereby increases its interest payments, reduces the tax it has to pay.

Thin capitalisation is just a form of transfer pricing, and is not limited to companies, except where the legislation says so, but this guidance concentrates on corporate relationships.

**Thin capitalisation and tax planning**

As with transfer pricing more generally, thin capitalisation does not have to find an avoidance motive. The aim of transfer pricing is to ensure that, for tax purposes, arm's length prices are charged for goods, services, etc. However, company finance is an easy and attractive way for groups to change the jurisdiction within which profits arise, and tax planning will be an aspect of the financing plans for any major corporate acquisition.

Corporate thin capitalisation is usually seen in a group context, since it would be counter-productive (though not unheard of) for a company to increase its interest costs payable to a third party, just to reduce its tax payable. Besides, a borrower cannot borrow more (or pay more interest) than an arm's length lender is willing to lend, unless that money is guaranteed by one or more persons who are connected with the borrower for transfer pricing purposes, usually group members. Where the borrowing is intra-group, the interest remains within the group; the group as a whole is no less profitable, but the borrower has paid less tax, and, where the lender is in a country with a lower corporation tax rate than the borrower or has losses to absorb interest received, the group can end up far better off overall.

With third party borrowing supported by a group guarantee, interest is paid to a third party and value leaves the group, but in that case the issue may be a matter of where it is most tax efficient for the group's interest costs to arise. The inference is that the world-wide group has capacity to borrow but not necessarily within the UK entity, which is where it wishes to place the debt. However, guarantees, including less formal support such as a letter of comfort, can enable a company to borrow more cheaply than would be possible on a standalone basis.

### 15.3.1 *"The basic pre-condition"*

Section 147 TIOPA provides:

> (1) For the purposes of this section "the basic pre-condition" is that—
> (a) provision ("the actual provision") has been made or imposed as between any two persons ("the affected persons") by means of a transaction or series of transactions,
> (b) the participation condition is met (see section 148),
> (c) the actual provision is not within subsection (7) (oil transactions), and
> (d) the actual provision differs from the provision ("the arm's length provision") which would have been made as between independent enterprises.

Thus the "basic pre-condition" actually consists of four conditions or sets of conditions.

Section 151(1) TIOPA defines **"arm's length provision"** in line with the commonsense usage above:

> In this Part "the arm's length provision" has the meaning given by section 147(1).

Section 150 TIOPA defines transaction:

> (1) In this Part "transaction" includes arrangements,[2] understandings and mutual practices (whether or not they are, or are intended to be, legally enforceable).

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2 Section 150(5) TIOPA provides the standard, unnecessary definition of "arrangements": "In this section "arrangement" means any scheme or arrangement of any kind (whether or not it is, or is intended to be, legally enforceable)."

(2) References in this Part to a series of transactions include references to a number of transactions each entered into (whether or not one after the other) in pursuance of, or in relation to, the same arrangement.
(3) A series of transactions is not prevented by reason only of one or more of the matters mentioned in subsection (4) from being regarded for the purposes of this Part as a series of transactions by means of which provision has been made or imposed as between any two persons.
(4) Those matters are—
(a) that there is no transaction in the series to which both those persons are parties,
(b) that the parties to any arrangement in pursuance of which the transactions in the series are entered into do not include one or both of those persons, and
(c) that there is one or more transactions in the series to which neither of those persons is a party.

The International Manual provides:

**542040. Transaction or series of transactions** [March 2011]
... Mutual practices might include informal two-way trading arrangements between persons falling within the transfer pricing legislation.
Transactions within a series do not have to occur in a recognisable sequence. They may be simultaneous or removed in time from one another, but they have to be part of an overall arrangement or scheme.
The meaning of series of transactions is further widened by Section 150(4) TIOPA 2010, which sets out a number of situations that do not prevent a series of transactions being recognised as such. There may be a series of transactions, even if, in relation to the "affected persons" (INTM542020):
• there is no transaction in the series to which both those persons are parties,
• the parties to any arrangement in pursuance of which the transactions in the series are entered into do not include one or both of those persons, and
• there is one or more transactions in the series to which neither of those persons is a party
By recognising a series of transactions, the transfer pricing legislation can apply to more complex and indirect financial structures in the same way that it does to the most straightforward borrower/lender situation.
However, irrespective of the complexity or number of transactions which make up the "series", it should always be borne in mind that this

legislation is still about a provision within Section 147 TIOPA 2010 between two persons that results in a tax advantage. (INTM542020 and INTM542030)

A simple example of indirect finance which would fall within the definition of a series of transactions is a UK borrower being lent money by an entirely unconnected third party bank, with a party connected to the borrower guaranteeing the loan.

A more complex example is where a company in the same group as the UK borrower has provided a guarantee to one bank, which then provides a guarantee to a second bank, and the second bank then lends money to the UK borrower. Here there is a step - between the first and second banks - which does not involve either the parent or the borrower. This is still a series of transactions, and one which, though difficult to detect, would fall within the scope of the thin capitalisation legislation.

In cases such as these, the questions to ask in considering the provision are:

- Without the guarantee(s) would the borrower have been able and willing to borrow on these terms?
- Had the borrower and the guarantor been at arm's length from one another, would they have entered into the guarantee?

## 15.4 The participation condition

Section 148 TIOPA provides:

(1) For the purposes of section 147(1)(b), the participation condition is met if—

(a) condition A is met in relation to the actual provision so far as the actual provision is provision relating to financing arrangements, and

(b) condition B is met in relation to the actual provision so far as the actual provision is not provision relating to financing arrangements.

(2) Condition A is that, at the time of the making or imposition of the actual provision or within the period of six months beginning with the day on which the actual provision was made or imposed—

(a) one of the affected persons was directly or indirectly participating in the management, control or capital of the other, or

(b) the same person or persons was or were directly or indirectly participating in the management, control or capital of each of the affected persons.

(3) Condition B is that, at the time of the making or imposition of the actual provision—

(a) one of the affected persons was directly or indirectly participating in

the management, control or capital of the other, or
(b) the same person or persons was or were directly or indirectly participating in the management, control or capital of each of the affected persons.
(4) In this section "financing arrangements" means arrangements made for providing or guaranteeing, or otherwise in connection with, any debt, capital or other form of finance.

## 15.5 The general rule

If the"basic pre-condition" is met, we move on:

(2) Subsection (3) applies if—
(a) the basic pre-condition is met, and
(b) the actual provision confers a potential advantage in relation to UK taxation on one of the affected persons.

If that is the case we come to the general rule:

(3) The profits and losses of the potentially advantaged person are to be calculated for tax purposes as if the arm's length provision had been made or imposed instead of the actual provision.

Similarly if there are several affected persons:

(4) Subsection (5) applies if—
(a) the basic pre-condition is met, and
(b) the actual provision confers a potential advantage in relation to UK taxation (whether or not the same advantage) on each of the affected persons.
(5) The profits and losses of each of the affected persons are to be calculated for tax purposes as if the arm's length provision had been made or imposed instead of the actual provision.

The International Manual provides:

**542010. Introduction [March 2011]**
...Paragraph 1.65 of the OECD Transfer Pricing Guidelines is particularly helpful in finding the appropriate approach towards the arm's length provision in thin capitalisation cases. This says that the basic transfer pricing approach considers economic substance versus form in thin capitalisation cases:

> "[In cases] where the economic substance of a transaction differs from its form... the tax administration may disregard the parties' characterisation of the transaction and re-characterise it in accordance with its substance. An example of this circumstance would be an investment in an associated enterprise in the form of interest-bearing debt when, at arm's length, having regard to the economic circumstances of the borrowing company, the investment would not be expected to be structured in this way. In this case it might be appropriate for a tax administration to characterise the investment in accordance with its economic substance with the result that the loan may be treated as a subscription of capital."

This means that where a borrower obtains an actual loan of £100m from a non-arm's length source, but would only be able to borrow £60m at arm's length, the tax deduction for the interest costs should be restricted to those accruing on £60m of the £100m actually borrowed. The balance would have had to be provided in some other form, most likely as equity. This is not recharacterisation in the way that excessive interest was once reclassified as a distribution for tax purposes (see INTM542230). Debt which is found to be excessive may be treated as equity for the purposes of a thin cap analysis, but the interest on the £40m excess remains interest for tax purposes; it is simply disallowed in the computation.

There will be variations in the way debt is treated as equity. There may be negotiations which result in an amount of debt being recognised as serving an equity function, as if that debt had actually been permanently converted into equity, but there will be other instances, for example the application of a debt: equity ratio in an advance agreement, where equity will in effect vary from year to year.

This sort of "recharacterisation" should be uncontroversial, assuming the level of disallowance is agreed. It is a case of finding an explanation, should one be needed, for the presence and treatment of funds that have been deemed "excessive" in thin cap terms. However, if the argument goes further, for example towards saying that the transaction would not have taken place at all and something different would have happened at arm's length, it is recommended that the matter be discussed with Business International before the case is developed,

It is important to remember that thin capitalisation considerations are not limited to determining the amount which would have been borrowed at arm's length, but also extend to the other terms attached to the actual provision, such as the interest rate, duration and repayment terms. Any of these is capable of creating or extending a tax advantage for the UK borrower.

### 15.5.1 *Separate entity basis*

The International Manual provides:

> **542050. Separate entity basis for determining borrowing capacity**
> [March 2011]
> The separate entity principle comes from the basic precondition in Section 147(1)(d) TIOPA 2010 which defines the arm's length provision as that which would have been made as between independent enterprises. The arm's length borrowing capacity of the borrower is therefore the debt which it could and would, as a stand-alone entity, have taken on from an independent lender. It follows that in establishing the arm's length borrowing capacity of a particular borrower, it is necessary to consider the borrower separately from both the immediate grouping of which it is part and other members of the same global group. This is the "separate entity" or stand-alone basis for determining borrowing capacity.
> This approach is derived from OECD guidance, as expressed in 1.6 of the Transfer Pricing Guidelines:
>
> > By seeking to adjust profits by reference to the conditions which would have obtained between independent enterprises in comparable transactions and comparable circumstances, the arm's length principle follows the approach of treating the members of an MNE group as operating as separate entities rather than as inseparable parts of a single unified business. Because the separate entity approach treats the members of an MNE group as if they were independent entities, attention is focused on the nature of the dealings between those members.
>
> The main impact of the "separate entity" basis for determining borrowing capacity is that no account is taken of any guarantees, explicit or implicit, from connected companies (INTM542020). However, that is not the end of the story, as it is recognised that, even on a standalone basis, negotiations with a third party lender would include an assessment of the financial strength of the borrower, to inform the thinking of both parties. This would take into account the income, assets and liabilities within the borrower's subsidiaries. In broad terms, this will be based on the strength (or otherwise) of the borrower's consolidated balance sheet and profit and loss account, subject to some analysis of what underlies the figures on the face of the accounts. How this might be achieved would depend on the complexity of the situation.
> HMRC follows a practical approach and, if consolidated accounts are not drawn up as a matter of course, will request consolidated figures.

> There is no obligation on the borrower to produce audited consolidated accounts purely for HMRC, so properly drawn up schedules reflecting the consolidated position will be acceptable. This may not be a straightforward task if the exercise embraces companies resident in a number of countries and using a variety of accounting conventions. In such cases it may be helpful to discuss how HMRC may be satisfied without creating major expense and difficulty.
> There may be companies that need to be excluded from the homogenised group and dealt with according to their own characteristics e.g. finance companies which are likely to have higher proportions of debt than ordinary trading companies. Some subsidiaries may need to be excluded altogether e.g companies with a dividend block which a lender might not recognise as assets against which they would wish to lend. This whole question must be viewed pragmatically
> ...The separate entity principle for measuring borrowing capacity is illustrated by the following example.
> To determine the borrowing capacity of B Ltd, its results are consolidated with those of UK sub Ltd and the two overseas Subs. (INTM578050).
> A, C and D Ltd are not taken into account when measuring the borrowing capacity of B Ltd. However, as a separate matter, in the event that interest on the loan is found to be excessive and is disallowed because the borrowing capacity of B Ltd (including its subsidiaries) would not support the full amount of the loan from Overseas Lender, it may be possible for A, C or D Ltd to make a claim as guarantors under Section 192 TIOPA 2010, if they have assets not already pledged elsewhere....

## 15.6 "Differ from the provision that would have been made"

Section 151(2) TIOPA provides:

> For the purposes of this Part, the cases in which provision made or imposed as between any two persons is to be taken to differ from the provision that would have been made as between independent enterprises include the case in which
> [a] provision is made or imposed as between two persons but
> [b] no provision would have been made as between independent enterprises;
> and references in this Part to the arm's length provision are to be read accordingly.

The International Manual provides:

**542012. The "would" and "could" arguments** [March 2011]
The test of thin capitalisation is to compare the actual borrowing position with the arm's length borrowing position.
The arm's length principle recognises that connected parties have the opportunity to enter into transactions with each other on terms which differ from those which would be found in the open market between entirely unconnected persons. Where profits arise and where (and how much) tax is paid may also differ from the arm's length position.
The application of the arm's length principle requires a judgement on the merit of each individual case to establish what would have happened at arm's length; the terms on which the company in question:
- could have borrowed and would have borrowed (if anything), as a separate entity
- from a third party lender unconnected with the borrower, and
- without guarantees or other forms of comfort from any party connected with the borrower.

There are two main ways of looking at the borrowing: what the lender would do and what the borrower would do if the circumstances were as outlined above, and these are expressed as:
- the "could" argument - what a lender would have lent and therefore what a borrower could have borrowed - and
- the "would" argument - what a borrower acting in the best interests of their own business would have borrowed.

**The "could" argument**
This is generally the less subjective issue. The could argument focuses on what a lender would be prepared to lend to the company and on what terms, taking into account the borrower's capacity to borrow, the risk of default, assets (as security) and liabilities (additional drains on the borrower's resources), and its ability to service the debt: in short, how much and on what terms a lender would lend.
Risk elements will include amount, duration of lending, purpose, security, currency and the economic climate at a sector, national and international level.
**The "would" argument**
This issue is more subjective, since it can involve the whole basis on which the business is run. The "would" argument considers the borrower's perspective: whether the borrower would have entered into the actual transaction in the absence of a special relationship. Therefore, when trying to establish the amount and terms of arm's length debt, the "would" argument relates to how much, and on what terms, the borrower would have borrowed at arm's length bearing in mind the sort of issues

mentioned below.

So, the "would" argument requires analysis of the terms which a borrower would have agreed at arm's length, such as

- the amount of debt, and whether that leaves headroom to allow the borrower to absorb cyclical or seasonal variations, an unforeseen event or a fluctuation in interest rates or profits, and ultimately repay the principal;
- the costs of borrowing, and whether forecasts indicate that the borrower is likely to be able to service the debt fully and still have sufficient cash to operate as a profitable going concern;
- whether the other terms, such as the interest rate or provision for early repayment are ones to which the borrower would have agreed in the absence of a special relationship;
- whether the borrower would have taken out the loan at all.

Consideration of the "could" and "would" arguments should highlight situations such as where

- an arm's length interest rate is being applied, but the amount of debt is more than the borrower could have borrowed from an independent lender, or
- an arm's length interest rate is applied to an arm's length amount of debt, but the borrower appears to have no purpose of its own for borrowing the money (and therefore no reason to borrow other than the group relationship).

Debt is not necessarily paid down to nil. A certain level of debt is acceptable, even desirable in most companies, and while higher levels of acquisition debt tend to be reduced in the years following the transaction, there is likely to be a level of debt appropriate to the needs of the business, year on year, appropriate to achieving the right balance between debt, equity and profitability.

## 15.7 Securities (loans)

Section 152 TIOPA provides:

(1) This section applies where—
(a) both of the affected persons are companies, and
(b) the actual provision is provision in relation to a security issued by one of those companies ("the issuing company").
(2) Section 147(1)(d) [the actual provision differs from the arm's length provision] is to be read as requiring account to be taken of all factors, including—

(a) the question whether the loan would have been made at all in the absence of the special relationship,
(b) the amount which the loan would have been in the absence of the special relationship, and
(c) the rate of interest and other terms which would have been agreed in the absence of the special relationship.

The International Manual provides:

**542015. Summary of sections specific to thin capitalisation** [March 2011]
There are specific sections within Part 4 TIOPA 2010 that apply only to loans between two companies:
- Section 152 TIOPA 2010 requires certain factors to be considered when comparing the arm's length provision with the actual provisions in Section 147(1)(d) TIOPA 2010. INTM542080
- Section 181 TIOPA 2010 to Section 184 TIOPA 2010 sets out the conditions required for a lender to make a valid compensating adjustment claim where a disallowance has been made in the borrower's computations. INTM542110
- Section 153 TIOPA 2010 deals with the factors that are taken into account when a loan is supported by a guarantee, and the borrower and the guarantor have a special relationship. INTM542130
- Section 191 TIOPA 2010 to Section 194 TIOPA 2010 sets out the conditions required for a guarantor to make a valid compensating adjustment claim. INTM542120

**Non-corporates**
Part 4 TIOPA 2010 applies to loans made to companies by non-corporates where the participation condition in Section 148 TIOPA 2010 is met. However, the explicit instructions regarding factors to be considered as part of evaluating the arm's length provision in Section 152 TIOPA 2010 and Section 153 TIOPA 2010 do not apply as legislation to loans by non-corporates. Even so, the factors that are set out in Section 152 TIOPA 2010 and Section 153 TIOPA 2010 are generally those which are taken into account by lenders and borrowers acting at arm's length, so in practice the nature of the lender, corporate or non-corporate will have little if any impact on how the arm's length provision is determined.
Claims for compensating adjustments by non-corporates can be made under the conditions in Section 174 TIOPA 2010 to Section 178 TIOPA 2010.

### 15.7.1 *Disregard: Non-business loans*

Section 152(3) TIOPA introduces two disregards:

> Subsection (2) has effect subject to subsections (4) and (5).

Section 152(4) TIOPA provides:

> (4) If—
> (a) a company ("L") makes a loan to another company with which it has a special relationship, and
> (b) it is not part of L's business to make loans generally,
> the fact that it is not part of L's business to make loans generally is to be disregarded in applying subsection (2).

Why is this needed? The International Manual explains:

> **542080. Special rules for lending between companies** [March 2011]
> ...It might be arguable that at arm's length a company that is not generally in the business of making loans would not lend to another party under any circumstance. Section 152(4) TIOPA 2010 ensures that the fact that the lender is not generally in the business of making loans cannot be taken into account when evaluating the terms.

### 15.7.2 *Disregard: guarantee*

Section 152(5) TIOPA provides:

> (5) Section 147(1)(d) [the actual provision differs from the arm's length provision] is to be read as requiring that, in the determination of any of the matters mentioned in subsection (6), no account is to be taken of (or of any inference capable of being drawn from) any guarantee provided by a company with which the issuing company has a participatory relationship.
> (6) The matters are—
> (a) the appropriate level or extent of the issuing company's overall indebtedness,
> (b) whether it might be expected that the issuing company and a particular person would have become parties to a transaction involving—
> (i) the issue of a security by the issuing company, or

(ii) the making of a loan, or a loan of a particular amount, to the issuing company, and

(c) the rate of interest and other terms that might be expected to be applicable in any particular case to such a transaction.

Section 153 TIOPA repeats the same material:

(1) This section applies where the actual provision is made or imposed by means of a series of transactions which include—
(a) the issuing of a security by a company which is one of the affected persons ("the issuing company"), and
(b) the provision of a guarantee by a company which is the other affected person.
(2) Section 147(1)(d) [the actual provision differs from the arm's length provision] is to be read as requiring account to be taken of all factors, including—
(a) the question whether the guarantee would have been provided at all in the absence of the special relationship,
(b) the amount that would have been guaranteed in the absence of the special relationship, and
(c) the consideration for the guarantee and other terms which would have been agreed in the absence of the special relationship.
(3) Subsection (2) has effect subject to subsections (4) and (5).
(4) If—
(a) a company ("G") provides a guarantee in respect of another company with which it has a special relationship, and
(b) it is not part of G's business to provide guarantees generally,
the fact that it is not part of G's business to provide guarantees generally is to be disregarded in applying subsection (2).
(5) Section 147(1)(d) [the actual provision differs from the arm's length provision] is to be read as requiring that, in the determination of any of the matters mentioned in subsection (6), no account is to be taken of (or of any inference capable of being drawn from) any guarantee provided by a company with which the issuing company has a participatory relationship.
(6) The matters are—
(a) the appropriate level or extent of the issuing company's overall indebtedness,
(b) whether it might be expected that the issuing company and a particular person would have become parties to a transaction involving—
(i) the issue of a security by the issuing company, or
(ii) the making of a loan, or a loan of a particular amount, to the issuing

company, and
(c) the rate of interest and other terms that might be expected to be applicable in any particular case to such a transaction.

The International Manual provides:

**542090. Guarantees - what they do and what they are** [March 2011]
As explained in INTM542040, a provision may arise from a series of transactions rather than just a single transaction between two connected companies. In the context of thin capitalisation, a loan and a guarantee from a connected person constitute a provision consisting of a series of transactions. The most common instance will be a single loan supported by a single guarantee but the provision could consist of any number and combinations of loans and cross guarantees.

**The effect of a guarantee**
Guarantees most commonly support third party borrowing, but can be used to support loans between group companies: for example, a European group treasury company might provide finance to a fellow group company resident in the UK, but under guarantee from the UK borrower's parent company.

With the additional comfort offered to the lender by a guarantor, the lender might provide a loan on more advantageous terms than the borrower could have obtained otherwise, because the guarantee will reduce the risk to the lender. In the event of a failing borrower and no guarantee, a third party lender's prospects of recovering its outlay would be at risk. However, with a guarantee in place, the lender should have greater and more immediate success in recovering debt and interest, simply by exercising its rights under the guarantee and seeking payment from the guarantors, than it would by waiting for a distribution of assets in a liquidation, or having to write off all or part of the loan. The guarantor would of course have to demonstrate that it could make good its pledge, and probably provide security in relation to its commitment.

The effect of a guarantee on loan terms is varied. Guarantees may help secure:

- A larger loan
- A lower rate of interest
- An increase in duration
- Less demanding covenants on the borrower

Any of these may have implications for the transfer pricing of the transaction e.g. a larger loan may be obtainable, but it may be more than the borrower would be able or willing to take on at arm's length. Also, the guarantee may secure preferable terms as compared to what would be otherwise on offer. A lower interest rate on a larger amount of debt might be regarded as a more attractive and not a more expensive deal. See INTM542100.

The presence of a guarantee does not necessarily signify a change in lending terms, and in any case larger, longer, etc, do not mean "better" for the borrower; a larger loan may be more than the borrower would or could borrow without this help, and therefore more than the borrower could or would borrow at arm's length. Lenders may seek guarantees as part of a belt and braces approach, a typical example being the cross guarantees required by lenders when they lend to a group of companies.

**542100. Evaluating guarantees: starting with the arm's length cost of debt** [March 2011]

Section 153 TIOPA 2010 (Paragraph 1B Schedule 28AA) deals with the pricing of guarantees between connected companies. It adopts a similar approach to the way transfer pricing of securities between companies operates - see Section 152 TIOPA 2010 (INTM542080). However to understand how the section works it is better to start by looking at the factors that have to be disregarded before looking at the factors that are specifically to be taken into account.

Section 153(4) TIOPA 2010 has the same effect for guarantees as Section 152(4) TIOPA 2010 has for loans. It ensures that where the guarantor is not generally in the business of making guarantees, that circumstance cannot be taken into account when evaluating what the guarantee fee would be at arm's length.

Section 153(5) and (6) TIOPA 2010 ensure that guarantees from connected companies are ignored, so that the borrower's borrowing capacity is evaluated on a separate entity basis (INTM542050). These subsections repeat what was said at Section 152(5) and (6) TIOPA 2010, except with different intent. Section 152 is about how the arm's length provision is calculated for the borrower, for the purposes of testing whether a security is on arm's length terms. Section 153 repeats the same test, but as a precursor to working out whether a guarantee has an arm's length value. The exercise should isolate the effect of the guarantee e.g. has it provided access to a larger loan than would have been taken on at arm's length?

Looking at the loan whilst ignoring the effect of any guarantees establishes the amount the borrower would have been able to borrow in its own right, and the terms on which it would have done so. The legislation specifically states that guarantees should be disregarded in considering the following specific issues:

- the level or extent of overall debt
- whether a loan would have been entered into
- the rate of interest or other terms

Once this is established, the legislation considers the transfer pricing of the guarantee fee itself - see INTM542105.

**542105. Establishing the arm's length value of a guarantee** [March 2011]

Establishing the arm's length value of a guarantee

This is about guarantee fees and their worth to the borrower: where the borrower is actually charged for the provision of a guarantee. This is therefore about:

- what value the guarantee brings to the borrower
- whether that guarantee gives the borrower improved terms over and above what it could obtain on a separate entity basis i.e. without the support of any but its own subsidiaries.
- What is the appropriate level for the guarantee fee

Section 153 (Paragraph 1B) first establishes the arm's length price of the loan without guarantees. This does not necessarily mean that guarantees will be ignored in pricing the debt. In considering what guarantee, if any, would have been provided at arm's length. Section 153(2) TIOPA 2010 (formerly Paragraph 1B(2) Schedule 28AA ICTA 1988) asks that "all factors" be taken into account in working this out, and particularly asks what would have happened in the absence of the special relationship between the borrower and the provider of the guarantee (i.e. at arm's length):

- would the guarantee have been provided at all
- what amount would have been guaranteed
- what consideration (fee, etc) and other terms would have been agreed

This is simply a matter of applying a transfer pricing test to guarantee costs.

At arm's length, a company will not take on the extra cost of a guarantee unless that guarantee makes the overall cost of finance cheaper than it would be on a stand-alone basis. If the cost of the guarantee itself is greater than the saving it brings, it will be disallowed to the extent that it causes the total finance costs relating to the guaranteed debt to exceed the stand-alone arm's length price.

The scenarios below set out how Section 153 TIOPA 2010 operates for the borrowing company. "Cost of loan" refers to actual costs of borrowing excluding guarantee fees and not adjusted by transfer pricing provisions. These scenarios will not indicate the arm's length price of a guarantee, but will show whether the guarantee has brought a benefit to its holder.

1. Guarantee fee charged and cost of loan exceeds arm's length

The borrower is already paying more than it would if borrowing on a separate entity basis. In arm's length terms, the value of the guarantee is nil and it simply represents an additional cost. The terms of the loan are adjusted for transfer pricing purposes to the arm's length amount, and the guarantee is disregarded. Not only will the non-arm's length element of the loan cost be disallowed, so will the whole of the guarantee fee. There is no apparent benefit from this guarantee, so any claim that there is value meriting a guarantee fee should be subject to a thorough analysis to identify if the guarantee provides any other, less obvious commercial benefit that would justify the payment of a fee. A guarantee might enable a borrower to spread its finance costs over a longer period, which might be advantageous in certain circumstances.

2. Guarantee fee charged and cost of loan is equal to the arm's length

The cost of the loan is arm's length so no adjustment is required with respect to loan costs, but as in 1. above, it would be difficult to justify a guarantee fee. The guarantee fee would be disallowed.

3. Guarantee fee charged and cost of loan is less than arm's length

This situation may arise where the guarantee is taken into account in setting the terms of the loan. For example, the presence of the guarantee may improve the credit rating of the borrower and achieve a reduction in the interest rate. As the guarantee has reduced the cost of the loan to below the stand-alone cost, there is a clear benefit to the borrower in entering into the guarantee. It is therefore likely that at arm's length a fee would be paid, as there is a genuine benefit. However, the borrower would only agree to pay a fee at arm's length if there was an overall saving, and the level of the fee should reflect this.

4. No guarantee fee charged and cost of loan is less than arm's length

Where there is a guarantee in place but no fees have been charged, the guarantee may still provide the borrower with beneficial terms, such as a reduced interest rate. The arm's length cost of the loan will exceed the actual cost of the loan, because the guarantee reduces finance costs without itself costing anything. It might be argued that, at arm's length, a fee would be charged for such an effective guarantee, but one may not be imputed because transfer pricing legislation operates as a one way street. This scenario creates no tax advantage, so the basic transfer pricing conditions are absent. Of course if the guarantor negotiated a fee, that would be considered on its merits.

Evaluating the arm's length value of a guarantee fee should be more than a simple mathematical comparison of actual and arm's length costs. It is worth emphasising that all relevant factors should be considered:

- the obligations of the guarantor
- its ability to fulfil them
- an analysis of the improvement to the borrower's credit worthiness
- consideration as to whether the guarantee brings the borrower something beyond the implicit parental or group support provided by passive association with fellow group members.

> It may be that the benefits provided by a guarantee, particularly informal understandings, are such that a guarantee fee would not normally be justified. Furthermore where the guarantor is unable to honour its commitments under the guarantee because of the state of its own finances, the guarantee will in practice have no value.

## 15.8 Definitions

### 15.8.1 *Special relationship*

Section 154 TIOPA provides some definitions introduced by s.154(1)

> Subsections (3) to (7) apply for the purposes of sections 152 and 153....

Section 154(3) TIOPA provides:

> "Special relationship" means any relationship by virtue of which the participation condition is met (see section 148) in the case of the affected persons concerned.

The term "special relationship" is used in the OECD model treaty without definition (though discussed in the commentary) but the definition here is narrower.

### 15.8.2 *Guarantee*

Section 154(4) TIOPA provides:

> Any reference to a guarantee includes—
> (a) a reference to a surety, and
> (b) a reference to any other relationship, arrangements, connection or understanding (whether formal or informal) such that the person making the loan to the issuing company has a reasonable expectation that in the event of a default by the issuing company the person will be paid by, or out of the assets of, one or more companies.

The International Manual has an interesting passage on implicit guarantees which is not set out here as it is not relevant to the themes of this book.

### 15.8.3 *Participatory relationship*

Section 154(5) TIOPA provides:

> One company ("A") has a "participatory relationship" with another ("B") if—
> (a) one of A and B is directly or indirectly participating in the management, control or capital of the other, or
> (b) the same person or persons is or are directly or indirectly participating in the management, control or capital of each of A and B.

### 15.8.4 *Security*

Section 154 TIOPA provides:

> (6) "Security" includes securities not creating or evidencing a charge on assets.
> (7) Any—
> (a) interest payable by a company on money advanced without the issue of a security for the advance, or
> (b) other consideration given by a company for the use of money so advanced,
> is to be treated as if payable or given in respect of a security issued for the advance by the company, and references to a security are to be read accordingly.

Subsection (6) is standard form. However subsection (7) means that all loans are "securities." It would have been clearer to use the word "loan" rather than to (mis)use the word "securities", but there it is.

## 15.9 Potential advantage in relation to UK taxation

Section 155 TIOPA provides:

> (1) Subsection (2) applies for the purposes of this Part.
> (2) The actual provision confers a potential advantage on a person in relation to UK taxation wherever, disregarding this Part, the effect of making or imposing the actual provision, instead of the arm's length provision, would be one or both of Effects A and B.
> (3) Effect A is that a smaller amount (which may be nil) would be taken for tax purposes to be the amount of the person's profits for any

chargeable period.
(4) Effect B is that a larger amount (or, if there would not otherwise have been losses, any amount of more than nil) would be taken for tax purposes to be the amount for any chargeable period of any losses of the person.

### 15.9.1 *Disregarded income*

Section 155(5) provides a disregard for disregarded income:

> In determining for the purposes of subsection (3) or (4) the amount that would be taken for tax purposes to be the amount of the profits or losses for a year of assessment in the case of a non-UK resident, there is to be left out of account any income of that person which is—
> (a) disregarded income within the meaning given by section 813 of ITA 2007 (limits on liability to income tax of non-UK residents), or
> (b) disregarded company income within the meaning given by section 816 of that Act.

Subsection (6) provides two more disregards:

> (6) For the purposes of subsections (2) to (4)—
> (a) Part 7 (tax treatment of financing costs and income), and
> (b) paragraph E of the list in section 1000(1) of CTA 2010 (excessive interest etc treated as a distribution),
> are to be disregarded.

## 15.10 Exemption for small companies

Section 166 TIOPA provides what appears to be a general exemption, which is then restricted by significant exceptions.

> (1) Section 147(3) and (5) do not apply in calculating for any chargeable period the profits and losses of a potentially advantaged person if that person is a small or medium-sized enterprise for that chargeable period (see section 172).

Section 166(2) provides the signposts in accordance with the dictates of plain english drafting:

> (2) Exceptions to subsection (1) are provided—

(a) in the case of a small enterprise, by section 167, and
(b) in the case of a medium-sized enterprise, by sections 167 and 168.

## 15.11 Election into transfer pricing regime

I mention the first exception only for completeness. Section 167(1) TIOPA provides:

> (1) Subsections (2) and (3) set out exceptions to section 166(1).
> (2) The first exception is if the small or medium-sized enterprise elects for section 166(1) not to apply in relation to the chargeable period. Any such election is irrevocable.

Why would anyone would want to elect into the regime?

## 15.12 Resident of non-qualifying territory

The next exception is more important. Section 167 TIOPA provides:

> (3) The second exception is if—
> (a) the other affected person, or
> (b) a party to a relevant transaction,
> is, at the time when the actual provision is or was made or imposed, a resident of a non-qualifying territory (whether or not that person is also a resident of a qualifying territory).

Section 167(4) TIOPA provides some general definitions:

> For the purposes of subsection (3)—
> (a) a "party to a relevant transaction" is a person who, if the actual provision is or was imposed by means of a series of transactions, is or was a party to one or more of those transactions, and
> (b) "qualifying territory" and "non-qualifying territory" are defined in section 173.

Resident is based on the OECD model definition. Section 167(5) TIOPA provides:

> In subsection (3) "resident", in relation to a territory—
> (a) means a person who, under the law of that territory, is liable to tax there by reason of the person's domicile, residence or place of

management, but
(b) does not include a person who is liable to tax in that territory in respect only of income from sources in that territory or capital situated there.

## 15.13 Qualifying Territory

Section 173 TIOPA provides:

> (1) In section 167(3)—
> "non-qualifying territory" means any territory which is not a qualifying territory, and
> "qualifying territory" means—
> (a) the UK, or
> (b) any territory in relation to which condition A or condition B is met.

I refer to **"qualifying territory conditions A and B"** to avoid confusion with the myriad conditions in TIOPA.

### 15.13.1 *Qualifying territory conditions A and B*

Section 173 TIOPA provides:

> (2) Condition A is that—
> (a) double taxation arrangements have been made in relation to the territory,
> (b) the arrangements include a non-discrimination provision, and
> (c) the territory is not designated as a non-qualifying territory for the purposes of this subsection in regulations made by the Treasury.
> (3) Condition B is that—
> (a) double taxation arrangements have been made in relation to the territory, and
> (b) the territory is designated as a qualifying territory for the purposes of this subsection in regulations made by the Treasury.

Non-discrimination provision has a commonsense definition:

> (4) For the purposes of subsection (2)(b) a "non-discrimination provision", in relation to any double taxation arrangements, is a provision to the effect that nationals of a state which is a party to those arrangements (a "contracting state") are not to be subject in any other

contracting state to—

(a) any taxation, or

(b) any requirement connected with taxation,

which is other or more burdensome than the taxation and connected requirements to which nationals of that other state in the same circumstances (in particular with respect to residence) are or may be subjected.

(5) In subsection (4) "national", in relation to a state, includes—

(a) any individual possessing the nationality or citizenship of the state, and

(b) any legal person, partnership or association deriving its status as such from the law in force in that state.

(6) In this section "double taxation arrangements" means arrangements that have effect under section 2(1) (double taxation relief by agreement with territories outside the UK).

CHAPTER SIXTEEN

# SAVINGS AND INVESTMENT INCOME

## 16.1 Savings and investment income – Introduction

Savings and investment income is charged under Part 4 ITTOIA (occasionally supplemented other provisions). Interest, dividends and royalties each need a chapter to themselves. This chapter contains some general comments and deals with some remaining categories of savings income.

It is necessary to identify the charging provision for each type of income in this category and consider:

(1) When is a receipt "income" in nature and when is it capital?
(2) What is the source of the income?
(3) Where is the source?

These are distinct (though sometimes related) questions. They are generally governed by case law, though occasionally statute chips in.

## 16.2 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 question whether a receipt is "income" in the hands of the recipient remains important. References to "income" in tax legislation do not include capital receipts unless statute expressly so provides (which it often does).

This issue often arises in the context of distributions from trusts and non-resident companies, where the income/capital distinction is fraught.

## 16.3 Why does source of income matter?

The classification of the source of income is important because different rules apply to income with different types of source. In particular, it may be necessary or helpful to identify the source of income before one goes on to identify the location of the 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" or "originating" cause[2] but these paraphrases are of no practical assistance.

## 16.4 Why does location of source matter?

The question of the geographical location of a source of income is fundamental to the territorial scope of income tax.

Section 368 ITTOIA provides:

> (1) Income arising to a UK resident is chargeable to tax under this Part whether or not it is from a source in the UK.
> (2) Income arising to a non-UK resident is chargeable to tax under this Part only if it is from a source in the UK.

This is a statutory statement of a principle which was formerly in part in the statute and (where absent) was inferred by the courts.[3] It rests ultimately on a principle of international tax law.[4]

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

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

3 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."

4 "The jurisdiction to impose income tax is based either on the relationship of the income (tax object) to the taxing state (commonly known as the source or situs principle) or the relationship of the taxpayer (tax subject) to the taxing state based on

Secondly, income must have a source outside the UK to qualify as RFI and so to qualify for the remittance basis.

Statute formerly used a variety of expressions[5] but now the standard terms are: "source in/outside the UK" or "income arising in/outside the UK"; these expressions are synonymous.

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

The concept of the location of income is sometimes said to be misconceived:

> Income itself does not have a geographical location.[6]

It seems to me that this is an overstatement.[7] In most cases it is proper to say that income has a location, and easy to identify it, as the same passage goes on to state:

> By long standing convention, however, income is assigned a geographical location by reference to the location of the assets and activities that are used to generate the income. When all of those assets and activities are located in one State, that State may be considered to be the unambiguous source of the income.

The problem is how to identify the location in harder cases. The passage continues:

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residence or nationality. Under the source principle, a State's claim to tax income is based on the State's relationship to that income. For example, a State would invoke the source principle to tax income derived from the extraction of mineral deposits located within its territorial boundaries. Source taxation is generally justified on the ground that the State has contributed to the creation of the economic opportunities that allow the taxpayer to derive income generated within the territorial borders of the State. Of course, jurisdiction to tax is also about power, and a State generally has the power to tax income if the assets and activities that generated it are located within its borders...." (United Nations Manual for the Negotiation of Bilateral Tax Treaties between developed and Developing Countries) 2003.

5 e.g. in section 65 ICTA 1988 (repealed) the test was whether a possession or security was "out of the UK", but that meant "having a source out of the UK"; see ITTOIA EN Vol II para 1642.

6 Para 2, United Nations Manual for the Negotiation of Bilateral Tax Treaties between developed and Developing Countries) 2003.

7 Contrast the view that the situs of a chose in action is fictional, which is rejected in 70.1 (Concepts of situs).

> ... When some of the assets or activities generating income are located in more than one State, the source of the income is less clear. For example, business profits derived from the manufacture of goods in State A and their sale in State B have a significant relationship to State A and to State B. In these circumstances, some rules for determining source are needed.

An American scholar makes the same point:

> ... the source of income is difficult to define. In fact, many public finance economists would claim that the concept lacks meaning in the majority of cases... the problem has been partially solved by arbitrary rules. ... Economists argue that defining the true economic source is almost impossible, because income has contributions from many countries.[8]

In more complex matters, where several states are involved, it is clearly correct that there is no (economically) "true" source of income. However tax law must somehow choose connecting factor(s) to link a source to a state. In principle, it does not matter what the rule is, as long as there is some rule and its application is clear. There are many possible connecting factors, and the selection of the determining factor(s) must to some extent be arbitrary.

The IT rules for the location of an income source are different from the situs of asset rules for IHT/private international law.[9] It would aid clarity of thinking not to use the same word, situs, in both contexts, so in this book I prefer to use the term "**location**" of a source of income (abbreviated to location of income) and keep *situs* for IHT/international law concepts and CGT. But the usage of "situs" in an income tax context is too well established to alter easily, and no real difficulty ought to arise as long as one bears in mind that IHT/international law situs of assets, and IT location of source of income, are different concepts (though the rules often overlap.) "Locality of income" is sometimes used as a synonym of location of a source of income.

The location of a source is also important for double tax treaties.[10] However DTAs sometimes lay down their own rules for locating a source

8 Reuven Avi-Yonah, *International Tax as International Law*, Cambridge University Press (2007), p.27, 38

9 See 70.1 (Concepts of situs).

10 See "Treaty Problems Relating to Source" [1998] BTR 222.

(for treaty purposes) so it may be necessary to distinguish between domestic law source location and treaty-source location.

### 16.4.1 *Formal* v. *substantive source rules: the policy background*

An American scholar draws an interesting distinction between formal and substantive rules for determining the location of a source of income. This is helpful in identifying the policy issues behind the framing of location of source rules:

> Source rules fall into two basic categories. The first category comprises formal rules. These rules do not attempt to trace the economic source of the income, but rather seek to achieve administrative ease and certainty. For example, the source rule for dividends is residence of the payor. Consider the following example demonstrating the formal rule: Suppose a foreign corporation exists and all of its income is earned in the United States - it has no other business activity.[11] From an economic perspective, it is clear that a dividend paid by this foreign corporation to its shareholders is U.S.-source. But it is foreign-source under the dividend rule, because the payor is a foreign corporation. Notice also that this means that the source of dividend income is under the control of the taxpayer ... The main reason behind this rule is that it is administratively hard to tax a dividend from a foreign corporation to foreign shareholders, but easy to tax a dividend from a U.S. corporation. The rule for interest is also a formal rule, and it is the same as the rule for dividends - the residence of the payor. This is fortunate because of the difficulty of distinguishing debt from equity in many cases; at least the source rule is the same. ...
>
> The other kind of source rule is the substantive rule, which attempts to trace the economic source of the income. The first one of these is the rule for royalties, ... No universal consensus exists about what the source rule for royalties should be. Many countries have a source rule for royalties that focuses on the residence country; the place of ownership of the underlying copyright or the place of production (research and development). The American rule is a place of use rule, meaning that it focuses on where the copyright or patent is utilised. ...
>
> There are other categories in which a substantive rule applies. In services, for example, the place of delivery of service controls. In many

11 Author's note: In the USA a foreign corporation is non-resident: there is no central management and control test for corporate residence.

cases, it is not so easy to determine the place of delivery of service, either, because many high value-added services can now be delivered over long distances. In the past, when these rules were formulated, most services were delivered at the same place they were consumed, because physical proximity between the service provider and service consumer was necessary. Although that continues to be true for certain services - you cannot have long-distance haircuts - most services today (including teaching and legal and medical services) do not require such physical proximity. A disjunction may therefore exist between the place of delivery of the service and the place of receipt of the service that did not exist at the time the rules were formulated. Nevertheless, the rule continues to state that the place of delivery controls; in other words, the place where the service provider is located prevails. ...

The basic difference between formal rules and substantive rules is that the formal rules require one single determination (residence of the payor, residence of the seller, or passage of title), whereas substantive rules attempt to trace the economics of the transaction. Formal rules are generally relatively easy to administer, from both the IRS perspective and the taxpayer's perspective, whereas substantive rules may involve much more difficult determinations. For example, in the case of patents and copyrights, the rule requires determination of the location of use, which may be difficult to determine if it is used in many countries: it may be difficult to break up the income into where the service was actually delivered. Not all substantive rules are difficult to administer: real estate is relatively easy because the location of real estate governs residency, and location is simply to determine in real estate. Most of the important applications of substantive rules, however, are difficult to administer and are more difficult for the taxpayer to avoid because the formal rules are much more under the taxpayer's control.[12]

### 16.4.2 *Location of source of income when there is no source*

It was once the case that income tax was charged only on income from sources specified in the schedules, so in the absence of a source of income there could be no income tax. This is no longer so:

Income tax is traditionally a source-based annual tax, liability depending upon the existence of a source of income falling under one of the

12 Reuven Avi-Yonah, *International Tax as International Law*, Cambridge University Press (2007), p.42

> Schedules during the year of assessment (see *Brown v National Provident Institution* 8 TC 57). ...
> It is, however, no longer true to say that liability to income tax depends upon the existence during the year of assessment of a source within the charge. There are cases (such as post-cessation receipts) when liability depends upon the existence of income defined by reference to a source which does not exist within the year of assessment. Or liability may depend upon an event, such as a balancing charge on the sale of an asset which has attracted a capital allowance, or the receipt of a capital sum from a particular kind of transaction, which is deemed to be taxable income received in that year of assessment or sometimes spread over several years of assessment.[13]

ITTOIA EN Vol II para 1639 notes that:

> Such chargeable amounts [capital receipts subject to income tax] could not therefore be said to derive from a "source" in the traditional sense.

ITTOIA EN was concerned that this might cause difficulty in finding the location of the source:

> 1640. Although the definition [of RFI] uses "income which arises from a source" in respect of all income within the definition, specific rules have been added, in view of Lord Hoffmann's remarks [set out above], in sections 428(3) (deeply discounted securities) and 658(2) (beneficiaries' income from estates in administration), to attribute a foreign source to the income in question to ensure that there is no doubt that the definition applies to these provisions.

Accordingly, s.368(3) ITTOIA provides:

> References in this section to income which is from a source in the UK include, in the case of any income which does not have a source, references to income which has a comparable connection to the UK.

ITTOIA EN Vol II expands on this:

> 34. However, while the term "source" may apply to the majority of

13 *Walker v Centaur Clothes Group* 72 TC 379 at p.416.

> receipts chargeable to income tax it does not apply to all such receipts. "Source" is something from which income arises and not all sums charged to income tax are by nature income. "Source" may not be the appropriate term where the amount charged to tax represents a profit on a transaction which is not by nature income and would not be charged to income tax without a specific charge. Indeed, the chargeable profit may arise on the disposal of an income source. This restricted meaning of "source" is supported by Lord Hoffmann's judgment in *Walker v Centaur Clothes Group Ltd*, 72 TC 379 ... [set out above].
> 35. It has therefore been necessary to consider how to express the territorial scope in cases where there is no natural source of income.
> 36. [Section 368(3)] is broadly worded to catch such income. Where the connection such income has to the UK is comparable to the connection that income with a source in the UK has to the UK, then it is treated for the purposes of this section as income from a source in the UK.

It is hard to see that this concern was justified, but s.368(3) does no harm.

## 16.5 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.

## 16.6 Open-ended investment companies and AUTs

ITTOIA EN Vol II discusses the location of the source of OEIC income:

> 50. The definition of an open-ended investment company in section

> 468(10) ICTA carries a limitation that the company should be incorporated in the UK under the OEIC regulations of 1996. Section 468(10) ICTA is inserted in section 468 of ICTA by para 10(4) (Open-ended Investment Companies (Tax) Regulations 1997 SI 1997/1154). All open-ended investment companies within the definition in section 468(10) ICTA are therefore subject to the company residence rule in section 66 FA 1988 ("regarded for the purposes of the Taxes Acts as resident"). Open-ended investment company interest distributions treated as made by a UK resident company will be UK source income. Section 249 FA 1994 could in theory also apply to make such companies non-resident (as explained in connection with industrial and provident societies). In that case interest distributions made will be treated as dividends from non-resident companies.

For AUTs see 35.2 (Income accruing to unit trust).

## 16.7 Industrial and provident societies

ITTOIA EN Vol 2 explains the source of income from an industrial and provident society:

> 52. Under section 66 of FA 1988 a society registered under the Industrial and Provident Societies Acts will be resident in the UK through incorporation. A society may, however, be non-resident where it also satisfies a residence test in the territory of a treaty partner of the UK and the treaty awards residence to that other territory. Section 249 of FA 1994 will then apply to treat the society as non-resident.
>
> 53. Section 486(4) of ICTA provides that share or loan interest is chargeable under Schedule D Case III. Theoretically therefore payments by a registered society may arise outside the UK but be charged under Schedule D Case III and not able to benefit from treatment specific to Schedule D Cases IV and V. For the sake of consistency this section[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.

## 16.8 Alimony and maintenance income

The source of alimony income is the country whose court ordered the

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

payment.[15] HMRC agree. ESC A12 provides:

> Where alimony or maintenance payments are paid under a UK court order or agreement, the income arises from a UK source regardless of the country of residence of the payer.

However, alimony and maintenance is not usually taxable, because relief under s.727 and s.730 ITTOIA usually applies, so the question of source does not often arise for UK tax purposes.

Foreign tax may of course be payable if the payments have a foreign source under the foreign law. However if

(1) there is a DTA with an "other income" article in OECD model form, and
(2) the recipient is treaty-resident in the UK,

DTA relief will usually give relief against the foreign tax (even though the income is not taxable here). This is strictly a matter for the foreign law, but the INT Manual notes the point:

> **161130. The source rule - concessions** [January 2011]
> ... Note, however, that a UK resident payee, may, if foreign tax has been deducted from alimony etc. payments, be entitled to exemption from foreign tax if the relevant double taxation agreement so provides (for example in a specific Article or in the other income Article – see INTM153200 and INTM153240). If this happens or is likely to happen, then invite the payee to make a claim to the foreign Revenue authority for repayment of any tax deducted and for exemption from tax on future payments. Guidance on how to make such claims are given in the entries relating to the respective individual countries.

ESC A12 by concession allowed a foreign tax credit where alimony was UK source under UK principles and foreign source under foreign law principles and so suffered UK and foreign tax. However this has little role to play since 1988 since UK tax is no longer payable and foreign tax credit is not needed and the INT manual discussion on this issue seems to be 2 decades out of date.

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15 See *Bingham v IRC* 36 TC 254 where a UK resident made maintenance payments to his ex-wife who was resident in the Netherlands. The payments had been ordered by a Dutch court and so were not UK source income.

## 16.9 Casual income

The BI Manual provides:

> **BIM80130 - Miscellaneous income: Scope of the provisions: Sweep-up - judicial comment**
> ...Income from "property"
> The case of *Alloway v Phillips* [1980] 53 TC 372 involved the wife of one of the Great Train Robbers. Whilst living in Canada, she received £39,000 from a newspaper. It was not in dispute that she had provided information to the newspaper which led to the newspaper publishing a series of articles. It was found that she had entered into an agreement, governed by English law, to assist the newspaper.
> The Court of Appeal held that the £39,000 was taxable in the UK under the Miscellaneous Income provisions as it arose from "property" in the UK. Lord Denning MR said at page 387D:
>
> > "The truth is that she had a chose in action in England. It was property in England: but she had no property at all in Canada. She had no copyright there. She only had the information in her head which she told to the newspaper reporter. That is not a species of property known to the law of England"

In *Alloway v Phillips* the location of the source of income was held to be the place that the benefit of the contract (the chose in action) was situate, and the contract being enforceable in the UK the income was taxable. This is not a suitable test, as taxpayers can in principle choose the place where the contractual right is situate. *Alloway v Phillips* is one of those cases where the Court decided the result first and the reasoning second.[16] It is considered that the place where the work is done is the correct test for income in this category. But until such time as the Courts say so, a taxpayer is entitled, indeed strictly required, to proceed on the basis that the reasoning of the Court of Appeal is correct in law.

16 "If the criminals or their wives get money by relating their stories to newspapers, they ought to pay tax on their profits and gains. That is this very case. The wife is now in England. She is outside the jurisdiction of the Canadian courts. She received the money here and ought to pay tax here ..." (Lord Denning, 53 TC 372 at p.387).

CHAPTER SEVENTEEN

# INTEREST INCOME

## 17.1 Interest - Introduction

This chapter considers:
(1) The taxation of interest income
(2) Withholding tax on payment of interest to non-residents
(3) Withholding tax on payment of interest by deposit-takers (banks)
(4) The EU Interest and Savings Directive
Each topic requires a book to itself, except for the EU directive which requires several volumes. I focus on matters closest to the themes of this book. I do not consider corporation taxation of interest (the loan relationship rules) or the EU interest and royalties directive 2003/49/EC of 3rd June 2003 which applies to interest and royalty payments made between associated companies of different member states. Each of those would also require long books to themselves.

For interest on FOTRA securities and foreign currency securities see 18.1 (Exempt interest of non-residents).

For relief for payment of interest, see 15.1 ( Deduction of Interest in Computing Property Income).

## 17.2 Interest: charge and location of source

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

> Income tax is charged on interest.

I refer to the person paying interest as "**the debtor**" and the recipient as "**the creditor**".

Section 370 ITTOIA provides:

> (1) Tax is charged under this Chapter on the full amount of the interest arising in the tax year.
> (2) Subsection (1) is subject to Part 8 (foreign income: special rules).

This incorporates the remittance basis for foreign source interest. Foreign source interest is outside the scope of withholding tax and qualifies for the remittance basis, so the question of source matters to both creditor and debtor.

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

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

The location needs to be known by the debtor (who may have to deduct tax at source) and creditor (who may be taxable on the interest). This suggests no weight should be given to factors not likely to be known by both parties.

Factors which the parties can manipulate without commercial cost or inconvenience are not suitable (at least from HMRC's viewpoint and one can expect the courts to sympathise).

Debts are frequently assigned, and it is suggested that:

(1) assignment should not alter the location of the source; and
(2) facts not likely to be known by an assignee should not affect the location.

Many of the connecting factors may change, and it is possible that the source of interest can change its location. However, it would not be convenient for location of a source to change very often. There are two ways to deal with this:

(1) to place little or no weight on features which may easily change; or
(2) to look at the situation at the time the debt arises, and to ignore later changes.

Solution (1) seems preferable.

There are many possible connecting factors. It would not be possible to compile a complete list but the main factors are as follows:

(1) the debtor:
    (a) residence of debtor;

   (b) place of business of debtor;[1]
(2) payment of the interest:
   (a) place where interest is paid;
   (b) situs of funds out of which interest is paid;[2]
(3) contract under which interest is paid:
   (a) proper law;
   (b) place where contract would be enforced;
   (c) place where contract is made;
(4) situs of debt on which interest is due under IHT/international law principles (ie location of deed if debt is a specialty);
(5) place where debtor uses the money borrowed (eg to purchase UK/non-UK situate asset);
(6) place where money is lent or where credit is provided;
(7) situs of security for debt (if any);
(8) residence of guarantor (if any);
(9) residence of creditor.

I shall evaluate these factors in order.

### 17.2.1 *Residence and place of business of debtor*

Residence of the debtor is in principle a satisfactory connecting factor. In the case of dual resident debtors, the place of business connected with the loan would usually act as a suitable tie-breaker.[3]

A difficulty arises if debtors change their residences, which if not common is by no means impossible. This was pointed out in *Philips*.[4] But a solution might be to ignore subsequent changes of residence. Similarly, if a debtor dies and the liability is that of PRs, the place of residence of the PRs should not affect the source of the interest.

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

2 This is often called the “source” of the payment but it is hopelessly confusing to use the word “source” in that way.

3 See 70.12.1 (Meaning of “residence” and dual resident debtor).

4 See 17.3.3 (*IRC v Philips' Gloeilampenfabrieken)* [1955] NZLR at p.898: “In my opinion, the fallacy in the able argument presented by [counsel for the Commissioner] was exposed when he felt obliged to submit (as indeed he was if he was to be consistent) that if a New Zealand citizen, while in London, found himself in financial difficulties and had to obtain from a London money-lender a loan, which he was able to repay over a period of years only after he had returned to his own country, the London money-lender could be assessed with [New Zealand] income tax ...”

## 17.2.2 *Payment of the interest (place where interest is paid or situs of funds out of which interest is paid)*

This is not a suitable connecting factor as it can and often will change from year to year. This view is supported by *IRC v Philips' Gloeilampenfabrieken*:

> It is not sufficient to ascertain the fund out of which the income was in fact paid, which is no more than the reservoir from which it was drawn. It is not whence it was paid, but why it was paid, that is the determining factor. The emphasis is not upon the receipt, but upon the derivation of the income. Consequently, it does not constitute the source within the meaning of the section that the money [used to pay the interest] was drawn from or provided by the trading profits in New Zealand. The New Zealand company [the debtor] was free to obtain the funds with which to perform its obligation anywhere it chose, from deposits in England, if it had any, or from borrowing in England, or from the profits of its trading in New Zealand. That was a domestic matter. The money could "come from" any of these "sources", but none of them would be the source from which the [creditor] derived what it received as income.[5]

In other words, one should not equate the location of the source of the interest with the situs of the *resources* that the debtor uses to pay the interest.[6]

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5 See 17.3.3 (*IRC v Philips' Gloeilampenfabrieken*) [1955] NZLR at p.898.

6 For completeness, I should mention *IRC v Broome* 19 TC 667, where the features of the loan were as follows:

(1) (a) The debtor was (primarily) resident in Kenya (also UK resident, but that does not matter).
    (b) However, the original debtor died. His executors were UK resident.

(2) The executors [debtors] paid the interest in the UK out of funds in the UK.

(3) The loan was enforceable in Kenya.

(4) The creditor was resident in Kenya.

Finley J held:

"There is no doubt at all that if a payment is made by a person here out of a source which is here, then that payment attracts tax. ... I think it was payment out of a source here. The first two payments are perhaps a little more clear, because there the payment was actually made to Earl Kitchener [the creditor] personally in this country. He happened to be here; he was resident abroad, but he happened to be here, and he was actually paid by the executors in London; and equally [the other

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

These are not suitable connecting factors as they are within the control of the parties.[7]

### 17.2.4 *Situs of debt: location of deed if debt is a specialty*

For IHT/international law the situs of a specialty debt is the location of the deed.[8] This is obviously an unsuitable connecting factor. The debtor will not have possession of the deed and may not know its location. The location is easily changeable, and the rule would allow easy tax planning.

This view is supported by *Philips*:

> 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.[9]

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*.[10]

My view could also obtain support from *Bank of Greece*[11] where

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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."

This passage adopts uncritically the view criticised here that the funds used to pay interest determine the source of interest. It is suggested that no guidance should be taken from *Broome* and it has (rightly) been ignored in all later cases.

7 Place of enforceability is also unsuitable as a contract may be enforceable in more than one place, or the place of enforceability may be unclear.
The place the contract is made is also unsuitable because the place the contract is made is itself often difficult to identify. See 13.18 (Where is contract made).

8 See 70.13 (Specialty obligation).

9 See 17.3.3 (*IRC v Philips' Gloeilampenfabrieken*) [1955] NZLR at p.898.

10 See 17.3.3 (*IRC v Philips' Gloeilampenfabrieken*).

11 See 17.3.1 (*Bank of Greece*).

although the court did not seriously address the question of the location of a source of interest, its approach was certainly not consistent with the IHT/international law approach.

For a simple debt, the IHT/international law approach takes us back to residence as a connecting factor, which is discussed above.

It is not illogical or inconsistent to say that the situs of a debt for IHT/international law purposes is in one country but the location of the source of interest on that debt for income tax purposes is in another. This is the case for shares, which may be non UK situate for IHT/international law but whose dividends may be UK source (if the company is UK resident.) One might simply say that the two taxes apply different rules. Alternatively, and more subtly, one might say that the source of interest (for IT purposes) is not the debt but the transaction which gives rise to the debt (which may be located in a different place from the location of the debt).[12] Either way, the IHT/international law situs rule is not the test.

I stress this as the view that the location of the source of interest for IT should be equated with IHT/international law situs of the debt has from time to time found support.[13]

### 17.2.5 *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.

### 17.2.6 *Place where money is lent (where money is received)*

This is a sensible connecting factor. It may be objected that it allows tax planning where money is lent in one jurisdiction and then immediately transferred to another. But the courts could easily look through transient arrangements of that kind to identify the place where the money is substantially received.

### 17.2.7 *Situs of security for debt*

A rule that source of interest on a secured debt depends on the location of

12 *Philips* takes this approach:

13 See 17.3.2 (*Hafton Properties*); 17.4.1 (HMRC view before 1979).

the property on which the debt is secured is not sensible or workable, for the following reasons:

(1) A debt may be charged on property in two different countries.
(2) The rule becomes absurd if a large debt is secured on an asset of a small value. Would one say that a £100 million debt is situate in Jersey if it is secured on property there worth £100,000? Also, one cannot have a rule where the location of interest depends on the relative value of the debt or the security, which may fluctuate from time to time (though that might be resolved by looking only at the position at the time the debt arises.)
(3) If land determines the location of interest from of a debt secured on land, then a debt charged on (say) shares should be situate where the shares are situate.

This rule would sometimes allow scope for tax planning.

### 17.2.8 *Residence of guarantor (if any)*

No weight should be given to the residence of a guarantor, since in the normal course of events a guarantor would not be called on to make any payment.

### 17.2.9 *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.

### 17.2.10 *Unsatisfactory approaches*

The most unsatisfactory approach of all is to say that it is a question of fact.[14] The meaning of "source" is a question of law and so is the question

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14 Sometimes a "practical hard" matter of fact, the phrase derives from *Nathan v Federal Commissioner of Taxation* [1918] HCA 45; (1918) 25 CLR 183 and is also mentioned in *Rhodesia Metals v CT* [1940] AC 774 at p.789, but the adjectives are meaningless. The point is made discreetly by Lockhart J at first instance in *Spotless* ("... a little opaque...")

of whether known facts (which will usually be simple) fall within that meaning. It is the task of the courts to provide an answer to that question.

Equally unsatisfactory is to say that the answer is whatever a "practical man would regard as the real source". The only way in which a man, practical or otherwise, can locate a source of interest (other than tossing a coin) is to apply a theory as to the priority of rival connecting factors.[15] The exhortation to adopt a "practical approach" is harmless but not particularly helpful. No-one advocates that the court should adopt an impractical approach. But those who stress this approach should bear in mind that the one thing that a practical man will demand of the law is that it will provide a clear *answer* to the question of where is a source. There is nothing more impractical than uncertainty. What Kurt Lewin said of psychology is also true of tax: there is nothing so practical as a good theory.

It is not satisfactory to say that all the features listed are relevant, and if different features point in different ways, it is a matter of carrying out a balancing exercise. We need guidance on which factor has priority or there is no law on the subject at all. The formulation derives from Commonwealth cases on the source of *trading* income.[16] 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.[17] 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

15 See 17.3.3 (*IRC v Philips' Gloeilampenfabrieken*) [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."
Similarly, though in a different context, *IRC v Pratt* 57 TC 1 at p.52:
> "It is very simple to say that something is a question of fact, or mixed fact and law, and leave it at that, but this does not solve anything at all."

Contrast Keynes' *dictum* that "practical men who believe themselves exempt from intellectual influence are the slaves of some defunct economist".

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

17 See 13.5 (Trading income of non-resident).

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.[18]

## 17.3 Case law on source of interest

The case law is not easy reading.

### 17.3.1 *Bank of Greece*

The facts of *Bank of Greece*[19] are a little complicated and unusual, and one needs to understand them in order to see clearly what the case is about. The facts are not very fully stated by the House of Lords but further details can be teased out from the various reported cases concerning these much litigated bonds.

The case concerned bearer bonds issued by a Greek bank in 1927. The bonds suffered various changes in the turbulent years which followed. The bonds had the following features (using the numbering of the list in the above paragraph):

(1) The debtor was non-resident (a Greek bank).

(2) (a) Payment was to be made in sterling.[20] Payment was to be made in London or (at the option of the creditor) in Athens, by cheque in London.

(b) Payment would in the ordinary course have ultimately derived from funds situate in Greece.[21]

(3) The bonds were governed by English law and were enforceable in England.[22] (Enforceablility was originally recognised in Greece, but

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18 See 17.3.3 (*IRC v Philips' Gloeilampenfabrieken*) [1955] NZLR 868 at p.896.

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

20 For completeness, in 1935 this changed so that Greek residents could only be paid in drachmae: see [1958] AC 509 at p.510 but nothing turned on that.

21 I think this is what Lord Hailsham means in the somewhat convoluted sentence at p.494A.

22 [1958] AC 509.

that ceased to be the case following a moratorium under Greek law, raising conflict of law issues which twice went to the House of Lords.)

(7) The debt was originally secured by lands in Greece but these properties were taken over or disappeared following the German occupation of Greece in 1941.[23]

(8) The guarantor was non-resident.

It is fairly clear (and all sides accepted) that the interest on the bonds originally had a Greek source. Almost[24] all the features of the debt pointed the same way, to Greece. The House of Lords held that the interest had a foreign source in these words:

> [1] the bond itself is a foreign document, and
> [2] the obligations to pay principal and interest to which the bond gives rise were obligations whose source is to be found in this document.

This was adequate for the decision as it related to a point not in dispute. However, the *dictum* is inadequate as a basis for ascertaining the location of a source of interest in other cases. The court did not say how it reached its conclusion: it just described the loan and stated the conclusion.

The conclusion that some have drawn from this case is that all the features listed in the list above were relevant, and if different features point in different ways, it is a matter of carrying out a balancing exercise (how one goes about that is never explained). This is a complete misreading. *Bank of Greece* provides no support for that approach whatsoever. The speech in the case had no need to say anything about the

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23 46TC 472 at p.483H.
At p.493H Lord Hailsham says that the debt was secured by lands *and public revenues* in Greece, As far as I can tell from the case reports this seems to be a slip, or perhaps Lord Hailsham was referring to the income of the bank as "public revenues" as the National Bank of Greece was publically owned. Nothing turns on that point but it is important to note that the bonds were bank bonds and not government bonds.

24 The following features in *Bank of Greece* did not cause it to have a UK source:
(1) payment made in sterling
(2) English proper law
(3) interest paid in England.
(4) Karminski LJ adds that "the loan was raised in London": 46 TC at p.489.

location of source of interest paid by the principal debtor, because that location was not in dispute. The court heard no argument about the principles of identifying the location of the source of interest. The relevant cases were not cited. In my view *Bank of Greece* gives no guidance at all on what is the test for the location of the source of interest. The fragment of the sentence ("the bond is a foreign document") was merely descriptive of the facts of the case and not intended to lay down a general test for location of a source of interest. If it lays down a test at all, it is imponderable. In a marginal case, how does one decide if a bond is a foreign document? The test can only be applicable to interest on securities.

The actual dispute in *Bank of Greece* concerned the location of the source of income consisting of guarantee payments. The original borrower, the principal debtor, (the National Mortgage Bank of Greece) had defaulted on the bond and the payments were made by the guarantor.[25]

It was not completely clear that income in the form of guarantee payments was to be classified as "interest".[26] However if it was not interest it is sensible that location of the source of such income should be determined on principles similar to those which apply to interest, so that makes no difference.

Why was it argued the income had a UK source?

> The only circumstances relied on by the Appellants as supporting their contention that the obligation was located inside the UK were as follows.
>
> [1] Although the original guarantor had no branch in the UK, the present Appellants had acquired one on their universal succession in London.[27]
>
> [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

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25 To be precise, the payments were made by a company which had succeeded to the guarantor following an amalgamation, and which was subject to the same obligations as the original guarantor, but that made no difference.

26 Two of the three judges in the CA held that the payments were interest, and in the House of Lords this was said to be "attractive". But nothing turned on this point.

27 Lord Hailsham means that the guarantors who succeeded to the original guarantor acquired a branch in London on their succession to the original guarantor.

enforced was in London.[28]

There is some strength in this argument but it did not win the day. These changes did not affect the location of the source of income:

> Speaking for myself, I do not see how an obligation originally situated in Greece for the purposes of British income tax could change its location either by reason of the fact that
> [1] one guarantor had been substituted for another, or ...
> [2] the second guarantor so substituted subsequently acquired a London place of business, or ...
> [3] the Government of Greece had by retrospective legislation altered by moratorium and substitution of a new guarantor for the purposes of Greek law the obligations imposed upon the principal debtor and the guarantor.
> The Appellants acquired no obligation different from that of the original guarantors, and that was the obligation imposed on the original guarantors by the terms of the bonds.[29]

*Bank of Greece* is authority for the (sensible) proposition that sources of interest are fixed and do not move with changes of circumstances of the debt.[30] It is not relevant to any other aspect of the location of a source of interest.

### 17.3.2 *Hafton Properties*

In *Hafton Properties v McHugh* 59 TC 420 (a decision at Special Commissioner level) the facts were weighted as strongly as possible in favour of a foreign source, except there was a UK resident debtor. Under the original loan agreement, a US company borrowed from a US bank, the loan being secured on US property. Hafton (UK resident) acquired the property subject to the mortgage. It paid interest. This was not UK source:

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28 46 TC at p.494.

29 46 TC at p.494.

30 More accurately, the case is authority for the proposition that the changes which occurred in the *Bank of Greece* case did not change the location of the source. It is open to a court to distinguish that from other types of changes. However the changes which occurred there were so fundamental that it is considered that there will be few if any cases where the location of a source of interest will move.

> [1] In one respect the Greek Bank case is different from this one, in that in that case the debtors (both original and substituted) were at all times essentially Greek in character. Nevertheless I collect from Lord Hailsham's speech a clear disinclination to regard sources of income as being peripatetic. He looked to the nationality (if I may so put it) of the document creating the obligation, and, applying the sentence which I have already read from that speech to the present case, there can be no doubt that the obligation here was American in character.
>
> [2] That is fortified, of course, by the fact that the debt was a mortgage debt. Such a debt is regarded for private international law purposes (at any rate) as a speciality debt, the situs of which is to be found where the mortgage deed is to be found. The mortgage deed is, and so far as I know always has been, in the United States.[31]

Point [1] is right. If a change of guarantor does not affect location of a source of interest, neither should a change to the identity of the principal debtor. This point will not often arise because the facts of *Hafton Properties* (purchase of property subject to mortgage) are unusual. A mortgage is usually paid off at the time of the purchase.

A more common situation is that an individual who has borrowed funds later comes to the UK and continues to pay interest. *Hafton* supports the view that (whatever the test for location) the interest does not become UK source merely because the debtor becomes UK resident. Conversely interest does not cease to be UK source just because a debtor becomes non-resident.

Point [2] is therefore *obiter*; it is considered that situs of the debt on IHT/international law principles should not carry much if any weight, for the reasons given above.

### 17.3.3 *IRC v Philips' Gloeilampenfabrieken*

I have already mentioned *IRC v Philips' Gloeilampenfabrieken ("Philips")*.[32] This decision of the Court of Appeal of New Zealand considers and cogently rejects various alternative tests of source, including the location of funds used to pay the interest and IHT/international law situs rules. It concludes:

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31 59 TC 420 at p.426.

32 10 ATD 435 [1955] NZLR 868 accessible *www.kessler.co.uk*.

> the actual source of this income was the credit made available by way of loan under the agreement made in the Netherlands in the course of the respondent's business in that country. ...the source of the income was the business transaction carried out in the Netherlands...[33]
>
> ... the source is located where the transaction from which the debt took its origin took place...[34]

This is the place of credit test. It was said to be equivalent to the test of asking where the loan was made.[35] A particular attraction of this test is that it is fixed at the time the loan is made and does not change.

Unfortunately this test does not resolve all the issues as one then has to ask where the credit was provided. The answer may not be obvious.

The facts of *Philips* were also slightly complicated and unusual. The debtor (a New Zealand company) owed a trading debt of £80k to the creditor (a Dutch company). The debtor was unable to pay. Rather than leave that debt outstanding:

(1) the creditor lent £80k to the debtor
(2) the debtor used the £80k to pay the trading debt

(ie the old debt was paid and a new one came into existence).

The loan agreement was made in Holland and governed by Dutch law. The money was not received in New Zealand though payment of the borrowed money was made in a convoluted way:

(1) the Dutch company creditor drew a cheque and sent it to the New Zealand company
(2) the New Zealand company endorsed it and returned it to the Dutch company.

On these facts the credit was not provided in New Zealand, so the source of the interest was not in New Zealand.

The High Court of Australia applied the same test in *Studebaker Corporation of Australasia v Commissioner of Taxation for New South Wales* where the facts were more straightforward: an Australian debtor paid interest on a trade debt arising on the purchase of cars from America. The interest did not have source in Australia.[36]

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33 [1955] NZLR at p. 809, 891.

34 p.898.

35 p.899.

36 (1921) 29 CLR 225 accessible *www.austlii.org* at p.233: "The attribution of locality to the obligation to pay interest [the situs of the debt] is not decisive. The facts must be examined, and when we find that the interest arises from business transacted and

The Appeal Division of South Africa applied the same test in *IRC v Lever Bros* where a South African debtor paid interest on a debt arising on the purchase of UK shares from a UK vendor under a UK contract. The interest did not have a source in South Africa.[37]

The High Court of Singapore has adopted the same test.[38]

### 17.3.4 *Hong Kong cases and practice*

In *IRC v Hang Seng Bank* [1990] STC 733 at p.740 the Privy Council state the position quite clearly:

> If the profit was earned by ... lending money ... the profit will have arisen in or derived from the place where ... the money was lent ...

In *IRC v Orion Caribbean* [1997] STC 923 at p.930 the same court made (I think) the same point, but more cautiously:

> If [a company] lent its own money to a borrower in, say, New York,[39] 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, ie the issue was the source of trading income. Since different principles apply to trades[40] 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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wholly carried out in America the conclusion must be that it was not derived from any source within new South Wales." Similarly *Commissioner of Taxes v. Dunn and Co Ltd* [1918] AD 607, in which interest earned by an English company on advances on open account for the purchase of goods in the UK for despatch to a South African business firm was held to be derived from a source in the UK, where the capital was employed in making the purchases.

37 [1946] AD 441, 14 SATC 1 accessible *www.kessler.co.uk*.

38 *CH Pte Ltd v Comptroller of Income Tax* (1988) 1 MSTC 7022 accessible *www.kessler.co.uk*. In this case an agreement was made in Malaysia, but (which is considered to be the key fact) the money lent was received in Singapore. (A cheque received outside Singapore but paid into a Singapore account constitutes a receipt in Singapore.)

39 I assume this means that the money was lent (received) in New York.

40 See 17.2.10 (Unsatisfactory approaches).

Revenue explain:[41]

> 2. Only interest arising in or derived from Hong Kong is liable to profits tax. For many years, the Department has taken the view that for the purpose of determining the place where interest arises or is derived from, it is the location of the originating cause that almost invariably determines the source. In essence, the place of derivation of interest is the place where the credit was provided to the borrower, i.e. *the place where the funds from which the interest is derived were provided to the borrower*, commonly known as the "provision of credit" test. This view is based on the decisions in *IRC v Philips Gloeilampenfabrieken,* and *IRC v Lever Brothers & Unilever*.[42]
> 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.[43]

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41 Departmental Interpretation and Practice Notes No. 13 (Revised) Profits Tax: Taxation of Interest Received, December 2004, accessible *www.ird.gov.hk/eng/pdf/e_dipn13.pdf.*

42 For these two decisions see 17.3.3 (*IRC v Philips' Gloeilampenfabrieken*).

43 Emphasis added. The statement continues with three exceptional cases:

"[1] Whilst the emphasis is generally placed on the provision of the credit, in some situations, such as mortgages, the originating cause may well be the mortgage itself.

[2] In addition, interest has a Hong Kong source where it forms an integral part of a trading transaction carried out in Hong Kong, e.g. where a Hong Kong manufacturer sells his goods to an overseas buyer on extended credit terms. In such situations, the interest is just as much a part of the profit as the trading profit itself and also arises in Hong Kong, e.g. BR 20/75, IRBRD, vol. 1, 184 and *Studebaker Corporation of Australasia v C of T,* 29 CLR 225.

[3] It should also be noted that the 'provision of credit test' is not applicable where the loans are not simple loans of money. The Privy Council held in the case of *IRC v Orion Caribbean* 4 HKTC 432 [1997] STC 923 that where the taxpayer earned its profits by borrowing and lending of money, the proper test to determine the source of the profits was the operation test, i.e. "one looks to see what the taxpayer has done to earn the profit in question and where he has done it". In the case of a money lending business, the taxpayer's business would normally encompass a broader range of activity, including the borrowing and/or lending of money. For this type of business, the Department will apply the operation test instead of the provision of credit test in determining the source of the interest income."

Cases [2] and [3] are both trading cases and not governed by the location test for interest.

## 17.3.5 *Spotless*

The source of interest was also an issue in *Commissioner of Taxation of the Commonwealth of Australia v Spotless Services*.[44] 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.
> [1] The borrower, EPBCL, was incorporated in the Cook Islands and carried on business there. It did not carry on business in Australia.
> [2] The deposit was repaid, together with interest, less withholding tax, from the Cook Islands.
> [3] 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

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Whether case [1] should be an exception is more doubtful, though it has a little support from *obiter* in *Philips* at p.898: "Where the debt is a secured one, it is possible that the application of the practical test may, in some cases, make it arguable that the source is where the security is; or where the registry is wherein the mortgage deed is registered..."

44 I could not find the case on *www.austlii.org* so have put it on *www.kessler.co.uk*. The case went on to the High Court of Australia but the source point was discussed only at first instance and in the Court of Appeal.

> received in return there was no contract between the lender (the taxpayer) and the borrower (EPBCL). If EPBCL failed to honour the certificate of deposit on the due date the taxpayers could have sued on the certificate and there would have been no answer in law to their right to judgment."
>
> 12. Once the contention that the contract was in reality made in Australia and that what occurred in the Cook Islands was a mere "formal step designed to screen the reality" is rejected and the banker's letter of credit issued by Midland is seen for what it was, a security to secure performance by EPBCL of repayment of the loan with interest, and not as an investment in itself, the matters contended for by the Commissioner as matters of practical substance sourcing the interest in Australia are either not factually correct or not sufficient to outweigh the Cook Islands elements.

## 17.4 HMRC view(s)

### 17.4.1 *HMRC view before 1979*: *IHT/international law situs rules*

The IR consultative document Tax Treatment of Interest paid by Companies to Non-residents[45] provides:

> In the case of a simple contract debt it is settled law that the source is where the debtor is resident. Before the ending of exchange control, the Revenue was normally able to accept that interest paid abroad in a foreign currency under a specialty contract (ie a contract under seal governed by foreign law) to a non-resident could have a foreign source, even though the payer was a UK resident company.

This (more or less) adopts the IHT/international law situs approach to location of a source, which is wrong on principle[46] and rejected in every reported case.[47]

This view survives in the Double Taxation Relief Manual:

> **1730. Interest**
> There is sometimes some difficulty in deciding whether interest is

45 January 1983 accessible *www.kessler.co.uk*.

46 See 17.2.4 (Situs of debt: location of deed if debt is a specialty).

47 Apart perhaps from the stray comment of the Special Commissioner in *Hafton* and even there situs is of subsidiary importance: see 17.3.2 (*Hafton Properties*).

> treated as having a UK source where the borrowing is made by a UK branch. ...
> The leading case on this subject is a Privy Council decision on a Hong Kong estate duty matter (*Kwok Chi Leung Karl* [1988] STC 728). The Privy Council decided that where a debtor company has two places of residence where a debt may be enforced, the locality of the debt (and its source for tax purposes in the absence of statutory provision to the contrary) falls to be determined by reference to the place of residence where under the contract creating the debt the primary obligation is expressed to be performed (that is where the creditor would apply first for his money).

*Kwok* concerned situs for estate duty, applying IHT/international law rules and is not relevant to the source of interest for IT purposes.

A different practice is recorded in Revenue/Treasury correspondence in 1969. According to the Revenue, interest has a foreign source if:

(a) the loan contract is made abroad
(b) the loan contract is governed by foreign law
(c) the interest is payable abroad, and there is no UK paying agent and
(d) the loan is not secured on any specific assets or revenue in the UK.[48]

Note that this practice envisages interest paid by a UK resident debtor having a foreign source.

### 17.4.2 *HMRC view 1979–1993: residence of debtor*

The consultative document continues:

> The abolition of exchange control has meant that a transaction in the form of a foreign specialty contract can now take place entirely between UK residents. The Revenue therefore now generally has to regard interest paid by a UK borrower as having a UK source, whatever the nature of the contract ...

This (more or less) equates source with residence of the debtor. The Revenue forthrightly admit that their change of view was made for

48 Note by the Inland Revenue to the Working Party on Balance of Payments Aspects of Tax Questions 20 November 1968; Letter DA Walker (HM Treasury) to JE Redman (Inland Revenue) 10 January 1969; both accessible *www.kessler.co.uk*.

pragmatic reasons and not by reference to the law. In the circumstances it is not altogether surprising that their view could not be maintained. The consultation paper gives the impression that this practice lasted for 15 years but I doubt if the view was strictly enforced.

There is no support for this view in any of the case law, though in practice a residence test will often lead to the same result as other better established tests.

### 17.4.3 *HMRC view 1993–2008: balance all factors*

HMRC next changed their position in RI 58 (November 1993):

> **Schedule D Case III—meaning of "source"**
> ...The current [HMRC] view on the location of the source for interest is based on ... the Greek Bank case. The factors considered relevant in that case (leading to the conclusion that the income involved did not have a UK source) were—
> [1] there was an obligation undertaken by a principal debtor which was a foreign corporation;
> [2] the obligation was guaranteed by another foreign corporation with no place of business in the UK;
> [3] the obligation was secured on lands and public revenues outside the UK;
> [4] funds for payments by the principal debtor of principal or interest to residents outside Greece would have been provided
> [i] either by a remittance from Greece or
> [ii] funds remitted by debtors from abroad[49]
> (even though a cheque might be drawn in London).
> Although the Greek Bank case was concerned with income which turned out not to have a UK source, inferences can be drawn from that case about the factors which would support the existence of a UK source and [HMRC] regard the most important as—
> [a] the residence of the debtor, that is the place in which the debt will be enforced;
> [b] the source[50] from which interest is paid;

49 I am not sure what is meant by this.

50 [Author's Note] I think this means the situs (on IHT/international law principles) of the funds from which the interest is paid. It does not mean the location on IT principles of the source of income out of which the interest is paid (which could of course be different).

> [c] where the interest is paid; and
> [d] the nature and location of the security for the debt.
> If all of these are located in the UK then it is *likely* that the interest will have a UK source.
>
> (Emphasis added)

This adopted a balance all the factors approach. This is not supported by *Bank of Greece*. *Spotless* does support this approach, but it does not support the selection of these four factors as the most important.

Assuming one does adopt that approach, "likely" was a timid word to use when all four of what HMRC identified as the "most important" connecting factors point the same way. The problem is when different connecting factors point different ways as they frequently do. Here the RI copped out:

> It is not possible for [HMRC] to comment individually in advance on 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.[51]

### 17.4.4 *HMRC view from 2009: balance all factors*

HMRC did not announce a change of view, but from 2008 the SAI Manual takes a slightly different line, and RI 58 is now described as "superseded by SAIM 9090 onwards".[52] I take that to be notice that HMRC have withdrawn from it.[53]

The SAI Manual also adopts a balance all the factors approach but it

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51 RI 58 ended with wishful thinking:
"[HMRC] hope that this summary of [their] views will assist practitioners and their clients in determining for themselves where the source of interest with which they may be concerned is located."

52 See the HMRC online version of Tax Bulletin 9, *www.hmrc.gov.uk/bulletins/tb9.htm* also recorded in the Yellow Book 2008/09.

53 However INT Manual still supports RI 58:
**342030 UK source** [September 2009]
The onus is on the payer to decide whether tax is properly to be deducted having regard to settled case law principles [!] and all the facts surrounding the loan. In particular, the payer should refer to the approach and criteria endorsed by the House of Lords in the National Bank of Greece case (46 TC 472). HMRC's position in that case is outlined in Tax Bulletin 9 of November 1993 [RI 58].

offers us an expanded selection of eight relevant factors, and an inkling of priority:

> **9090. Yearly interest: UK source: The general rule** [January 2009]
> Whether or not interest has a UK source depends on all the facts and on exactly how the transactions are carried out. HMRC consider the most important of factor in deciding whether or not interest has a UK source to be
> [1] the residence of the debtor and
> [2] the location of his/her assets.
> Other factors to take into account are
> [3] the place of performance of the contract and
> [4] the method of payment;
> [5] the competent jurisdiction for legal action and
> [6] the proper law of contract;
> [7] the residence of the guarantor and
> [8] the location of the security for the debt.
> This list of factors is derived from the leading case on the source of interest, *Westminster Bank Executor and Trustee Company (Channel Islands) Ltd v National Bank of Greece SA* (46 TC 472).

In fact *Bank of Greece* provides no support for a balance the factors approach or for this particular selection of eight factors.

> HMRC consider the residence of the debtor to be most important because this, along with the location of the debtor's assets, will influence where the creditor will sue for payment of the interest and repayment of the loan.

The SAI Manual then defines "residence":

> 'Residence' in these circumstances is not the same as tax residence. Residence of the debtor is residence for the purposes of jurisdiction.

It would greatly assist clarity of thinking not to use the word "residence" (which has a specific meaning in tax) to mean something else. I shall reluctantly refer to the concept as "**jurisdiction-residence**" to distinguish it from tax-residence.

What is the test of jurisdiction-residence? In the case of an individual it means tax-residence, and in the case of a company, place of business. The International Tax Handbook provides at para 1103:

> An important factor in determining the source of interest is the residence of the debtor. 'Residence' does not, however, necessarily mean tax residence, rather it means where the [debtor] company has a business presence and can be sued for the debt. If it has more than one such presence then the source will normally be where, under the contract, the company is primarily required to pay the interest and repay the principal. It is, therefore, possible for a UK resident to pay interest which has an overseas source if a borrowing is made and interest is paid by an overseas branch. Likewise it is possible for a UK branch of a non-resident company to pay UK source interest.[54]

The SAI Manual makes the same point for interest paid by companies:

> **9095. Yearly interest: UK source: Companies**
> *Interest paid by companies*
> In deciding whether or not interest has a UK source, in addition to the factors described in SAIM9090, there are other matters to be taken into account for companies.
> **Companies and branches**
> Where the debtor is a company it may of course have more than one residence – for example it may be registered in a US state but managed and controlled from the UK.[55] Jurisdiction in relation to a corporation will in general depend on where the corporation does business (except where the EU Regulation or the 1968 Convention apply – see SAIM9090). So for these purposes it will be resident where it carries on business. If a debtor company has a number of places of residence/business then to decide the location of the debt you have to look at the terms of the loan agreement. The loan agreement should say where the interest and loan are payable, which (if the company is also resident in that place) will determine whether or not the interest has a UK source.
> When it comes to considering loans made to a branch of a UK company the source of the interest is overseas if all the following factors apply:
> [1] an overseas branch of a UK resident company has entered into a loan agreement overseas;
> [2] the loan is for the business of the overseas branch;
> [3] the overseas branch pays the interest from its income;
> [4] the loan agreement obligations are enforceable in the jurisdiction in

54 This is based on IHT/international law situs principles: see 70.12.1 (Meaning of "residence" and dual resident debtor).

55 "Residence" is being used here in a non-standard way, but it does not matter.

> which the branch is situated.

The paragraph does indicate a "safe haven" situation where one can be confident that the interest paid by a UK resident payer does not have a UK source.

The SAI Manual continues:

> Conversely, where a branch of a non-UK resident company enters into a loan agreement in the UK for the business of its UK branch and the UK branch pays the interest then the interest is regarded as having a UK source.

### 17.4.5 *Impact of modern private international law*

The background law (that is, private international law) has moved on considerably since the date of the situs cases which underlie the HMRC view, such as *New York Life Insurance* decided in 1924. Jurisdiction is now largely governed by international conventions, under which it is only very approximately correct to say that residence of the debtor is the test of jurisdiction, (even though in many cases the end result be the same). In short, it is not the case that the residence or place of business of the debtor is the place the debt will be enforced.[56] Do we continue to apply the historic residence tests? Or do we say interest arises where the debt is enforceable, ignoring the place that the debtor resides?

The author of the SAI Manual is aware of the problem, but does not know the answer:

> **9090. Yearly interest: UK source: The general rule** [January 2009]
> *Duty to deduct tax from interest with a UK source*
> **EU rules**
> If the debtor is resident within the EU, the Council Regulation (EC) 44/2001 on Jurisdiction and the Recognition and Enforcement of Judgments in Civil and Commercial matters, ["the Judgments Regulation"] and the 1968 'Brussels Convention',[57] may have an impact

56 See 70.12 (Simple contract debt). In *Bank of Greece* the debt was enforceable in the UK but the interest was not UK source.

57 [Author's footnote] The Judgments Regulation applies in EU Member States. It supersedes the 1968 Brussels Convention except for some territories which fall within the scope of the Convention and which are excluded from the Regulation

on the general rule described above.

Different rules apply for individuals, corporations, and trusts.

The usual rule is that where an individual is domiciled in a contracting state, then they should be sued in the courts of that state (Article 2 of the Regulation/Convention).[58] Domicile is defined according to the rules of that contracting state but for these purposes only, it is, in the UK, linked to the individual's residence. Under these rules an individual is domiciled in England for example if he is resident there and the nature and circumstances of his residence indicate that he has a substantial connection with England.[59] So an individual resident in England would in general terms only be sued in the courts in that country. However this is a complex area and there are exceptions. For example it may be argued that:

[1] the case does not fall within the Regulation;
[2] another convention or international agreement gives jurisdiction to another state's courts
[3] proceedings have already begun in another state's courts; or
[4] it has been agreed under Article 22 of the Brussels Convention[60] that the courts of a particular state have exclusive jurisdiction.

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pursuant to Article 299 of the Treaty (now Article 349 TFEU).

58 [Author's footnote] Article 2 of the Judgments Regulation 44/2001 provides: "Subject to this Regulation, persons domiciled in a Member State shall, whatever their nationality, be sued in the courts of that Member State."

59 [Author's footnote] Article 59 of the Judgments Regulation provides:
"1. In order to determine whether a party is domiciled in the Member State whose courts are seised of a matter, the court shall apply its internal law.
2. If a party is not domiciled in the Member State whose courts are seised of the matter, then, in order to determine whether the party is domiciled in another Member State, the court shall apply the law of that Member State.
In England, s.41(3) Civil Jurisdiction and Judgments Act 1982 provides:
"... an individual is domiciled in a particular part of the UK if and only if—
(a) he is resident in that part; and
(b) the nature and circumstances of his residence indicate that he has a substantial connection with that part.

60 [Author's footnote] I think the reference should be Article 23 Council Regulation (EC) No 44/2001 on Jurisdiction and the Recognition and Enforcement of Judgments in Civil and Commercial Matters, which provides:

> "1. If the parties, one or more of whom is domiciled in a Member State, have agreed that a court or the courts of a Member State are to have jurisdiction to settle any disputes which have arisen or which may arise in connection with a particular legal relationship, that court or those courts shall have jurisdiction..."

Point [4] is common, as the parties may agree any jurisdiction which suits them. What happens then? HMRC will not say (I expect they do not know):

> In any case in which it is argued that a UK resident debtor can be sued in a Member State in precedence to the UK courts please refer the case to CT&VAT (Financial and Insurance Team).

The SAI Manual then turns to consider the impact of the modern law on debts owed by companies:

> **9095. Yearly interest: UK source: Companies**
> *Interest paid by companies*
> **Companies within the EU**
> Under both the EU Regulation and 1968 Convention, domicile is the main ground of jurisdiction and will, at first sight, determine the rules for the recoverability of debts. EU regulation 44/2001 provides for a definition of domicile for corporations so that the company is domiciled where it has its statutory seat (in the UK its registered office), central administration or its principal place of business.[61] However it is important to note that a corporation is not domiciled in a country for these purposes merely because it does business there. If an EU based company carries on business in a country in which it is not domiciled you have to consider the terms of the loan agreement to determine the situation of the debt. For example, if a company which has its principal place of business in the UK also carries on business in another Member state, where the interest and loan are payable in that other Member state

61 [Author's footnote] Article 60 Judgments Regulation provides:

> "1. For the purposes of this Regulation, a company or other legal person or association of natural or legal persons is domiciled at the place where it has its:
> (a) statutory seat, or
> (b) central administration, or
> (c) principal place of business.
> 2. For the purposes of the UK and Ireland 'statutory seat' means the registered office or, where there is no such office anywhere, the place of incorporation or, where there is no such place anywhere, the place under the law of which the formation took place."

Thus the Judgments Regulation provides *three* places where a company is domiciled and may be sued. There is no single place where the debt can be enforced which would serve as a test for the location of a source.

> and that member state's courts have jurisdiction then the interest will be non-UK source.
> For branches of EU companies the position is as described above for branches generally.[62]

For the reasons given in 70.12.2 (Place-of-debtor rule v. jurisdiction where debt enforced) it is suggested that the better approach is to pay no regard to modern conflicts law in determining the source of interest, even if the place where the debt is enforceable is not the place where the debtor resides.

### 17.4.6 *Interest from securities*

The RDR Manual provides:

> **33550 - Remittance Basis: Identifying Remittances: Specific Topics: Accrued Income Scheme** [July 2010]
> ... Securities are "foreign" where income(in practice, interest) from them would be relevant foreign income. This will include, for example, a security issued in registered form by a non UK company, which maintains the register of note-holders outside the UK.[63]

The rule that the source of interest on registered bonds of a foreign company is the location of the register seems a sensible rule and is consistent with *Bank of Greece*.

## 17.5 Source of interest: conclusion

There are two rival solutions to the question of where is the source of interest: the place of credit test and the balance all the factors approach. It is submitted that the courts ought to adopt the place of credit test, ie the source of interest is where the credit is provided, or where money is lent,

62 [Author's footnote] Article 5(5) Judgments Regulation provides:
"A person domiciled in a Member State may, in another Member State, be sued:
... 5. as regards a dispute arising out of the operations of a branch, agency or other establishment, in the courts for the place in which the branch, agency or other establishment is situated;"

63 The comment is made in relation to the AIS remittance basis, but the point made here relating to the source of interest has a more general application. The text is also found in EN FB 2008.

ie where the money lent is received (the two phrases being understood to come to the same thing). This is consistent with case law, principle, international practice (at least in Hong Kong)[64] and provides a reasonable element of certainty. The English courts are not bound to follow it, however.

The rival balance of all the factors approach is supported by *Spotless* and (after some dithering) HMRC practice, though it would need at least half a dozen reported cases before one could have much idea of the relevant factors and their relative priority, and in practice it is unlikely that the law would ever be clear. If (contrary to my view) such an approach were adopted, 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. 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 (eg rents of UK land). This cannot be enough to make the interest UK source. The origin of funds used to pay interest is a weak connecting factor. (I would submit it should not be a connecting factor at all.)

(3) Suppose a debt were wholly non-UK connected but had a UK resident debtor. It is suggested that this alone does not give the source of interest a UK location.[65]

### 17.5.1 *Commentary*

HMRC rightly say:

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

65 *Norfolk and Montagu on the Taxation of Interest and Debt Finance* (looseleaf) para 3.172, points out that s.338(4)(d) ICTA (now repealed) assumed it was possible for a UK resident to pay interest with a non-UK source.

> The current tests in UK law of whether, for the purposes of deduction of tax, payment of interest is made from a UK source are unclear and cause confusion.[66]

It is surprising that the question of the source of interest has not given rise to more litigation or to clearer principles. The reason may be that HMRC have in practice taken a relaxed view on source (which no doubt encourages taxpayers to take a relaxed view on disclosure). Of course, there is no guarantee that will continue. Also, DTAs sometimes render the point irrelevant.[67]

The test in the OECD Model Treaty is superior to both the place of credit test and the balance all the factors approach.[68] However 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 Supreme Court. A HMRC consultation document in 2003 proposed this sensible reform but the proposal was quietly dropped. The reason why was never announced. Tax reforms generally have winners and losers. The losers cry louder than the winners, and that is an obstacle for many tax reforms. But it is not clear that this was the case here since it is hard to identify significant classes of "losers", ie persons who could say with any confidence that they were not taxable under the present law.

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66 "Income tax: Meaning of UK Source for Payments of Interest and Royalties" Consultation document 10 December 2003, para 1.1. The courts have made the same point in the passage in *Spotless* cited above: "Where ... the transaction is complex in terms of its background, its nature and its execution, and where ... important aspects of the transaction have their origin in locations in several different countries, it will usually be difficult to identify the real source of income so generated."

67 See 17.10 (Double tax treaty relief).

68 Article 11(5) OECD Model Treaty provides:

> "Interest shall be deemed to arise in a Contracting State when the payer is a resident [ie treaty-resident] of that State. Where, however the person paying the interest, whether he is a resident of a Contracting State or not, has in a Contracting State a permanent establishment in connection with which the indebtedness on which the interest is paid was incurred, and such interest is borne by such permanent establishment, then such interest shall be deemed to arise in the State in which the permanent establishment is situated."

If we adopted the OECD model treaty test one modification might be desirable: that where a debtor changes residence, the source of interest does not change (ie the source is determined and fixed at the time the debt arises.) But that point could be argued both ways.

## 17.6 Non-resident's withholding tax

Section 874 ITA provides:

> **874 Duty to deduct from certain payments of yearly interest**
> (1) This section applies if a payment of yearly interest arising in the UK is made—
> (a) by a company,
> (b) by a local authority,
> (c) by or on behalf of a partnership of which a company is a member, or
> (d) by any person to another person whose usual place of abode is outside the UK.
> (2) The person by or through whom the payment is made must, on making the payment, deduct from it a sum representing income tax on it at the basic rate in force for the tax year in which it is made.

For interest paid by individuals, trustees and PRs the obligation to withhold arises under s.874(1)(d) when the following conditions are satisfied:

(1) A payment of yearly interest.
(2) The interest arises in the UK.
(3) The payment is made to a person whose "usual place of abode" is outside the UK. In the following discussion a person whose usual place of abode is outside the UK is described (for brevity) as "**outside the UK**".

### 17.6.1 *Collection of tax deducted and interest on late payment of tax*

The rules for the collection of tax deducted are in chapters 15-17 ITA 2007, s.945-964 ITA. I do not address them here, though I hope to do so in a future edition.

INT Manual provides:

> **542190. Consequences of failing to deduct withholding tax** [March 2011]
> ...
> ***Assessing the unpaid income tax***
> Chapter 15, Part 15 of Income Tax Act 2007 (formerly Schedule 16 ICTA 1988) provides for returns and collection of income tax in respect of payments falling within Section 946 ITA 2007, which specifically includes payments of yearly interest where a deduction is required under

Section 874.
The rules, under Section 951 ITA 2007 are that:
• the income tax on the interest is due on the same date as the return reporting the payment, at the basic rate
• both the return and tax are due within 14 days of the end of the quarter within which the payment of interest was made
• no assessment is required for collection of this tax.
This means that withholding tax, and where applicable, late payment interest, are due and payable even if HMRC does not raise an assessment.
Section 957 ITA 2007 sets out what should happen if it appears that a section 946 payment (which this is) has not been included in a return, and the tax arising on the payment has not been paid:
(1) This section applies if an officer of Revenue and Customs thinks—
(a) that there is a section 946 payment which should have been included in a return under this Chapter and which has not been so included, or
(b) that a return under this Chapter is otherwise incorrect.
(2) An officer of Revenue and Customs may make an assessment, to the best of the officer's judgement, on the person who made the return, or who should have made one.
Note that the onus is on the payer to fulfil their obligation, and to rectify the position if they do not.

## 17.7 To whom is interest paid?

Since the duty to withhold arises on a payment to a person who is not in the UK, it is necessary for non-residents' withholding tax to identify the person to whom the payment is made.[69]

Suppose interest is paid to a transparent (*Baker*-style) interest in possession trust which is not a settlor-interested trust. It is suggested that the interest is paid "to" the trustees (who have a lien). So if the trustees are in the UK but the life tenant is outside the UK 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

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69 Similar issues arise elsewhere: see 13.4 (To whom does trading income accrue?). Somewhat different issues arise for deposit-takers withholding tax: see 17.11(Withholding tax on interest from deposit-takers)

(2) the trustees are outside the UK and the settlor is in the UK.

At first sight there is no obligation to deduct as the interest is treated as income of the settlor "and of the settlor alone". Following the deeming, the payment should be treated as paid to the settlor. Conversely, if the settlor is outside the UK, there is an obligation to deduct even if the trustees are in the UK. It is suggested that that is the correct view. This is consistent with the position for deposit-takers. HMRC agree. TDSI guidance notes[70] para 2.3 provide:

> [2] The current HMRC view is that Stiftungs are Trusts for UK tax purposes. For TDSI purposes, the deposit should be considered to belong to the settlor[71] and the TDSI treatment depends on the nature of the settlor – so if the settlor is an individual, BRT [basic rate of tax] must be deducted.
> [3] If the settlor can show that they have not retained an interest, the Financial Institution can treat the Stiftung as an interest in possession trust ... and the TDSI position will depend on the nature of the beneficiary. If the beneficiary is an individual, BRT must be deducted.

But this result is surprising: the payer is expected to know whether the payee is outside the UK, but they cannot be expected to know if the recipient is a settlor-interested trust, and if so, who is the settlor and is the settlor outside the UK.

Section 646(8) ITTOIA provides:

> Nothing in sections 624 to 632 is to be read as excluding a charge to tax on the trustees as persons by whom any income is received.

This is not entirely to the point but it illustrates the view that the deeming of s.624 does not apply in all cases.

Suppose:

(1) interest is paid to a non-resident company within s.720; and

(2) the transferor is in the UK.

The transferor is taxable under s.720 on income treated as arising to them, but the interest is still the income of the company. So there is an obligation to deduct.

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70 *www.hmrc.gov.uk/tdsi/guidance-notes.pdf*. For TDSI (tax deduction scheme for interest) see 17.11 (Withholding tax on interest from deposit-takers).

71 [Author's footnote] It is assumed that the Stiftung is a settlor-interested trust.

## 17.8 Usual place of abode

### 17.8.1 *Introduction*

The expression "usual place of abode" occurs in the context of withholding tax on rent and copyright royalties, as well as in the context of withholding tax on interest. The meaning in all cases is the same.[72]

The expression is discussed in a variety of HMRC manuals. I set out all relevant passages whether or not the manual has interest specifically in mind.

The phrase "settled or usual abode" is often used as an explanation or paraphrase of the concept of residence[73] so one might think that there is no difference between residence and "usual place of abode". However in the HMRC view there is a difference, though the concepts overlap. The PI Manual provides:

> **4800 Overseas landlords** [May 2010]
> *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.

Likewise the SAI Manual para 9080:

> **9080. Yearly interest: 'place of abode' of recipient**
> *Meaning of 'place of abode'*
> Section 874(1)(d) ITA 2007 requires deduction of tax from a payment to a person "whose usual place of abode is outside the UK". This phrase is distinguishable from the concept of "residence"...

### 17.8.2 *Individuals*

The PI Manual provides:

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72 This view is adopted by ITA EN para 2648: "The term 'usual place of abode' is consciously retained, *because it is a technical term*, distinct from residence" (emphasis added).

73 See 3.8 (Case law on residence).

**4800 Overseas landlords** [May 2010]
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].)[74] Do not treat someone as having their usual place of abode outside the UK if they are only temporarily living outside the UK, say for six months or less.

The SAI Manual makes the same point more tersely:

**9080. Yearly interest: 'place of abode' of recipient**
An individual's usual place of abode is outside the UK if he or she usually lives abroad, unless that arrangement is temporary.

This roughly equates "usual place of abode" with ordinary residence.

The former Inspectors Manual made some comments which are not in the current manuals. Perhaps there has been a change of practice, or at least of emphasis:

**4005. Usual place of abode** [October 2003]
The term 'usual place of abode' should be interpreted in the light of the intention of [what is now s.906 ITA], which is to enable tax in respect of income from a copyright in this country to be collected both where the copyright owner lives wholly abroad and also where his visits to the UK are not of sufficient duration to enable the tax to be collected with any ease under the ordinary machinery.
A person may be regarded as having his usual place of abode in this country if he usually or habitually lives here for considerable periods each year, for example, for an unbroken period of three or four months, or for broken periods amounting to five or six months. A person with a house in this country, but habitually here for so short a time that there is or has been difficulty in collecting tax under a direct assessment upon him, should not be considered as having his usual place of abode here. If, however, the conditions are such that tax can clearly be collected

74 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.

without difficulty, no objection need be taken to regarding the person as having his usual place of abode in this country.
[It will be observed that it is possible for a person who has a house here to be 'resident' - and also 'ordinarily resident' - and yet not to have his 'usual place of abode' here.][75]
(If a copyright owner's usual place of abode is in the UK this fact connotes that he is resident and carries on his vocation of author etc. in this country. He is consequently liable to direct assessment on the whole of his profits, including any lump sum payments and payments from abroad.)

### 17.8.3 *Companies*

The PI Manual continues:

> **4800 Overseas landlords** [May 2010]
> b. Companies that have their main office or other place of business outside the UK, and companies incorporated outside the UK, will normally have a usual place of abode outside the UK. However if the company is treated as resident in the UK for tax purposes, do not treat it as having a usual place of abode outside the UK.

The SAI Manual addresses the question of UK branches of non-resident companies:

> **9080 Yearly interest: 'place of abode' of recipient**
> *Companies*
> A non-UK resident company that has a UK permanent establishment that is within the charge to corporation tax does not have a usual place of abode abroad.[76]

This practice seems surprising, but it favours the taxpayer so it will not be challenged.

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75 Author's note: This also refers to the supposed available accommodation rule: see above footnote.

76 Accessible *www.hmrc.gov.uk/cnr/nrl_guide_notes.pdf.* The HMRC guidance notes on the Non-resident Landlords Scheme likewise provides:
"2.5 The UK branch of a non-resident company, where that branch is within the charge to Corporation Tax, does not have a usual place of abode outside the UK for the purposes of the NRL Scheme."

### 17.8.4 *Trustees and PRs*

The SAI Manual 9080 provides:

> **9080 Yearly interest: 'place of abode' of recipient**
> *Trustees*
> Trustees, including personal representatives, have a usual place of abode abroad if each trustee, considered as an individual or a company as the case may be, has a usual place of abode there. So if one trustee does not have a usual place of abode abroad, neither does the trust.[77]

This text was probably composed before the statutory residence rules for trustees and PRs. One might have thought that the usual place of abode for trustees and PRs is where they are resident under those rules. But the HMRC practice favours the taxpayer so it will not be challenged. It is also satisfactory for HMRC; as long as one trustee is here, HMRC can collect tax from that trustee and do not need the assistance of a withholding tax.

### 17.8.5 *Miscellaneous*

The HMRC guidance notes on the Non-resident Landlords Scheme makes further comments which are also relevant to deduction of interest:

> **Jointly owned property**
> 2.7 Where a property is jointly owned and one or more of the joint owners has a usual place of abode outside the UK, the share of rental income applicable to those joint owners falls within the NRL Scheme. The share applicable to joint owners who do not have a usual place of abode outside the UK does not fall within the Scheme. For husband and wife joint-ownership cases, see para 2.8 below.
> **Husband and wife joint-ownership cases**
> 2.8 Where a husband and wife jointly own a UK property and both have their usual place of abode outside the UK, the NRL Scheme applies to both spouses and each is treated as a separate landlord in their own right.

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77 The PI Manual similarly provides:
"c. Trustees have a usual place of abode outside the UK if all the trustees have a usual place of abode outside the UK."

If the husband and wife both wish to receive the rental income with no tax deducted they must each complete a separate application form and send it to the Inland Revenue (see Chapter 11 below). In such cases, letting agents and tenants should pay rental income with no tax deducted only to the spouse(s) named on Inland Revenue authorities they hold. Under no circumstances should they pay with no tax deducted to a husband and wife where they hold an authority to do so for only one spouse. But if only one of the spouses has a usual place of abode outside the UK, the NRL Scheme applies only to that spouse's share of the rental income. The rental income belonging to the UK resident spouse is not within the Scheme and no Inland Revenue approval is required to pay the income with no tax deducted.

**Members of HM Armed Forces and other Crown Servants**

2.9 Members of HM Armed Forces and other Crown Servants, including diplomats, are treated no differently from any other non-resident landlords. So if they receive UK rental income and have a usual place of abode outside the UK (see para 2.3 above) the NRL Scheme applies to them.

2.10 If members of HM Armed Forces and other Crown Servants whose usual place of abode is outside the UK wish to receive rental income with no tax deducted, they should apply to HMIT Public Department 1 or South Wales Area tax office, as appropriate, for approval (see Chapter 11.1 below).

**How do letting agents and tenants know whether a landlord has a "usual place of abode" outside the UK?**

2.11 A landlord's usual place of abode (see paras 2.3 to 2.6 above) will usually be evident without the need for special enquiries. If it is outside the UK, letting agents or tenants should operate the NRL Scheme. If the usual place of abode is in doubt, letting agents and tenants should get more information from the landlord to satisfy themselves on the point. In particular, PO Box numbers and "care of" addresses alone should *not* be relied on as evidence that the Scheme does not apply. In cases of difficulty letting agents can get advice from the Centre for Non-Residents (see para 1.15 above).

2.12 Where letting agents and tenants have no reason to believe that a landlord has a usual place of abode outside the UK they are not required to make any special enquiries. In these circumstances they do not have to operate the Scheme.[78]

78 Accessible *www.hmrc.gov.uk/cnr/nrl_guide_notes.pdf.*

### 17.8.6 *Commentary*

Do we need a concept of "usual place of abode" in addition to concepts of residence and ordinary residence? At first sight it seems that the law could and should be simplified by replacing the reference to usual place of abode with a reference to ordinary residence. At present perhaps we need a separate concept: a rule requiring deduction of interest at source on payment to a non-ordinarily resident would be difficult to apply because "ordinary residence" is far too unclear. For a payer to ascertain the ordinary residence of the lender would require searching enquiries and even then the payer would often not know the position. The lender himself may not know. To ascertain the "usual place of abode" may perhaps be a little more practical (though I am not altogether sure about that). However if we had proper definitions of "residence" and ordinary residence, then we could and should adopt them here and "place of abode" should be abolished.

## 17.9 Exceptions to obligation to deduct

Sections 875–888 ITA set out 14 exceptions to the duty to deduct. In outline:

| Section | Exemption |
|---|---|
| 875 | Interest paid by building societies |
| 876 | Interest paid by deposit-takers |
| 877 | UK public revenue dividends |
| 878 | Interest paid by banks |
| 879 | Interest paid on advances from banks* |
| 880 | Interest paid on advances from building societies |
| 881 | National Savings Bank interest |
| 882 | Quoted Eurobond interest |
| 883 | Interest on loan to buy life annuity |
| 884 | Relevant foreign income* |
| 885 | Authorised persons dealing in financial instruments |
| 886 | Interest paid by recognised clearing houses etc |
| 887 | Industrial and provident society payments |
| 888 | Statutory interest |

The most relevant to the themes of this book are marked * and considered in more detail below.

### 17.9.1 *Foreign source interest*

Section 884(1) ITA provides:

> The duty to deduct a sum representing income tax under section 874 does not apply to a payment of interest which is chargeable to income tax as relevant foreign income.

This is otiose, as the obligation applies only to interest arising in the UK. The SAI Manual correctly states:

> **9090 Yearly interest: UK source: The general rule** [January 2009]
> The obligation to deduct tax from interest that has a UK source is imposed by Chapter 3 of Part 15 ITA 2007 ... Section 874 ITA 2007 specifies that the interest must be "yearly interest arising in the UK". Section 884 ITA 2007 makes it clear that this excludes "relevant foreign income", that is, income arising outside the UK (see SAIM1130).
> So whether or not tax should be deducted from interest paid on an overseas loan depends on the source of the interest. If the interest has a UK source tax must be deducted, if it does not then tax should not be deducted.

### 17.9.2 *Interest paid to UK bank*

Section 879(1) ITA provides:

> The duty to deduct a sum representing income tax under section 874 does not apply to a payment of interest on an advance from a bank if, at the time when the payment is made, the person beneficially entitled to the interest is within the charge to corporation tax as respects the interest.[79]

This would apply on payment of interest to a UK branch of a non-resident

79 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)."

bank, though it may be that such companies do not have their usual place of abode abroad.

### 17.9.3 *Short interest*

Tax law distinguishes between:
(1) "yearly" or "annual" interest (the terms are synonymous); and
(2) other interest (known as "short" interest).
The duty to deduct tax does not apply to short interest. The SAI Manual explains the distinction:

> **9075. Yearly interest: Case law on short and yearly interest** [January 2009]
> *When is interest "short" or "yearly"?*
> Although tax law has made a distinction between yearly and short interest since 1806, there is no statutory definition of yearly interest. The distinction rests wholly on case law.
> The classic example of short interest is interest payable on a bank loan for less than a year. In the early case of *Goslings and Sharpe v Blake* (2 TC 450), the Court of Appeal confirmed that interest on such a loan, where there was no provision to extend the borrowing for more than a year, could not be yearly interest, notwithstanding the use of an annual percentage rate.
> It is therefore a useful starting point to say that where a loan or debt is for less than a year, there is a presumption that it gives rise to short interest. Conversely, interest on a loan or debt that exists for more than a year is likely to be yearly interest.
> But you cannot just apply this as a mechanical rule, with the benefit of hindsight. Particular difficulties may occur where, at the time when a loan or debt comes into existence, it is not clear how long it is going to last.
> For example, the case of *Bebb v Bunny* (1854) 1 K&J 216 concerned the payment into court of the purchase price of a property, with interest on the delayed payment. It would have been possible for the interest to have run for more than a year if the purchaser had been particularly late in paying. The judge held that the interest was yearly. On the other hand, the Court of Appeal held, in *Gateshead Corporation v Lumsden* [1914] 2 KB 883, that certain interest which had run for more than a year was nevertheless short interest. The interest in question was statutory interest due to Gateshead Corporation on late-paid contributions towards the cost of making up roads. The court took the view that the mere failure by the Corporation to enforce the debt within a year did not make the interest "yearly interest".
> To distinguish interest arising on long-term loans from that arising on apparently short-term debts, the courts began to lay stress on the debt having "a measure of permanence" or being "in the nature of an investment" as opposed to being merely "temporary accommodation". Thus in *Corinthian Securities Ltd v Cato* (46 TC 93) the Court of Appeal decided that interest on a bank loan, repayable on demand, was yearly interest because the loan had the quality of investment –

even though, in the event, the loan was called in after 6 months.

However, the leading case on yearly interest is now considered to be *Cairns v MacDiarmid* (56 TC 556). In this case, the Court of Appeal saw the intention of the parties as the determining factor. If the debtor and creditor intend that the debt should subsist for more than a year, or where there is mutual acceptance that the interest may have to be paid from year to year, the interest will be yearly. This principle was applied in *Minsham Properties Ltd v Price* (63 TC 570), where a loan from a parent company, repayable on demand, gave rise to yearly interest because it was regarded by both parties as permanent finance.

It was felt in *Cairns v MacDiarmid* that merely asking whether a loan had the character of an investment was a less useful test – even an overnight deposit of money might be regarded as an "investment".

**9076. Practical application** [November 2007]

*Applying case law principles*

It is always a question of fact whether, in any particular case, interest is yearly or short. The intention of the parties will be the most important factor in deciding the question (see SAIM9075).

The question of whether interest is short interest, from which the payer has no obligation to deduct tax, is most likely to arise in the context of payments made by a UK resident to a person whose usual place of abode is outside the UK. If the interest is short, there is no need for the recipient to apply under a relevant Double Taxation Agreement to receive the interest gross (or with tax withheld at a reduced rate). There is guidance at INTM505010 onwards.

A UK resident may make a series of loans, each of less than a year, to a non-resident, and claim that the interest is short. HMRC staff should refer to the guidance at INTM542010 in such cases.

Uncertainty may also arise as to whether there is a duty to deduct tax from interest in circumstances comparable to that in *Bebb v Bunny* (SAIM9075) – where a sum of money remains outstanding for a period that may, or may not, be longer than a year. For example, a manufacturer might guarantee to refund the purchase price, with interest from the date of claim, if a product proves faulty: such claims may normally be processed speedily but, in disputed cases, may drag on for over a year.

Where the parties intend at the outset that monies due will not be left outstanding longer than 12 months, the interest will be short – even if, in a few cases, there are delays which prolong the period over which interest accrues. If however the parties anticipate at the beginning that the debt will exist for more than a year, or appear to be indifferent as to whether it will or not, the interest is likely to be yearly.

Where the payer of the interest is uncertain about whether it is short or yearly, they may in practice "play safe" by deducting tax. If the recipient of such interest objects to the tax deduction, HMRC staff should advise him or her to take up the matter with the payer, see SAIM9180.

If, conversely, the payer decides that interest is short and pays it gross, HMRC staff should not challenge that view unless

- the decision appears to be completely unjustified on the facts and in the light of relevant case law, or there is reason to suspect a definite intention of

avoiding the payment of withholding tax; and
- material sums of tax are at risk.

Overdraft interest is usually short interest.

The INT Manual formerly provided:

> ***542010. Provisions of Section [s.874 ITA]*** *[March 2007]*
> *In some circumstances, an overseas lender may seek to circumvent the provisions of [what is now s.874 ITA] by advancing a series of short-term consecutive loans, each for a period of less than one year. It may then be argued that the interest is not annual interest but short interest, to which the provisions of [s.874 ITA] do not apply. This argument is open to challenge unless the UK borrower can show that there was no need for long term funding or that alternative sources of funding were readily available to replace that which was argued to be short term.*
> *Where Inspectors meet a situation in which a long-term funding requirement is being met via a series of short-term loans, they should refer for advice to CT & VAT, Business Profits & Relief.*

This was deleted when the manual was rewritten in March 2011. Perhaps HMRC now accept these arrangements. Challenge would be harder if the short-term loans are each from separate lenders.

### 17.9.4 *Discounts and premiums*

The duty to deduct tax does not apply to:

(1) profits on discounts (which are normally treated as interest but which are expressly taken out of the duty to deduct);

(2) premiums even though premiums may be charged to income tax.

SAI Manual rightly provides:

> **3070 Taxation: Profit on disposal**
> *Deduction of tax*
> Discounts or premiums payable on the redemption of relevant discounted securities[80] are not payments of interest. Consequently the payments are made without deduction of tax.

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80 Discounts and premiums on securities which are not "relevant discounted securities" are also not "interest".

However, the distinction between interest and premiums can be fraught.

## 17.10 Double tax treaty relief

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.2 TIOPA], persons resident in the territory with the government of which the arrangements are made are entitled to exemption or partial relief from UK income tax in respect of any income from which deduction of tax is authorised or required by the Income Tax Acts.

This applies where interest qualifies for relief under a DTA. 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[81] or basic rate otherwise appropriate;
>
> and where such notice is given, any income to which the notice refers, being income for a year for which the arrangements have effect, which the UK payer pays after the date of the notice to the non-resident named therein shall, subject to the following provisions of these regulations, be paid as directed in the notice...

### 17.10.1 *Which treaties provide relief?*

The question whether interest qualifies for exemption depends of course on the DTA concerned. The OECD Model Convention does not provide

81 The rate "otherwise appropriate" is always the basic rate, never the lower rate; the drafter has failed to amend the wording of the regulation to keep up with the changes to the rates of tax in 2008. But no harm arises from this error.

exemption but only a partial relief. About one third of UK DTAs provide full relief, including France, Ireland, Luxembourg, Switzerland and USA.[82] HMRC publish a convenient digest of DTAs.[83]

The Jersey, Guernsey and Isle of Man DTAs do not provide exemption for interest. They do however provide an exemption for industrial or commercial profits. The treaties are in similar form so I take the Jersey DTA as an example. Art 3(2) Jersey DTA provides:

> The industrial or commercial profits of a Jersey enterprise shall not be subject to UK tax unless the enterprise is engaged in trade or business in the UK through a permanent establishment situated therein. If it is so engaged, tax may be imposed on those profits by the UK, but only on so much of them as is attributable to that permanent establishment.

This confers relief on interest, provided:

(1) The recipient is a Jersey enterprise, defined as "an industrial or commercial enterprise or undertaking carried on by a resident of Jersey"[84] (eg a Jersey bank).

(2) The recipient is not engaged in trade or business in the UK through a PE in the UK (or if it is so engaged, the interest is not profits attributable to that PE).

(3) The interest is or is part of the "industrial or commercial profits".

A person who makes a simple loan by way of investment does not carry on an industrial or commercial enterprise, and interest on such a loan does not constitute industrial or commercial profits. However a business (such as a bank) which includes lending does constitute an industrial or commercial enterprise and the interest is part of its profits.[85] HMRC agree. The International Manual provides:

> **355225. Industrial or commercial profits paragraph** [July 2005]
> Para 3 provides for the relief from UK tax of "the industrial or commercial profits of a Jersey enterprise".
> In practical terms, this means that we can allow relief on UK interest

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82 UK/France Art.11; UK/Ireland DTA Art.12; UK/Luxembourg DTA Art.11; UK/Switzerland DTA Art.11; UK/USA DTA Art. 11.

83 *www.hmrc.gov.uk/cnr/dtdigest.pdf.*

84 Jersey/UK DTA art.2(1)(h).

85 The issue was discussed in more detail in the 6th edition of this work, but the Manual passages cited makes this academic.

paid to a bona fide bank in Jersey, since it can be held that interest represents part of the bank's profits as defined by para 3.

So if you get a claim from a bank in Jersey you will need to;

- be certain that it is a recognised bank – the Banker's Almanac will help you here[86]
- consider if you should have the loan agreement reviewed by the inspector of taxes who deals with the accounts of the UK borrower – the guidance at INTM342010 will help you here

If these checks are satisfactory, you can allow **full** relief.

**But** if you receive a claim from a Jersey enterprise in respect of any other category of income, please refer to Technical Advice Group before taking any action.

The International Manual provides:

**337310. Background to claims by foreign financial concerns** [April 2004]

Under a long-standing practice approved by the Board a claim by an overseas financial concern for interest which bears the character of income arising from their trading activities or forms part of their trading income may be relieved under the Business Profits Article (provided the Business Profits Article doesn't clearly exclude interest for example Kenya) in either of the following circumstances

- there is no interest article, or
- the conditions of the interest article are not satisfied.

**337320. Claims by Channel Islands and Isle of Man Banks** [March 2007]

CAR Residency is authorised to consider claims and applications for relief at source by banks in the Channel Islands and the Isle of Man in respect of interest under paragraph 3(2) of the Double Taxation Arrangements with those countries. The basis for this is that the interest forms part of the 'industrial and commercial profits' of the banks.

Relief in respect of interest is available only to a bona fide bank. If you receive a claim or correspondence about relief under paragraph 3(2) from any other concern in the Channel Islands or Isle of Man you should refer the case to Technical Advice Group.

**337330. How to deal with claims from foreign financial concerns** [April 2004]

If you receive a claim or correspondence for income which can be

86 [Author's footnote]: see *www.bankersalmanac.com*.

considered under the Business Profits Article as outlined in INTM337310 you should deal with it as follows:

Where there is no interest article in the relevant Double Taxation Agreement (DTA) and the claimant is not trading in the UK through a permanent establishment, exemption may be authorised under the business profits article on form 241(Int-Roys).

Where in such circumstances the claimant is trading in the UK through a permanent establishment, necessitating restriction of relief under that article, and in cases where there is an interest article but claims under it are automatically restricted because the claimant is trading in the UK through a permanent establishment, you will need to consult the Inspector dealing with the permanent establishment and arrange for any interest attributable to the permanent establishment to be included in his computation of liability. Form 502 should be used for this purpose. Provided the Inspector has no objections the interest can then be exempted under the business profits article using form 241(Int-Roys).

You should issue form 501 (amended as necessary) with the Inspector's copy of the exemption notice where relief is authorised under the business profits article and there is trading in the UK through a permanent establishment. Where there is no trading through a permanent establishment you need to send a memo with the exemption notice explaining the circumstances in which relief has been authorised.

Note: These provisions do not apply where the rate of relief under the business profits article is more favourable than under the interest article and relief is available under the latter.

**337340. Requests to extend the provisions to other income** [April 2004]

If the claimant asks you to extend the concession to dividends or other distributions you should ask the UK Inspector for the permanent establishment (PE) to confirm that

- the payments represent trading income and
- they are not attributable to the Branch or PE.

The reason for doing this is because dividends/distributions, unlike interest and royalties, cannot be brought into the charge to corporation tax on the PE (Section 11(2) ICTA 1988).

### 17.10.2 *Procedure for claiming relief*

For the procedure see RI 79, Tax Bulletin 41, and the HMRC booklet "Double Taxation Relief Provisional Treaty Relief Scheme".

The application forms are available online.[87]

The International Manual provides:

> **542200. The interaction between UK taxing rights and double taxation agreements** [March 2011]
> Where UK-source interest is paid to a person taxable in another state, the same income might be taxable both in the source state (the UK) and in the recipient's country. If the person being subjected to double taxation (the recipient of the interest) makes a certified application to HMRC's treaty team, fulfilling the relevant requirements, the double taxation can be reduced or eliminated so far as the relevant double taxation agreement (DTA) and domestic legislation allows. This is effected by the source state yielding some or all of its taxing rights.
> Chapter 1 of Part 2 of TIOPA 2010 (formerly Section 788 ICTA 1988) gives effect to the arrangements contained in DTAs, since domestic legislation is necessary to either remove or reduce the requirement to deduct tax in Section 874 ITA 2007, or to give entitlement to repayment of tax previously deducted.
> To obtain treaty benefits, the lender must demonstrate eligibility, in which case HMRC will give up its prospective taxing rights and issue a notice under SI 1970/488 directing the borrower to begin paying the interest on the loan in question in accordance with the DTA.

### 17.10.3 *Relief when borrower is a partnership*

HMRC say:

> In deciding whether or not HMRC Residency should exercise its discretion in meeting an application for relief at source [ie an application to pay interest without deduction], it must primarily have regard to the risk that the underlying conditions for relief might change over the lifetime of a Direction (which will normally last no longer than five years). Such changes might remove the basis for relief altogether, or in some other way prejudice the amount of tax that the UK is otherwise properly entitled to receive in that period.
> Given its duty of care to the UK Exchequer and taxpayer, HMRC Residency have to give particular consideration to the desirability of giving DT treaty relief where transparent concerns such as partnerships and LLCs are concerned. This is because, more often than not, there is a much higher risk that the beneficial owners of such concerns will change. Or that there will be fluctuations in income or profit apportionment that might erode the amount of UK-source income that is attributable to the DT treaty-resident beneficial owners who were identified at

87 Accessible *www.hmrc.gov.uk/cnr/app_dtt.htm#5*.

> the time the application for relief at source was made.
>
> Attention is drawn to the undertaking sought from claimants in the Declaration (Part F of the US/Company 2002) that they will notify HMRC Residency of any changes in the information given on the form. (A similar warning to notify any material changes is given to a UK payer when a Direction is issued to it.)
>
> Without calling into question the good faith of partnership or LLC claimants who give these undertakings, HMRC Residency considers that the problem of monitoring this aspect is particularly acute where there are a very large number of investors, or there is an unfeasible number of layers of participation - partners who are themselves partnerships, which contain yet more transparent partners.
>
> For these reasons, although HMRC Residency is willing to entertain any application for relief at source from partnerships or LLCs, it should be understood that it is likely to give relief in this way chiefly where:
>
> * HMRC Residency are able to accept satisfactory assurances about the monitoring and notification of membership from the claimant concern.
> * The number and type of the concern's membership is not a problem in the first place - for example, a small and fixed number of participators, such as US corporations engaged in a joint venture. Or where the concern is the business arm of a small number of joint intellectual property owners such as a band or similar collaborative venture.
> * In response to a successful representation of special considerations or factors that would allow us to decide that relief may safely be given in this form.
>
> Each case will be considered on its merits.
>
> Otherwise, HMRC Residency will consider giving relief only by meeting discrete repayment claims.[88]

Although this comment is made in relation to the USA DTA, it should apply to partnerships generally. On the other hand, it applies only to American LLCs (which are treated as transparent under the US DTA).

If interest is paid before a notice of non-deduction is obtained, tax deducted at source can be reclaimed by the creditor. If the loan agreement provided for grossing up where tax is deducted at source, the creditor may compensate the debtor for over-payment).

### 17.10.4 *Relief when borrower is outside the UK*

HMRC Residency Double Taxation Guidance Note 1 deals with applications for relief at source on interest payments where the borrower is outside the UK:

88 "HMRC Residency Double Taxation Guidance Note 3 partnerships and LLCs claiming relief under the 2002 UK/USA DTC."

> This Guidance Note explains how HM Revenue & Customs (HMRC) Residency Nottingham handles applications for relief at source from UK income tax under a double taxation treaty in respect of interest payments where both lender and borrower are outside the UK.
>
> [After some general comments on the law the note continues]
>
> In its consideration of an application for relief at source in such circumstances, HMRC Residency must be satisfied that all the elements necessary to give relief are present. In the circumstance where the payer of the interest is not situated in the UK, HMRC Residency will need satisfactory evidence that the payer has concluded that the payments are to be considered as UK-source and has formed the intention of deducting and accounting for tax accordingly.
>
> HMRC Residency's claim forms ask claimants to attach copies of relevant loan documentation as part of the normal process. In cases such as those discussed in the previous paragraph, HMRC Residency would also ask claimants to enclose supporting evidence confirming the payers' intentions. This could, for example, be copies of pertinent correspondence with the borrower or other relevant documentation.
>
> Without the comfort afforded by such supporting documentation, HMRC Residency may well take the view that it should not exercise its discretion under SI 1970/488 to authorise relief at source.
>
> However, it would then be open to the non-resident payee to make a repayment claim to HMRC Residency once the interest payments have commenced and tax has been deducted. HMRC Residency will be prepared to keep the application for relief at source open and on file pending this eventuality. If the non-resident payee is then able to forward a certificate of tax deducted completed by the payer, HMRC Residency may then be able to accept that the UK source categorisation of the payments has been established. Assuming that all the other conditions for Double Taxation treaty relief are present, HMRC Residency should then be in a better position both to repay the tax deducted and consider in a more positive light the appropriateness of issuing a Direction under SI 1970/488 for future payments.

This is quite the most absurd procedure which could possibly be imagined, for in many cases the payor will want to argue that the interest is not UK source but (since one can rarely[89] be sure) will want a direction to pay

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89 The guidance note states complacently that "The meaning of UK-source in this context will not normally give rise to difficulties." The author has not read the HMRC consultation paper on interest:

> "The current tests in UK law of whether … payment of interest is made from a

gross as a safeguard. Perhaps no-one takes any notice of it in practice.

17.10.5 *Interest paid before HMRC notice to pay gross*

The INT Manual provides:

> **542190. Consequences of failing to deduct withholding tax** [March 2011]
> ...
> An application by the overseas lender under a DTA or under the EU Interest & Royalties Directive (INTM400000), is likely to be made up of two elements, depending largely on how promptly the claim follows the making of the loan. These are:
> • A clearance application - for Section 874 no longer to apply (or only to apply to a lower rate of withholding specified in the relevant tax treaty). If the application is successful, the payer will receive a notice issued under SI 488/1970 advising them that they may henceforth, for a specified period, pay interest gross or at the lower rate on the income named in the notice;
> • A repayment claim - for tax which the payer of the interest has paid to HMRC in compliance with their Section 874 obligation, prior to the notice being issued.
> Forms available on the HMRC website cater for both elements on a single form.
> It is vital to understand that until the payer receives a notice directing them to do otherwise, the payer must withhold and account for the income tax on interest payments made to an overseas lender. The UK payer is not entitled to anticipate either the lender making an application or the outcome of them doing so. It is immaterial whether the lender is a fellow group company to the borrower, or a vast European lending institution for which the borrower is just another customer.
> If, while the obligation to withhold and pay over the tax persists, the payer fails to do so or does so late, then HMRC can assess and recover the tax, and charge late payment interest under Section 87 TMA 1970 on the outstanding income tax, running from the tax due date to the date of payment. See INTM542200 for what may happen in circumstances where a valid clearance/repayment claim is received.
> So-called "grossing up clauses" appear in loan agreements, requiring borrowers to pay over interest as if the treaty benefits already applied i.e.

UK source are unclear and cause confusion."
See 17.5.1 (Commentary)

without deduction or with deduction at a treaty-specified rate. Whether this appears in an agreement between group companies or with an unconnected lender, it remains a private agreement between those parties and does not affect the obligation of the interest payer, as outlined above.

The International Manual provides:

**542200. The interaction between UK taxing rights and double taxation agreements** [March 2011]

... If clearance is obtained early in the term of the loan, before any interest payments have been made, then all the interest accruing on the loan (up to the expiry of the treaty clearance if applicable) can be paid without deduction, or subject to a lower rate of income tax, depending on the DTA. However, a problem arises when the benefits set out in the DTA have not yet been obtained and the company paying the yearly interest does so - for whatever reason - without withholding and accounting for the income tax.

Although it is recognised that once treaty clearance has been granted (following a successful certified DTA application), income tax will either no longer be withheld or may be withheld at a lower rate, it must also be recognised that clearance applies only to arm's length interest payments made after the clearance is granted. The obligation to deduct income tax from yearly interest paid prior to clearance will not have been removed, and therefore remains enforceable. For payments of interest made before clearance is notified, double taxation is relieved by the lender making a claim for repayment of the income tax withheld. Forms available on the HMRC website allow repayment claims to be made at the same time as the certified application for treaty benefits, although the repayment relief can only go back 5 years after the 31st January next following the year of assessment to which it relates (Section 43(1) TMA 1970).

***Section 87 TMA 1970 - late payment interest***

In addition to the unpaid income tax remaining due and payable on payments of yearly interest not covered by a treaty clearance notice, late payment interest will accrue under Section 87 TMA 1970 on any unpaid tax, from the due date (normally 14 days after the quarter in which the yearly interest was paid) until payment. It will accrue whether or not the income tax has been assessed, and while any income tax paid can be repaid if it is subject to a valid repayment claim from the lender, there is no relief or discharge from the Section 87 TMA 1970 interest charge on the payer.

The Section 87 TMA 1970 late payment interest charge is both mechanical and neutral, and accrues at the same rate irrespective of the reason for late payment. While it is not a penalty (though penalties are available for failure to make a return under Part X of TMA70), it stands to reason that if the loan is large, and the tax is outstanding for a long time, the interest charge will be correspondingly greater than in other circumstances.

This is the position for pre-clearance interest payments made gross, even after a DTA clearance application has been made, and clearance granted. While the UK may give up its taxing rights, HMRC does not give up its right to recompense for the late payment of the income tax from the time when it was due. UK taxing rights do not simply disappear following a DTA clearance application, taking with them all associated obligations. HMRC surrenders primary taxing rights to the tax authority of the claimant's country of residence, but retains the power to assess income tax which has not been accounted for and which has not been paid under a notice giving permission to pay gross. Interest payments made before the date on which clearance takes effect are not subject to the clearance. This is the statutory position, unaffected by the fact that assessment and collection of the tax might take place after a certified DTA clearance application has been lodged, in circumstances where it would be immediately repayable to the applicant (assuming a successful claim).

However, in circumstances where there is an established entitlement to repayment, HMRC will by concession, circumvent the assessment and repayment process, and if assessments are raised, they will be "interest only" assessments to collect the Section 87 TMA 1970 interest.

***Assessing only the Section 87 TMA 1970 late payment interest - concession***

Despite the existence of the powers mentioned above to recover tax which is owing, HMRC considers that in circumstances where it is clear that

- the overseas recipient of the interest has applied for, and has been granted, clearance to receive future interest payments from the source in question without deduction of income tax under SI 1970/488; and
- the lender would be entitled to repayment of the tax for the period for which income tax should have been withheld, so that it is clear that if tax had been accounted for each period concerned, ultimately HMRC would not have retained it

the right to assess and collect the tax will be set aside and only the Section 87 TMA 1970 interest will be sought. For more detail, see the Thin Cap Practical guidance from INTM574000 onwards.

The notion that tax collected from the payer will inevitably be repayable to the overseas recipient is not one that may be assumed. It must be established as a fact and a legal right.

### 17.10.6 *Commentary*

The EU has issued a recommendation to encourage relief from withholding tax where treaty relief applies. Where “in exceptional cases” tax relief at source is not feasible, member states are invited to set up standardised and quick refund procedures.[90] The recommendation is not binding but hopefully it will lead to a review of the UK law and practice.

The deduction scheme for royalties allows self-certification. It is suggested that a similar system should be introduced here.

## 17.11 Withholding tax on interest from deposit-takers

The legislation is in chapter 2 part 15 ITA. HMRC refer to this as the tax deduction scheme for interest (“TDSI”) but I prefer not to use that label as this is only one of the three tax deduction schemes for interest discussed in this chapter. HMRC have issued 139 pages of guidance notes.[91] This contains much interesting material which is not set out here for reasons of space.

Section 851 ITA provides:

> (1) This section applies if—
> (a) a deposit-taker or building society makes a payment of interest on an investment (see section 855(1)), and
> (b) when the payment is made, the investment is a relevant investment (see section 856).
> (2) The deposit-taker or building society must, on making the payment, deduct from it a sum representing income tax on it at the basic rate in force for the tax year in which it is made.

Section 852 ITA authorises exceptions to be made by statutory instrument. Sections 853 and 854 ITA provide an elaborate definition of “deposit-taker” but for present purposes it is sufficient to note that the expression includes banks.

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90 EU recommendation 19 Oct 2009 on withholding tax relief procedures C(2009)7924 final.

91 February 2009, accessible *www.hmrc.gov.uk/tdsi/guidance-notes.pdf.*

### 17.11.1 *Investment and deposit*

Section 855 ITA provides commonsense definitions of these terms:

> (1) In this Chapter "investment" means—
> (a) a deposit with a deposit-taker,
> (b) a deposit with a building society,
> (c) shares in a building society, or
> (d) a loan to a building society.
> (2) In this Chapter "deposit" means a sum of money paid on terms which mean that it will be repaid (with or without interest)—
> (a) on demand, or
> (b) at a time or in circumstances agreed by or on behalf of the person who pays it and the person who receives it.

## 17.12 Relevant investment

The expression "relevant investment" is a label which brings in a number of rules. Section 856 ITA provides:

> (1) An investment is a relevant investment for the purposes of this Chapter if it meets—
> (a) the individual interest condition (see subsection (3)),
> (b) the Scottish partnership condition (see subsection (4)),
> (c) the personal representative condition (see subsection (5)), or
> (d) the settlement condition (see subsection (6)).
> (2) But an investment is not a relevant investment if any of sections 858 to 870 prevent it from being a relevant investment.

### 17.12.1 *Individual interest condition*

Section 856(3) ITA provides:

> An investment meets the individual interest condition if the only persons beneficially entitled to interest on the investment are individuals.

An investment held by a Baker IP trust meets this condition as the life tenant (assume, an individual) is beneficially entitled to the interest.

In the case of a settlor-interested trust within s.624, the income is deemed to accrue to the settlor and the settlor alone. If the settlor is an individual, the individual interest condition is satisfied.[92] HMRC appear to agree. TDSI guidance notes[93] para 2.3 provide:

> **Anstalts & Stiftungs**
> [1] Anstalts and Stiftungs are Liechtenstein business entities which are fiscally opaque. ...
> [2] The current HMRC view is that Stiftungs are Trusts for UK tax purposes. For TDSI purposes, the deposit[94] should be considered to belong to the settlor[95] and the TDSI treatment depends on the nature of the settlor – so if the settlor is an individual, BRT [basic rate of tax] must be deducted.
> [3] If the settlor can show that they have not retained an interest, the Financial Institution can treat the Stiftung as an interest in possession trust (see paragraph 2.9) and the TDSI position will depend on the nature of the beneficiary. If the beneficiary is an individual, BRT must be deducted.

17.12.2 *Scottish partnership condition*

Section 856(4) ITA provides:

> An investment meets the Scottish partnership condition if—
> (a) a Scottish partnership is beneficially entitled to all interest on the investment, and
> (b) that partnership consists only of individuals.

It is difficult to see the need for this since a Scottish partnership is transparent for IT purposes. However, it does no harm.

17.12.3 *PR condition*

Section 856(5) ITA provides:

92 If the settlor is NOR, the NOR exemption applies.

93 Accessible *www.hmrc.gov.uk/tdsi/guidance-notes.pdf.* For TDSI (tax deduction scheme for interest) see 17.11 (Withholding tax on interest from deposit-takers).

94 [Author's footnote] More accurately, the interest on the deposit should be considered to belong to the settlor.

95 [Author's footnote] It is assumed that the Stiftung is a settlor-interested trust and that the settlor is UK resident.

> An investment meets the personal representative condition if
> [a] personal representatives are entitled to any interest on the investment and
> [b] they receive it in that capacity.

Section 856(5)[b] seems to me otiose, though it does no harm.

### 17.12.4 *Settlement condition*

Section 856(6) ITA provides:

> An investment meets the settlement condition if
> [a] all interest on the investment is income arising to the trustees of a discretionary or accumulation settlement and
> [b] they receive it in that capacity.

Section 856(6)[b] seems to me otiose, though it does no harm.

The key term here is "discretionary or accumulation settlement". Section 873(1) ITA provides a referential definition:

> A settlement is a discretionary or accumulation settlement for the purposes of this Chapter if any income arising to the trustees would (unless treated as income of the settlor) be to any extent income within subsection (2) for the tax year in which it arises.

So we need to turn to s.873(2):

> Income is within this subsection so far as it is—
> (a) accumulated or discretionary income as defined in section 480 (other than income arising under a charitable trust or an unauthorised unit trust in relation to which section 504 applies), or ...[96]

So to follow s.873(2)(a) we need to turn to s.480 ITA. This is discussed elsewhere; see 22.2.1 (Accumulated or discretionary income).

Having dealt with s.873(2)(a), we turn to s.873(2)(b). This is somewhat more confusing:

> (2) Income is within this subsection so far as it is—

96 I consider s.873(2)(b) separately below.

(b) an amount of a type set out in section 482 (unless the trust is a unit trust scheme or the amount is income arising under a charitable trust or is excluded by section 481(5)).

So to follow s.873(2)(b) we need to turn to s.482 ITA. This is discussed elsewhere; see 22.2.3 (Other income taxed at top rates). If one reviews the 11 types set out in s.482 one emerges somewhat confused as these types are not interest. This does not make sense, and I would be grateful to any reader who could explain.

## 17.13 Exceptions for non-residents

### 17.13.1 *Non-resident individual*

Section 858 provides:

**858 Declarations of non-UK residence: individuals**
(1) This section applies to an investment with a deposit-taker or building society which meets the individual interest condition in section 856(3).
(2) The investment is not a relevant investment if—
(a) an appropriate person[97] has made the declaration set out in subsection (3) to the deposit-taker or building society,
(b) the declaration contains the undertaking set out in subsection (4),[98]
(c) the declaration contains the name and principal residential address of the individual or (as the case may be) each of the individuals entitled to the interest,
(d) the declaration contains such other information as the Commissioners for HMRC may reasonably require, and
(e) the declaration is in such form as the Commissioners may prescribe or authorise.

Section 858(3) then sets out the terms of the declaration:

97 Section 857(5) provides:
"In this section 'appropriate person' means—
(a) a person who is beneficially entitled to interest on the investment, or
(b) a person to whom any such interest is payable."

98 Section 858(4) provides:
"The undertaking is an undertaking by the person making it to notify the person to whom it is made if any individual in respect of whom it is made becomes ordinarily UK resident."

The declaration is that, at the time when the declaration is made—
(a) the person who is beneficially entitled to the interest is not ordinarily UK resident, or
(b) (as the case may be) all the persons who are so entitled are not ordinarily UK resident.

The form is R105. I refer to this (adopting the terminology of the TDSI guidance note) as "**NOR declaration**".

In short, the requirement for exemption from deposit takers withholding is non-ordinary residence. Curiously, "usual place of abode" (which is more or less the same) is the requirement for the *imposition* of non-resident's withholding.[99] Some irreconcilable policy choices are at play here, on one hand to facilitate collection of UK tax from non-residents and on the other to facilitate investment in the UK by non-residents. For the year during which a person becomes ordinary resident, see 6.13 (Withholding tax on interest).

### 17.13.2 *Interest in possession trusts*

The person beneficially entitled to the interest is the life tenant and if that person is NOR, the NOR exemption applies.

### 17.13.3 *Non-resident discretionary trust*

Section 861 ITA provides:

**861 Declarations of non-UK residence: settlements**
(1) This section applies to an investment with a deposit-taker or building society which meets the settlement condition in section 856(6).
(2) The investment is not a relevant investment if—
(a) an appropriate person[100] has made the declaration set out in subsection (3) to the deposit-taker or building society,
(b) the declaration contains the undertaking set out in subsection (4),[101]

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99 See 17.6 (Non-resident's withholding tax).
100 Defined s.861(5): "In this section 'appropriate person' means—
(a) any person who is a trustee entitled to receive interest on the investment, or
(b) a person to whom any such interest is payable."
101 S.861(4) provides:
"The undertaking is an undertaking by the person making it to notify the person to whom it is made if—

(c) the declaration contains such information as the Commissioners for Her Majesty's Revenue and Customs may reasonably require, and
(d) the declaration is in such form as the Commissioners may prescribe or authorise.
(3) The declaration is that, at the time when the declaration is made—
(a) the trustees who are entitled to the interest are non-UK resident (see section 475), and
(b) no person who is a trustee has reasonable grounds for believing that any beneficiary under the settlement is—
  (i) an individual who is ordinarily UK resident,
  (ii) a company which is UK resident, or
  (iii) a Scottish partnership any of the partners of which is an individual who is ordinarily UK resident or a company which is UK resident.

The term "beneficiary" is defined in s.873 ITA:

(3) A person is a beneficiary under a discretionary or accumulation settlement for the purposes of this Chapter if—
(a) the person is an actual or potential beneficiary under the settlement, and
(b) condition A or B is met in relation to the person.
(4) Condition A is that the person is, or will or may become, entitled under the settlement to receive some or all of any income under the settlement.
(5) Condition B is that some or all of any income under the settlement may be paid to or used for the benefit of the person in the exercise of a discretion conferred under the settlement.
(6) The references in subsections (4) and (5) to any income under the settlement include a reference to any capital under the settlement so far as it represents amounts originally received by the trustees as income.

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(a) the trustees become UK resident,
(b) an individual in respect of whom it is made becomes ordinarily UK resident,
(c) a company in respect of which it is made becomes UK resident,
(d) an individual partner in any Scottish partnership in respect of which it is made becomes ordinarily UK resident,
(e) a company partner in any Scottish partnership in respect of which it is made becomes UK resident,
(f) a partner who is an ordinarily UK resident individual or a UK resident company joins any Scottish partnership in respect of which it is made, or
(g) a person within any of sub-paras (i) to (iii) of subsection (3)(b) becomes or is found to be a beneficiary under the settlement to which the declaration relates."

The definition is the same as in 37.5.1 (“Beneficiary”).

The form is Form R105 (DAT).

The TDSI guidance notes provide:

> **R105 (DAT) – change of trustees or beneficiaries**
> 4.33 Where the Financial Institution becomes aware that there has been a change of trustee or beneficiary, it may continue to pay interest without deduction of BRT if it has no reason to believe
> - that the trustees are or may be resident, or
> - a beneficiary is or may be ordinarily resident/resident in the UK, or
> - a new beneficiary is or may be ordinarily resident/resident in the UK.

17.13.4 *Non-resident Scottish partnership*

Section 859 ITA contains an exception for non-resident Scottish partnerships, which is not discussed here.

17.13.5 *Non-resident PRs*

Section 860 ITA provides:

> **860 Declarations of non-UK residence: personal representatives**
> (1) This section applies to an investment with a deposit-taker or building society which meets the personal representative condition in section 856(5).
> (2) The investment is not a relevant investment if—
> (a) an appropriate person[102] has made the declaration set out in subsection (3) to the deposit-taker or building society,
> (b) the declaration contains such information as the Commissioners for Her Majesty’s Revenue and Customs may reasonably require, and
> (c) the declaration is in such form as the Commissioners may prescribe or authorise.
> (3) The declaration is that the deceased was not ordinarily UK resident immediately before the deceased’s death.

102 Defined in s.860(4): “In this section ‘appropriate person’ means—
(a) any of the personal representatives who are entitled to receive interest on the investment, or
(b) a person to whom any such interest is payable.”

One would expect the rule to require withholding where the PRs were subject to tax and not where they were not subject to tax. But the actual residence of the PRs for IT purposes is not relevant. I suspect the reason may lie deep in the history of the provisions, and would be grateful to any reader who could elucidate the puzzle.

The TDSI guidance notes provide:

> **R105(PR) – personal representatives**
> 4.21 Form R105 completed by an investor before his or her death will remain in force after the date of death during the winding up of the estate. But if the personal representatives open an account in their own names, or transfer funds into an account in their own names, that account will not be an NOR account, unless and until the personal representatives make a NOR declaration. Personal representatives must make their declaration on
> - a photocopy of the R105(PR) (see Appendix 5), or
> - a downloaded copy of the R105(PR) from the HMRC website
> - a substitute form which has been approved by the HMRC.
>
> **R105(PR) – who can sign?**
> 4.22 In the case of an investment forming part of a deceased person's estate the form can be signed by either
> - the personal representative of the deceased (or legal equivalent in the country where they live), or
> - the person to whom the interest is paid.
>
> The person signing the declaration should tick the relevant box above the signature to show whether or not he or she is the personal representative (or legal equivalent in that country).
> It is the NOR status of the deceased which is important, and not that of the personal representative. Therefore, it is acceptable for a personal representative who is ordinarily resident in the UK to complete the declaration in respect of a deceased NOR investor.

### 17.13.6 *Policy and practical use of non-resident exceptions*

The former ITH para 876 explained the policy reason behind the exemption:

> There were moreover compelling policy considerations. An attempt to tax the interest could have harmed the balance of payments by discouraging foreigners from putting their money into the UK. For the same reason no attempt has been made to require banks to deduct tax

from interest paid to non-residents and interest belonging to persons not ordinarily resident is now excluded from the arrangements for deduction of tax from bank interest.

Since the conditions of all these non-resident exceptions could be onerous, I would have thought that the easier course would be to deposit funds with a non resident deposit-taker and not to use a UK bank. IHT may also be a reason for avoiding UK bank deposits. The remittance basis (and the temporary non-residents rules) may be another reason.

### 17.13.7 *Other exceptions*

The following exceptions to deposit takers withholding are mentioned for completeness and not discussed here:

- Client accounts: s.863 ITA
- Qualifying uncertificated eligible debt security units: s.864 ITA
- Qualifying certificates of deposit: s.865 ITA
- Qualifying time deposits: s.866 ITA
- Lloyds premium trust funds: s.867 ITA
- Sale and repurchase of securities: s.869 ITA
- Loans made by deposit takers: s.870(1)(a) ITA
- Debt on a security listed on a recognised stock exchange: s.870(1)(b) ITA
- Debt on a debenture issued by the deposit-taker: s.870(1)(c) ITA

## 17.14 Duty on deposit-taker

Section 857 ITA provides:

> **857 Investments to be treated as being or as not being relevant investments**
> (1) A deposit-taker or building society must treat every investment with it as a relevant investment unless satisfied that the investment is not a relevant investment.
> (2) If a deposit-taker or building society is satisfied that an investment is not a relevant investment, it may continue to treat the investment as not being a relevant investment until subsection (3) applies.
> (3) This subsection applies when the deposit-taker or building society has information which can reasonably be taken to indicate that the

investment is or may be a relevant investment.

The TDSI guidance notes provide:

**UK address**

4.9 Where the declaration shows a residential address in the UK it should not be regarded as acceptable unless it is known that the investor is temporarily in the UK (for example, as a student) and the address given is for the time being his or her principal residential address.

**Incompatible evidence**

4.10 If there is information which appears incompatible with the investor's status as indicated in his or her NOR declaration (for example, he or she appears to have a business in the UK), the Financial Institution cannot be satisfied that the deposit is a relevant investment and is obliged to seek further clarification from the investor of his status before the NOR declaration can be acted upon. The Financial Institution should contact the investor seeking an explanation of why he or she considers themselves to be not ordinarily resident. See also paragraph 4.37. If the investor is able to satisfy the Financial Institution that the declaration is valid, the Financial Institution can accept the declaration and need take no further action. Financial Institutions are recommended to retain some note of the enquiry. If the investor is unable to satisfy the Financial Institution that his or her NOR declaration is valid the Financial Institution should deduct BRT from any interest paid on the deposit.

**Joint accounts**

4.11 Any investor in a joint account may sign the form R105 on behalf of all the other investors. But if that investor ceases to be a party to the account, for example, if he or she dies, a new NOR declaration will be required. Financial Institutions can only pay interest on a joint account without deduction of tax if the investors are eligible to receive interest without deduction of tax for the same reason. For example, where one investor is entitled to register using form R85 and another investor is entitled to sign an NOR declaration on form R105 interest must be paid net. In other words, a mixture of a registration on form R85 [income within personal allowances] and form R105 is not allowed on the same joint account.

**Death of an investor**

4.12 If one party to a joint account dies or otherwise leaves the account, a new declaration is not required unless that person was the only signatory of the NOR declaration.

**Giving effect to the NOR declaration**

4.37 When Financial Institutions receive a NOR declaration which is fully completed in the form currently prescribed (or approved) by HMRC, they must satisfy themselves that there are no grounds for believing that the investor is or may be ordinarily resident in the UK or that the trustees are or may be resident in the UK, or that any of the beneficiaries are or may be ordinarily resident/resident, as appropriate. If they are so satisfied they must pay interest without deducting BRT.

If Financial Institutions have any information suggesting that the investor is or may be ordinarily resident in the UK, or that the trustees are or may be resident, or that any of the beneficiaries are or may be ordinarily resident/resident, they must not pay interest without deduction of BRT unless and until they have satisfied themselves that the investor is NOR or that the trustees are not resident and the beneficiaries are NOR/not resident, as appropriate.

The NOR supervisor normally carries out these checks on behalf of the Financial Institution. Financial Institutions must therefore put in place systems (clerical or computer-based) for ensuring that all relevant information is made available to the NOR supervisor. In particular all accounts in the branch to which the investor or trustees/beneficiaries is/are party, whether deposit or loan accounts (including mortgage accounts), and any such other accounts which are known to the branch should be reviewed. Examples of relevant information which could cast doubt on the validity of the declaration are

- a UK business in which the investor/trustees/beneficiaries appear to participate actively,
- a UK address or postal directions,
- an overseas PO Box or "c/o" address,
- a BFPO address, and
- a notification that the account is the subject of a third party mandate in favour of a UK resident or used as security for borrowing by UK residents or for borrowing in respect of the purchase of the UK property.

In making his or her decisions the NOR supervisor must not ignore information which comes to his or her attention by personal knowledge or otherwise. An example of this might be frequent or regular personal visits to the bank, cash transactions etc. The Financial Institution should put procedures in place so that information of a similar nature which comes to the knowledge of an employee who is responsible for handling any NOR accounts should similarly be drawn to the NOR supervisor's attention.

It will be unusual for such information to provide conclusive proof that the NOR declaration is invalid. However, where the information could reasonably be taken to indicate that the investor may be ordinarily resident in the UK, the trustees may be resident or that any of the beneficiaries may be ordinarily resident/resident, the Financial Institution is obliged to satisfy itself that the evidence does not render the NOR declaration invalid. One way of doing this would be by obtaining written confirmation from the investor. A note of any enquiries made should be kept in the investor's records or the trust records.

It may be possible to resolve doubts which arise without reference to the investor or trustees. For example if the investor is known to be a student in the UK it would be reasonable for him or her to make frequent personal visits to the bank. In such circumstances, no further action need be taken by the NOR supervisor and the NOR declaration may be accepted. NOR supervisors are recommended to retain some record of the decisions.

**The continuing obligation**

4.38 Once an NOR declaration has taken effect, Financial Institutions must continue to pay interest without deducting BRT unless and until they receive information suggesting that the investor is or may be ordinarily resident in the

UK, or the trustees are or may be resident, or any of the beneficiaries are or may be ordinarily resident/resident. This is called the "continuing obligation". They must put in place systems so that as far as possible all relevant information which can be readily linked to a NOR account is brought to the attention of the NOR supervisor. Relevant information is that which points to a UK connection, for example

- notification of a UK address,
- change of account title,
- applications for credit cards, loans or mortgages suggesting UK residence,
- use of the deposit as security for borrowing by UK residents or for borrowing in respect of the purchase of UK property,
- the grant of third party mandates in favour of a UK resident,
- the grant of a "lien" on the account,
- information which comes to the NOR supervisor's attention by personal knowledge,
- the existence of a UK business in which the investor has an active interest, and
- frequent or regular personal visits to the Financial Institution, cash transactions in the UK etc.

Where information indicates that the investor is or may be ordinarily resident in the UK or the trustees are or may be resident in the UK, or any of the beneficiaries are or may be ordinarily resident/resident in the UK, as appropriate, strictly the Financial Institution should treat the deposit as a relevant investment immediately and begin to deduct BRT. However, provided the Financial Institution has taken steps to satisfy itself that the investor has remained NOR, and, if necessary, has asked the investor to confirm that he or she has remained NOR (or in the case of trustees or beneficiaries that they are NOR/not resident, as appropriate), the Financial Institution may continue to pay interest without deducting BRT for up to 180 days to enable enquiries to be concluded. In exceptional cases HMRC may allow up to a further 180 days. Any Financial Institutions needing more than 180 days should apply to ...

HMRC recommends that where the matter is resolved without correspondence the NOR Supervisor records why he or she considers that the declaration remains valid.

Where the investor or the trustees is/are unable to satisfy the Financial Institution that a NOR declaration remains valid the Financial Institution should treat the deposit as a relevant investment and deduct BRT. Where the investor has not given all the necessary information within 180 days (or any further period HMRC may allow) the Financial Institution must deduct BRT from any future payments of interest.

**Overseas Students**

4.39 Students entering the UK for a period of study lasting less than four years are normally treated as not ordinarily resident in the UK. HMRC recommend that institutions make a diary note to review these accounts at the end of 4 years. If, at the end of 4 years, there is still a UK address on the account then you have 180 days to check the position with the investor.

If there is a reply and the investor is now ordinarily resident in the UK the

Financial Institution should cancel the form R105 and deduct BRT from future payments of interest. The investor may be eligible to complete a form R85.

If there is no reply and there is still movement on the account. The Financial Institution should cancel the form R105 at the end of 180 days and deduct BRT from future payments of interest.

If there is no reply, no movement on the account and no evidence suggesting the investor is ordinarily resident in the UK interest can continue to be paid gross.

**Change of name of investor**

4.40 Where the investor changes his or her name, for example by marriage, it is not necessary to replace the NOR declaration but the Financial Institution should ensure there is a clear audit trail. An example of a clear audit trail would be annotating the form with the revised details and endorsing the amendment with date stamp.

**Transfer of account between branches**

4.41 A new NOR declaration is not required when an account is transferred between branches. But Financial Institutions should ensure that there is a clear audit trail back to the original NOR declaration.

## 17.15 EU Interest and Savings Directive

The relevant law and practice is found in:

(1) European Directive 2003/48/EC on taxation of savings income in the form of interest payments (**"EUSD"**) which applies to EU states.

(2) International agreements made by non-EU states.[103]

(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).[104]

(4) Guidance notes issued by each state.[105]

A full discussion requires many volumes. Proposals are underway to amend and extend the law.[106]

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103 These are:

(1) UK Crown Dependencies: the Channel Islands and the Isle of Man.

(2) UK Overseas Territories: Anguilla, British Virgin Islands, Cayman Islands, Gibraltar, Montserrat, Turks and Caicos Islands,.

(3) Dependent Territories of the Netherlands: Netherlands Antilles and Aruba.

(4) Other countries: Switzerland, Andorra, Liechtenstein, Monaco and San Marino.

104 In the UK this has been done by the Reporting of Savings Income Information Regs 2003 (SI 3297).

105 In the UK see *www.hmrc.gov.uk/esd-guidance/guidance.htm* which is 71 pages long. But UK residents would not be concerned about UK law.

106 See Proposal for a council directive amending directive 2003/48/EC, COM(2008) 727 final 2008/0215 (CNS), accessible *ec.europa.eu/taxation_customs/resources/documents/taxation/personal_tax/savi*

In the following discussion, "**an ISD state**" is a state where Directive rules apply.

In short, the rules apply when a "paying agent"[107] established in one ISD state pays "interest"[108] to an individual who is "resident"[109] 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 will most often be affected where:

(1) they receive 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[110] in such a jurisdiction pay interest to a life tenant resident in the UK.

The paying agent has two choices:

(1) If the individual gives authority, the trustees may report the interest payments to HMRC in the UK.
(2) Alternatively the trustees must impose a withholding tax (also called a retention tax) on the payment of interest.[111] Statute uses the label "special withholding tax"[112] and I adopt that terminology for lack of better.

Several jurisdictions have taken the view before 2008/09 that the withholding/disclosure requirement does not apply when a payment of interest is made to a remittance basis taxpayer, if the interest is not remitted (and so not subject to UK tax).[113] This is a purposive

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*ngs_tax/savings_directive_review/COM(2008)727_en.pdf*

107 This term is elaborately defined: Art.4 EUSD. It includes trustees but not (in short) individual borrowers not carrying on business.

108 This term is also elaborately defined: Art.6 EUSD.

109 This term is defined in Art.3(3) EUSD.

110 Payment from a discretionary trust or non-transparent IP trust is not "interest" and so it does not require withholding or disclosure. The EUSD will eventually be extended to cover this.

111 The states that operate this tax are: Austria, Belgium, Luxembourg, Jersey, 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.

112 Section 136(6) TIOPA.

113 The Channel Islands and the Isle of Man take this view. See eg para 32 of the Isle of Man Treasury guidance notes accessible
*www.gov.im/lib/docs/treasury/incometax/guidance.pdf.*

> "32. In deciding to whom the retention tax will need to be applied the focus should be on the ultimate aim of the Directive which is to enable savings income

construction, as the point is not made in the text of the agreements and whether it is correct seems very doubtful. HMRC do not agree, but the point is not within their jurisdiction, and they actually benefit from this practice as they do not have to allow a tax credit. This point ultimately raises questions of EU or international law, but not questions of UK law.

However the EU has action on this point. An EU press release IP/09/1013, 25 June 2009, provides:

> The European Commission has decided to refer Luxembourg[114] to the European Court of Justice over its incorrect application of certain provisions of the Savings Tax Directive as regards interest payments made to beneficial owners who benefit from so-called "non-domiciled resident" status in their country of residence.
> Luxembourg refuses to apply the Directive to beneficial owners who benefit

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in the form of interest payments made in one Member State to beneficial owners who are individuals resident in another Member State to be made subject to effective taxation in accordance with the laws of the latter Member State. The emphasis should be on individuals, and also on those individuals who are not only resident in a Member State but are persons subject to effective taxation in accordance with the laws of the Member State. It is therefore consistent with the aims of the Directive, and therefore of the Agreements into which the Crown Dependencies have entered, that the retention tax will not apply to interest payments made to …

- a trust (unless, as in the case of an interest in possession trust, a relevant beneficiary has the immediate and absolute entitlement to an interest payment); …
- an individual where it is known to the paying agent that they benefit in their Member State of residence from an exemption from income tax; or where because no interest is remitted to the individual no liability to income tax arises in their Member State of residence."

Switzerland agrees: see *Eidgenössische Steuerverwaltung: Wegleitung zur EU-Zinsbesteuerung* (Swiss Federal Tax Authority Guidelines) § 37.

The operation of this practice from 2008/09 is a little more difficult, because the remittance basis depends on making a claim and at the time the interest is paid the claim will not yet have been made. But the practice will probably continue to be applied in cases where the individual confirms that they intend to make a remittance basis claim.

114 Belgium had previously taken the same view, see the 7th edition of this work, but it backed down so the proceedings are now against Luxembourg alone. I do not know if there are also proceedings against the tax havens which take the same view, but maybe Luxembourg will be a test case which will determine the point.

> from the so-called "non-domiciled resident" status in their country of residence. Consequently, Luxembourg paying agents do not levy withholding tax on interest payments to such beneficial owners.
>
> According to Luxembourg legislation, beneficial owners are considered to benefit from the "non-domiciled" status, if they are generally exempt from income tax in their State of residence for tax purposes or if the interest payments, as long as they are not transferred to the State of residence ("remittance"), are not subject to tax in that State.
>
> According to the Commission, Luxembourg cannot provide for an exemption from withholding tax in situations other than those expressly provided by article 13 of the Directive (the so-called "voluntary disclosure" procedure which allows the beneficial owner expressly to authorise the paying agent to report information to the tax authorities of his State of residence and the "certificate procedure" which ensures that withholding tax is not levied when the beneficial owner presents to his paying agent a certificate drawn up by his Member State of residence for tax purposes).
>
> The Commission is of the opinion that the paying agent has the obligation to establish the residence of the beneficial owner on the basis of minimum standards, as provided by article 3(3) of the Directive. If the beneficial owner is a resident of another Member State in accordance with these standards, the Member State of the paying agent must ensure that the latter applies the Directive and, in the case of Luxembourg, that the paying agent levies a withholding tax on interest payments to such a beneficial owner.
>
> Consequently, the Commission considers that Luxembourg's legislation, in its current state, is not compatible with articles 2, 3, 10 and 11 of the Directive.
>
> Given that the above Luxembourg tax rules were not amended following the reasoned opinion sent by the Commission in November 2008 ( IP/08/1815 ), the Commission has decided to refer the case to the European Court of Justice.
>
> The Commission's reference number for the case at issue is 2007/2178.

The current renegotiation of the EUSD may resolve the issue, but that will take years to come to fruition.

In practice, if the paying agent, guided no doubt by the local authorities, takes the view that the duty of withholding/disclosure does apply to unremitted interest, the individual will usually consent to the disclosure. Then there will be no withholding tax. No difficulty will normally arise out of that disclosure. The Directive and supplemental agreements are designed to prevent criminal tax evasion, not lawful tax planning of the kind considered in this book.

#### 17.15.1 *Credit for special withholding tax*

If tax is withheld, 75% of it is paid to the Member State where the beneficiary is resident.[115] But the beneficiary is entitled to a tax credit for 100% of the tax withheld.[116]

HMRC now accept that the credit is applicable even if it relates to unremitted income (un)taxed on the remittance basis.[117] Helpsheet 264 (Remittance basis) for 2010/11 provides:

> Where SWT is deducted you are treated as having paid an equivalent amount of Income Tax in the UK which can be set against your UK liability or repaid to you if the amount exceeds that liability.
>
> If the remittance basis applies to you and you set an amount of SWT against your Income Tax liability, or claim a repayment if the SWT exceeds your liability, the amount set off or repaid is treated as a remittance of the income at the time it is set off or repaid.
>
> *Example 4*
>
> Grace received £8,000 of interest from a Liechtenstein account after deduction of SWT of £2,000. Grace is non-domiciled in the UK and claims for her foreign income to be taxed on the remittance basis. Grace did not remit any of the money from her Liechtenstein account but includes an equivalent amount of Income Tax in her return for the SWT to set against other UK tax liability.
>
> Enter on page F 2/F 3 of the Foreign pages:

| | |
|---|---|
| Country or territory code (page F 2 column A) | LIE |
| Amount of income received (page F 2 column B) | £0 |
| SWT (page F 3 column D) | £2,000 |

> Setting off the SWT against Income Tax liability will mean that part of the interest income is remitted to the UK and will be a taxable amount at that time. Normally the 'set-off' will be regarded as having been at 31 January following the tax year. In this example that would be 31 January 2012. Grace will therefore have to enter taxable income of £2,500 on her next return (remittance £2,000 increased by the rate of SWT (20%) £500 total £2,500), she will not be entitled to any relief for SWT for that year as the full amount has been relieved in this tax year).
>
> If you claim for your foreign income to be taxed on the remittance basis and you remit part of the amount after SWT deducted then the amount of your income remitted is calculated by including the appropriate proportion of the SWT.

115 Art.12.

116 Art.14.

117 HMRC changed their mind in Tax Bulletin 84 (discussed in the 6th edition of this book).

**You are still able to claim the whole amount of SWT deducted in the year at column D.**

*Example 5*

Adam received interest of £800 from Jersey after deduction of SWT of £200. Adam is non-domiciled in the UK and claims for his foreign income to be taxed on the remittance basis. £400 of the interest was remitted to the UK.

| | |
|---|---|
| Interest received in UK | £400 |
| SWT | £100 |
| | £500 |

Enter on page F 2/F 3 of the Foreign pages:

| | |
|---|---|
| Country or territory code (page F 2 column A) | JEY |
| Amount of income received (page F 2 column B) | £500 |
| SWT (page F 3 column D) | £200 |

As in Example 4, the £200 set-off will be a further remittance at the date it is set off and subject to the same calculation until the total of the income £1,000 is taxed. In this example £250 of income should be included on the tax return of the year when the SWT £200 is set off – normally that would be the 2011–12 tax year for this example.

However, if a credit is given against tax, it is considered that 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 derived from the foreign interest, and so is regarded as remitted.

CHAPTER EIGHTEEN

# EXEMPT INTEREST OF NON-RESIDENTS

## 18.1 Exempt interest - Introduction

This chapter considers exemptions for interest on:
(1) FOTRA securities;
(2) foreign currency securities;
(3) international securities

## 18.2 Meaning of "FOTRA Securities"

Section 713(2) ITTOIA provides:

> In this Chapter "FOTRA security" means—
> (a) a security issued with a condition about exemption from taxation authorised by section 22 of F(No.2)A 1931,
> (b) a gilt-edged security which was issued before 6th April 1998 and without any such condition (other than 3½% War Loan 1952 Or After), or
> (c) 3½% War Loan 1952 Or After.

FOTRA stands for 'Free of Tax to Residents Abroad'.

### 18.2.1 *The exemption condition*

Section 713 ITTOIA provides:

> (3) In this Chapter "the exemption condition" has the meaning given by subsections (4) to (6), according to the kind of FOTRA security involved.
> (4) In relation to a security within subsection (2)(a), it means the condition authorised by section 22 of F(No 2)A 1931.

> (5) In relation to a security within subsection (2)(b), it means a condition with which 7.25% Treasury Stock 2007 was first issued, being a condition treated by section 161(1) of FA 1998 (non-FOTRA securities)—
> (a) as a condition with which the security within subsection (2)(b) was issued, and
> (b) as a condition authorised in relation to its issue by section 22 of F(No 2)A 1931.
> (6) In relation to 31/2% War Loan 1952 Or After, it means a condition of its issue authorised by section 47 of F(No 2)A 1915.

For these provisions see 53.4.1 (Conditions for exemption).

## 18.3 Deduction at source

Section 893 ITA 2007 provides:

> (1) A payment of a UK public revenue dividend is payable gross if—
> (a) it is a payment of interest on gross-paying government securities, and
> (b) no deduction at source application has effect in respect of the securities at the time the payment is made (see section 895).

Thus there are three conditions for gross payment. First the security must be a UK public revenue dividend, defined s.891 ITA:

> In this Chapter "UK public revenue dividend" means any income from securities which—
> (a) is paid out of the public revenue of the UK or Northern Ireland, but
> (b) is not interest on local authority stock.

Secondly the security must be a gross-paying government security, defined s.893(2) ITA:

> In this Chapter "gross-paying government securities" means—
> (a) gilt-edged securities (see section 1024), or
> (b) securities which are the subject of a Treasury direction under section 894(1) or (3).

Thirdly, holders may ask for tax to be deducted at source. It must be rare to want to apply for tax to be deducted, though it might perhaps be convenient for a basic rate taxpayer who does not otherwise have to put in a return.

## 18.4 The FOTRA exemption

Section 714 ITTOIA provides:

> (1) No liability to income tax arises in respect of profits from a FOTRA security if conditions A and B are met. ...
> (3) Condition A is that the profits are stated in the exemption condition to be exempt from income tax.
> (4) Condition B is that any requirements for obtaining the exemption imposed by the security's conditions of issue are met.

A non-resident individual or company would qualify for non-residents IT relief on the interest, so the exemption only matters in unusual cases, such as:

(1) Individuals who are UK resident but not ordinarily resident.
(2) Beneficiaries of UK discretionary trusts and estates.

### 18.4.1 *Sections 624 and 720*

Section 714 ITTOIA provides:

> (5) Whatever the exemption condition provides, amounts charged under the provisions specified in subsection (6) are not exempted by subsection (1).
> (6) The provisions are—
> Chapter 5 of Part 5 (settlements: amounts treated as income of settlor) so far as it applies to income within section 619(1)(a) or (b), and
> Chapter 2 of Part 13 of ITA 2007 (anti-avoidance provisions: transfer of assets abroad).

These anti-avoidance provisions override FOTRA exemption.

### 18.4.2 *Restriction on deductions*

For completeness, s.716 ITTOIA provides:

> (1) A person who meets conditions A and B may not bring into account for income tax purposes—
> (a) any amount relating to changes in the value of a FOTRA security, or
> (b) expenses related to holding it or to any transaction concerning it.
> (2) Condition A is that the person is the beneficial owner of the security.
> (3) Condition B is that the person is a person who would be exempt from tax on the security under this Chapter.

This can only apply to traders and is not of general importance.

## 18.5 Beneficial ownership

For a general discussion of the beneficial ownership requirement, see 53.5 (Beneficial ownership of FOTRA securities). The International Manual provides:

> **368040. The FOTRA condition** [October 2004]
> ...
> *Beneficial ownership of the security*
> To demonstrate beneficial ownership of the security, the claimant must hold the security on the interest date. In strictness a person who has sold a FOTRA security but receives the next interest payment due (an ex-dividend sale) ceases to be the beneficial owner of the security when he sells it.

It would be very strange if an ex-dividend sale caused the interest received post sale to become taxable, and I doubt if that can really be correct. In practice perhaps it does not often happen.[1]

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1 For completeness, The INT Manual continues:
"There is a column on the A1 claim form with the heading 'If sold, date of sale or write still held'. Entries in this column will alert you to a sale before the interest date. You should obtain guidance from Technical Advice Group before you take any action if
• a FOTRA security was sold before the interest date
• that column is left blank"
This is more than a decade out of date since from 1998 interest is paid gross and claims for repayment of deducted tax (formerly on form A1) are not needed.

## 18.6 FORTA securities held on trust

### 18.6.1 *Interest in possession trust*

The TSE Manual provides:

> **3185. FOTRA securities - resident trustees** [February 2011]
> ... From 6 April 1998 all interest on such securities is paid gross. Trustees need to know whether or not to Self-Assess liability. This depends upon the type of trust involved and the Residence status of the beneficiary.
> *Interest in possession trust (TSEM1105)*
> For any beneficiary who is not ordinarily resident (NOR) in the UK the interest is not taxable. Trustees should not include it on the returns. The authority for this is *Williams v Singer* 7 TC 387 (TSEM7070).

Thus (although not clear from the statute) all that matters is the ordinary residence of the life tenant. That is sensible.

### 18.6.2 *Discretionary trust*

Section 715 ITTOIA provides:

> (1) This section applies if—
> (a) a FOTRA security is held on trust, and
> (b) apart from this section, interest payable on the security would not be exempt from income tax under section 714 because of the security not being in the beneficial ownership of a person not ordinarily UK resident.
> (2) For the purposes of determining whether the interest is exempt under section 714 it is to be assumed that the security is in the beneficial ownership of a person not ordinarily UK resident if none of the beneficiaries of the trust is ordinarily UK resident at the time when the interest arises.
> (3) In subsection (2) "beneficiaries of the trust" includes any person known to the trustees as a person—
> (a) who is, or will or may become, entitled under the terms of the trust to receive income under the trust, or
> (b) to whom or for whose benefit such income may be paid or applied.
> (4) In subsection (3) "income under the trust" includes any property held on the terms of the trust and falling to be treated as capital so far as

it is or represents amounts received by the trustees as income.

ITTOIA EN change 116 provides:

> **Change 116: Interest from FOTRA securities held on trust: s.715**
> This change gives statutory effect to a practice relating to interest arising from FOTRA securities held on trust.
> FOTRA exemptions apply where gilt-edged securities are in the beneficial ownership of persons who are not ordinarily resident in the UK. The source legislation, principally section 154 of FA 1996, is rewritten in Chapter 6 of Part 6 of this Act. The beneficial ownership test lies within the definition of "FOTRA security" as it is part of the exemption condition of the securities. (See, in particular, section 22 of F(No 2)A 1931).
> Although in the case of bare trusts and trusts with an interest in possession, it is fairly clear where the beneficial ownership lies, in the case of discretionary or accumulation trusts it can be difficult to apply the beneficial ownership test. In some types of trust the beneficial ownership of an asset is, in effect, in suspense. In others, while it may be clear where the beneficial ownership lies, it may belong to a different person from the person entitled to the income.

The author does not have a sound grasp of the English law concept of beneficial ownership, but it does not matter, as the passage continues:.

> In practice, where interest from FOTRA securities held in trust arises to trustees and none of the beneficiaries of the trust is ordinarily resident in the UK, the beneficial ownership test is regarded as met whatever kind of trust is involved and no account is taken of whether the trustees themselves are resident or ordinarily resident. So if all the potential beneficiaries of a discretionary or accumulation trust (that is, those who have the right, at the discretion of the trustees, to benefit from the trust income or accumulated income) are not ordinarily resident in the UK, the FOTRA beneficial ownership test is treated as having been met.
> Section 715 of this Act gives effect to this practice. So, for the purposes of determining whether interest arising from a FOTRA security held in trust is exempt from income tax under section 714 of this Act, it is to be assumed that the security is in the beneficial ownership of a person who is not ordinarily resident if none of the beneficiaries of the trust is resident when the interest arises. (See section 715(1) and (2)). Section 715(3) defines "beneficiaries of the trust" widely so as to cover all potential income beneficiaries of discretionary and accumulation trusts.

> Section 715(4) brings in beneficiaries receiving accumulated income. This change is in taxpayers' favour in principle. But it is expected to have no practical effect as it is in line with current practice.

This applies even to a UK resident trust.

In a case where

(1) some beneficiaries are UK resident (so the requirements of this relief are not met) but
(2) the trustees distribute income to a non-ordinarily resident beneficiary relief is available under ESC B18.

## 18.7 Interaction of FOTRA exemption and DT relief

DT relief is obviously not needed where FOTRA exemption applies or where non-residents IT relief applies. There are a few gaps where DT relief could be useful, for instance, an individual who is resident and ordinarily resident in the UK but is treaty-resident outside the UK. The International Manual provides:

> **368110. FOTRA and DT claims** [October 2004]
> A person entitled to exemption from UK income tax on interest payments from a FOTRA security may claim repayment of some or all of the tax deducted under the terms of an interest article in a DTA. You should treat any such claim as a claim under the interest article. It follows that the claimant must satisfy the conditions of the DTA rather than the conditions for FOTRA exemption. In effect the payment loses the label of FOTRA and is treated in the same way as any other interest payment.
> In practical terms it makes no difference if the claimant is entitled to full relief under the DTA. However the person who received the FOTRA interest may be able to claim repayment of the tax deducted by meeting the requirements of the DTA without meeting the beneficial ownership condition for FOTRA exemption.
> If the claimant is only entitled to partial repayment of the tax deducted under the DTA he will probably receive credit for the UK tax retained against his liability to tax on the interest in his country of residence. You should therefore make the payment as claimed because to increase the payment may cause the claimant inconvenience when settling his liability to tax in the country of residence. You could explain to the claimant that full repayment would be available if he made a claim on form A1.

This is more than a decade out of date since from 1998 interest is paid gross and claims for repayment of deducted tax (formerly on form A1) are not needed. But the underlying points are still correct.

## 18.8 Exempt foreign currency securities

### 18.8.1 *Securities qualifying for relief*

Section 755 ITTOIA provides:

> (1) This section applies to interest on—
> (a) such foreign currency securities issued by a local authority or a statutory corporation as the Treasury direct, and
> (b) such foreign currency loans made to a statutory corporation[2] as the Treasury direct.

I refer to securities within s.755 as **"exempt foreign currency securities"**.

Section 756 ITTOIA defines "foreign currency" security:

> (1) For the purposes of section 755, a security or loan is a foreign currency one if under its terms the currency to be used for repayment is not sterling.
> (2) Subsection (1) is subject to the following qualifications.
> [Subsections (3) and (4) are transitional rules for securities issued before 6 April 1982.]
> (5) If in the case of a security there is an option as to the currency to be used for repayment, the security is only to be treated as a foreign

2 Terms are defined in s.755(4) ITTOIA:
In this section—
"company" means a company, as defined in section 1(1) of the Companies Act 2006 (c 46),
'foreign currency', in relation to loans and securities, has the meaning given by section 756, and
'statutory corporation' means—
(a) a corporation incorporated by an Act (other than a company), or
(b) any other corporation on which functions connected with carrying on an undertaking are conferred by an Act or by an order made under or confirmed by an Act.

> currency one if the option is exercisable only by its holder.
> (6) If in the case of a loan there is an option as to the currency to be used for repayment, the loan is only to be treated as a foreign currency one if the option is exercisable only by the person for the time being entitled to repayment or eventual repayment.

### 18.8.2 *Exemption from deduction at source*

Section 981 ITA provides:

> Despite the provisions of this Part there is no duty to deduct a sum representing income tax from a payment of interest within section 755(1) of ITTOIA 2005 (interest on foreign currency securities etc owned by non-UK residents).

### 18.8.3 *Tax exemption*

Section 755(2) ITTOIA provides:

> No liability to income tax arises in respect of interest to which this section applies if—
> (a) in the case of interest on a security, its beneficial owner is a non-UK resident, and
> (b) in the case of interest on a loan, the person for the time being entitled to repayment or eventual repayment is a non-UK resident.

A non-resident individual or company would qualify for non-residents IT relief on the interest, so the exemption does not matter in practice.

### 18.8.4 *Section 624 and 720*

Section 755(3) ITTOIA provides:

> But interest is not exempt under subsection (2) because a person is a non-UK resident if it is treated as another person's income under—
> Chapter 5 of Part 5 (settlements: amounts treated as income of settlor), or
> Chapter 2 of Part 13 of ITA 2007 (anti-avoidance provisions: transfer of assets abroad).

This is the same as the rule for FOTRA securities.[3]

ITTOIA EN provides:

> Subsection (3) of the section is an anti-avoidance provision. Section 581(3) of ICTA is very widely drafted: "where any income of any person is by virtue of any provision of the Income Tax Acts to be deemed to be income of any other person, that income shall not be exempt ..". In fact, there are only two sets of provisions under which this type of income could be deemed to be income of another person. The relevant provisions are listed in subsection (3) of the section.

### 18.8.5 *Commentary*

If the aim is to encourage investment in local authority and similar securities, why should the exemption be limited to foreign currency securities? It seems the object when the rules were introduced in 1969 was to encourage loans from foreign lenders who would not wish to lend in sterling; borrowers fared badly because of the devaluation in the subsequent sterling crisis.

Alignment of the foreign currency security with the FOTRA rules would be a small but worthwhile simplification. However the Treasury when asked for a list of exempt foreign currency securities stated that they did not hold the information and could locate no record of a direction having been given under s.755 ITTOIA 2005! It may well be that no exempt foreign currency securities exist, and the entire legislation is dead letter law. I would be grateful for readers comments on that.

## 18.9 Securities of international organisations

### 18.9.1 *Inter-American Development Bank*

Section 773 ITTOIA provides:

> (1) No liability to income tax arises for a non-UK resident in respect of income from a security issued by the Inter-American Development Bank if the liability only arises because one or more of circumstances A to C apply.

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3 See 18.4.1 (Sections 624 and 720).

(2) Circumstance A is that the security is issued in the UK or in sterling.
(3) Circumstance B is that the income is made payable or paid in the UK or in sterling.
(4) Circumstance C is that the Bank maintains an office or other place of business in the UK.

This reflects Section 9 of the Agreement Establishing the IDB:

(c) No tax of any kind shall be levied on any obligation or security issued by the Bank, including any dividend or interest thereon, by whomsoever held:
(i) which discriminates against such obligation or security solely because it is issued by the Bank; or
(ii) if the sole jurisdictional basis for such taxation is the place or currency in which it is issued, made payable or paid, or the location of any office or place of business maintained by the Bank.
(d) No tax of any kind shall be levied on any obligation or security guaranteed by the Bank, including any dividend or interest thereon, by whomsoever held:
(i) which discriminates against such obligation or security solely because it is guaranteed by the Bank; or
(ii) if the sole jurisdictional basis for such taxation is the location of any office or place of business maintained by the Bank.[4]

### 18.9.2 *Designated international organisations*

Section 774 ITTOIA provides:

(1) No liability to income tax arises for a non-UK resident in respect of income from a security issued by an organisation if—
(a) the organisation has been designated by the Treasury for the purposes of this section, and
(b) the liability only arises because one or more of circumstances A to C apply.
(2) Circumstance A is that the security is issued in the UK or in sterling.
(3) Circumstance B is that the income is made payable or paid in the UK

4 *http://idbdocs.iadb.org/wsdocs/getdocument.aspx?docnum=781584*

or in sterling.

(4) Circumstance C is that the organisation maintains an office or other place of business in the UK.

(5) The Treasury may by order designate for the purposes of this section—

(a) any of the Communities,

(b) the European Investment Bank,

(c) any international organisation that meets conditions A and B.

(6) Condition A is that one of its members is the UK or any of the Communities.

(7) Condition B is that the agreement under which that member became a member provides for the same kind of exemption from tax for income from securities issued by the organisation as this section provides.

See the Bretton Woods Agreement Order in Council, 1946 (SR&O 1946 No 36); International Finance Corporation Order 1955; International Development Association Order 1960; International Monetary Fund (Immunities and Privileges) Order 1977/825; International Organisations (Tax Exempt Securities) Order 1984; European Communities (Tax Exempt Securities) Order 1985; International Organisations (Tax Exempt Securities) Order 1991.

CHAPTER NINETEEN

# DIVIDENDS AND DISTRIBUTIONS

## 19.1 Dividends and distributions - Introduction

A full discussion of the taxation of dividends and distributions needs a book to itself. This chapter focuses on matters closest to the themes of this book. I do not discuss the corporation tax treatment of dividends and distributions received by UK companies.

## 19.2 Income from UK resident company

Section 383 ITTOIA imposes a charge on dividends and distributions from a UK resident company:

> (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.

Section 989 ITA defines "distribution" by reference to the wide and elaborate definition in CTA 2010:

> The following definitions apply for the purposes of the Income Tax Acts—
> "distribution" has the meaning given by Chapters 2 to 5 of Part 23 of CTA 2010, disregarding section 1027A of that Act.

Section 384 ITTOIA provides:

> (1) Tax is charged under this Chapter on the amount or value of the dividends paid and other distributions made in the tax year. ...

There is no reference to the remittance basis rules in part 8 ITTOIA, so dividends and distributions from UK resident companies are taxed on the arising basis (even for remittance basis taxpayers). This adopts or enacts the decision in *Bradbury v English Sewing Cotton Co* 8 TC 481 that the source of income from shares is located where the company is resident.

When the income consists of the transfer of a non-cash asset, there has been some debate whether the amount of the income 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.

### 19.2.1 *Tax credit*

Section 397 ITTOIA provides:

> (1) A UK resident or eligible non-UK resident receiving a qualifying distribution made by a UK resident company is entitled to a tax credit equal to one-ninth of the amount or value of the distribution (but see subsections (3) and (6)).
> (2) Such a person may claim to deduct the tax credit from—
> (a) the income tax charged on the person's total income for the tax year in which the distribution is made.
> (3) Subsection (1) only applies so far as the distribution is brought into charge to tax, and accordingly if the person's total income is reduced by any deductions which fall to be made from the distribution, the tax credit for the distribution is reduced in the same proportion as the distribution.

The SAIM explains subsection (3):

> **5100. Tax credits on qualifying distributions** [May 2010]
> [The manual paraphrases s.397(3) ITTOIA and continues:] So, for example, if an individual's total income is reduced by deductions (for example, personal allowances) such that the qualifying distributions are not, or are not wholly, brought into charge to tax, the value of the tax credits attaching to those distributions are correspondingly reduced. So a person may be entitled to a tax credit whose value is nil.

### 19.2.2 *Eligible non-UK resident*

Section 397(4) ITTOIA provides:

> For the purposes of this section "eligible non-UK resident", in relation to a qualifying distribution, means an individual who at any time in the tax year in which it is received is a non-UK resident within
> [a] section 278(2) of ICTA or
> [b] section 56(3) of ITA 2007 (Commonwealth citizens, EEA nationals etc.).

Subsection (4)[a] has no effect as s.278 ICTA was repealed in 2009 (the drafter forgot to repeal the cross reference here). There are seven categories of individuals within s.56(3) ITA, of which the only important one is EEA nationals.[1]

The individual has only to fall into the relevant category 'at any time' in the tax year, not necessarily throughout the tax year.

For completeness, s.397(5) ITTOIA provides:

> If a distribution is, or is treated under any provision of the Tax Acts as, the income of a person ("P") other than the recipient ("R"), P (not R) is treated as receiving it for the purposes of this section (and so P (not R) is entitled to a tax credit if P falls within subsection (1)).

### 19.2.3 *Grossing up*

Section 398(1) ITTOIA[2] provides for grossing up a dividend by the amount of the tax credit:

> If a person is entitled to a tax credit under section 397 or 397A 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 sections 397(1) and 397A(1)).

For instance:

1 See 41.7.1 (Entitlement to personal allowances under UK domestic law).
2 Flagged by s.384(3) ITTOIA.

Dividend: £1,000 **("net amount")**
Tax credit (one ninth): £111.11
Dividend plus tax credit: £1,111.11 **("gross amount")**

### 19.2.4 *Recipient non-eligible person: effective tax credit*

Section 399 ITTOIA provides:

> (1) This section applies if a person is not entitled to a tax credit under section 397 or 397A for a qualifying distribution included in the person's income for a tax year.
> (2) The person is treated as having paid income tax at the dividend ordinary rate on the amount or value of the distribution (but see subsection (7))...
> (6) The income tax treated as paid under subsection (2) is not repayable.

I call this **"an effective tax credit"** as the legislation uses the expression "tax credit" in the strict sense of a tax credit under s.397 or 397A.

Subsection (7) contains four exceptions concerning specialist topics not discussed here.

### 19.2.5 *Grossing up income of non-residents*

Section 399 ITTOIA provides:

> (3) For the purposes of subsection (2), if the person is non-UK resident the amount or value of the distribution is treated as the grossed up amount, unless the person is a company which is beneficially entitled to the income.
> (4) If the person is non-UK resident, the amount or value of the distribution is treated for the purposes of Chapters 3, 4 and 6 of Part 9 of ITA 2007 (special rates for trustees' income) as the grossed up amount.
> (5) In this section "the grossed up amount" means the actual amount or value of the distribution, grossed up by reference to the dividend ordinary rate for the tax year.

This is relevant to a non-resident trust because (in the absence of treaty relief) it affect how much tax is paid at the dividend rates. A non resident individual does not usually care about grossing up since no tax is due beyond the effective tax credit but grossing up might be relevant to an individual treaty-resident in a state where the treaty allows repayment of the tax credit.

## 19.3 Income from non-resident company

### 19.3.1 *Income dividends*

Section 402(1) ITTOIA imposes a charge to tax on dividends from non-resident companies:

> Income tax is charged on dividends of a non-UK resident company. ...

I refer to this as a charge on **"income dividends"** because s.402(4) ITTOIA provides:

> In this Chapter "dividends" does not include dividends of a capital nature.

Section 403 ITTOIA provides:

> (1) Tax is charged under this Chapter on the amount of the dividends arising in the tax year.
> (2) Subsection (1) is subject to ...[3] Part 8 (foreign income: special rules).

Section 403(2) ITTOIA introduces the remittance basis for foreign source income dividends.

ITTOIA EN discusses the meaning of "dividend" without shedding much light on the subject:

> 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.

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3 Omitted words relate to SIPs (outside the scope of this book).

### 19.3.2 *Non-dividend company income*

Non-dividend income from a non-resident company is taxed under s.687 ITTOIA:

> (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.[4]

Section 688 ITTOIA provides:

> (1) Tax is charged under this Chapter on the amount of the income arising in the tax year.
> (2) Subsection (1) is subject to ...[5]
> (c) Part 8 (foreign income: special rules).

Section 688(2)(c) ITTOIA introduces the remittance basis for foreign source non-dividend company income.

Thus we have two separate charging provisions:

(1) Section 402 imposes the charge on income dividends.
(2) Section 688 imposes the charge on income from companies other than dividends (which I call **"non-dividend company income"** ).

ITTOIA EN Vol. II explains why:

> 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

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4 The disapplied definition states:
"'Income' includes amounts treated as income (whether expressly or by implication)."

5 The exceptions in (a)(b) are outside the scope of this book.

> 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 from a company is classified as an income dividend (chargeable under s.402) or as non-dividend company income (chargeable under s.687). In either case the receipt is only taxable if it is income and not capital in nature.

### 19.3.3 *Tax credit and grossing up*

The topic of grossing up and tax credits on foreign dividends, in s.397A ITTOIA, needs a chapter, and is not discussed here; but I hope to cover it in a future edition.

## 19.4 Receipt from a non-resident company: income or capital?

What receipts from non-resident companies are income within the charge under s.403 or s.687? For receipts from UK resident companies the question does not arise. The charge is on "distributions" and the term is defined and includes a capital distribution. For receipts from non-resident companies, the charge is restricted to "income" and there is no guidance in the statute. So the income/capital distinction is one of the general law (eg 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.[6]

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6 See Law Commission Consultation Paper 175 (Capital and Income in Trusts, 2004) accessible *www.justice.gov.uk/lawcommission/index.htm*.

### 19.4.1 *The general principle*

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

> The rights and interests of shareholders in the assets and the profits of companies in which they hold shares vary widely in detail, but I think they can all be said to fall under three heads:
> (1) rights to participate in the distributable profits of the company while it is a going concern;
> (2) rights to participate in the division of the assets of the company in a liquidation, and
> (3) rights to participate in any distribution to shareholders on an actual or notional reduction of capital.
> Anything received under the first head is treated by English law as income of the recipients for both tax purposes and trust purposes (but subject as to the latter to any special provision of the trust) notwithstanding that the source of the distribution may be a profit not of the company's business but on capital account: see *In re Doughty* [1947] Ch 263 and *IRC v Reid's Trustees* 30 TC 431. Anything received under the second head is treated by English law as capital both for tax purposes and, subject as aforesaid, for trust purposes. So also is anything received under the third head. That this is so for trust purposes is clear from *In re Duff's Settlements* [1951] Ch 923, where moneys received by trustees on a distribution of part of a share premium account under the Companies Act 1948, s.56, were held to be capital for the purposes of their trust. My attention was not drawn to any case where the same has been held to be so for tax purposes on a distribution of a share premium account under s.56, but in my judgment that must follow.

The distribution of a share premium account of a Cayman company is income and not capital: *First Nationwide v HMRC* [2010] UKFTT 24 (TC).

The HMRC view was set out in the former Inspectors Manual. The material was deleted from the current SAI Manual, which deals with the question only cursorily at 5210. I set out the old Inspectors Manual passages, as they no doubt continue to reflect HMRC practice:

**1610. Distributions/foreign cos: In cash**
Published: 9/95
... a cash distribution to its shareholders by a foreign company will normally be assessable under Case V, whether it is attributable to the undivided[7] profits or to the capital resources of the company (*IRC v Reid* 30 TC 431). Where, however, cash —
a) is distributed on the liquidation of the company (*IRC v Burrell* 9 TC 27) or
b) comprises a return of part of the shareholder's capital interest in the company (*Rae v Lazard Investment Co* 41 TC 1; *Courtaulds Investments v Fleming* 46 TC 111),

the cash constitutes a capital sum not assessable as income under Case V. ...

This is correct, though (b) is a slightly abbreviated summary of the position as more fully set out in *Courtaulds Investments*.

**1613. Distributions/foreign cos: Not in cash: Release of assets**
Published: 9/95
Where a foreign company releases[8] some of its assets (for example, shares it holds in another company) to its shareholders, the distribution will normally be assessable under Case V by reference to the UK currency value of such assets at the date of distribution (*Pool v Guardian Investment Trust* 8 TC 167; *Wilkinson v IRC* 16 TC 52; *Briggs v IRC* 17 TC 11). Where, however, the assets are released on liquidation or are otherwise claimed to be a return of capital to the shareholder, the claim should be referred to Revenue Policy, International (Cases IV and V), Victory House in accordance with IM1610, last sub-para.

The Manual dealt separately with distributions of cash and distributions of non-cash assets but the principle is exactly the same.

### 19.4.2 *Stock option*

The Inspectors Manual continued:

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7 [Author's Note] "Undivided" in this context is an old-fashioned term for "undistributed".

8 [Author's Note] "Releases" here means "distributes". The word "release" was used in *Pool v Guardian* (1922), but is not normally used nowadays in this sense.

**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.

### 19.4.3 *Issue of shares or debentures*

The Inspectors Manual continued:

**1612. Distributions/foreign cos: Not in cash**
Published: 9/95
Where a foreign company capitalises undivided [ie undistributed] profits and —
a) issues to its shareholders the additional capital so created, in the form of its own shares or debentures, in proportion to the number of shares already held by them or
b) satisfies a dividend out of such profits by the issue of its own stocks or shares (for example, a "stock dividend" by a United States company),

such a distribution does not constitute income for Case V purposes in the hands of the shareholder. This principle applies when the distribution is actually made in shares, whether or not an effective option was given to the shareholder to receive cash in place of shares (*IRC v Blott*, 8 TC 101; *Whitmore v IRC* 10 TC 645; *IRC v Fisher's Executors*, 10 TC 302; *IRC v Wright* 11 TC 181). ...
In cases where the distribution is not actually made in shares and the shareholder accepts cash from the company under an option given to him to receive cash in place of shares, the cash is assessable as income in accordance with IM1610.
**1614. Distributions/foreign cos: Certificates of indebtedness**
Published: 9/95
As regards liability in respect of dividends received in the form of certificates of indebtedness redeemable at a future date, see *Associated Insulation Products Ltd v Golder* 26 TC 231.
See also IM4580 as regards liability on the sale or transfer of such certificates.

### 19.4.4 *Dividend reinvestment plans*

The former Inspectors Manual continued:

> **1615. Dividend reinvestment plans**
> Published: 9/95
> Some foreign companies, particularly in North America and Australia, establish dividend reinvestment plans for their shareholders. Such plans can be structured in a number of different ways, some of which result in liability under Case V when a dividend is declared, and others which do not. At one extreme is the pure bonus issue, when a dividend is declared payable in shares with no option for the shareholder to take cash. Alternatively a company may arrange for cash dividends to be paid to a third party, typically a bank, which then applies the dividends in the purchase of additional company shares in the market on behalf of the shareholder. The first situation falls within the principle of *IRC v Blott* (8 TC 107) – see IM1612. The second gives rise to a Case V charge because the reinvestment in the company is regarded as a voluntary application of income which has already arisen to the shareholder.
> Between these two extremes lies a variety of situations, each of which must be considered by reference to their own facts to determine whether a Case V charge arises...

## 19.5 Income distribution from non-resident company: location of source

If a distribution from a non-resident company is income in nature, the question arises as to where is its source. There are many possible connecting factors, but 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 a good illustration of how the income tax source rules may differ from the IHT/private international law situs rules.) This rule is clearly assumed in the way that the current legislation is drafted.

## 19.6 Distribution to non-shareholder

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 trusts for the benefit of the shareholder and their family. This was held to be a distribution (and so unlawful as the company had no distributable profits):

> 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 rule that a sale at an undervalue is a distribution has been changed by s.845 CA 2006 but that does not affect the separate point that a payment from a company to a non-shareholder may be classified as a distribution.

How does one reconcile this with s.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 better view is that 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 B has no source of income. A will be chargeable to tax on the distribution if A is a person receiving or entitled to the income: see s.689 ITTOIA.

What if the company is owned by a discretionary trust, and the company makes a distribution to B, a beneficiary? There are several possible solutions:

(1) The distribution is income of B in the form of a company distribution.
(2) The distribution is income of B in the form of a trust distribution.
(3) The distribution is:
  (a) income of the trustees in the form of a company distribution; and
  (b) income of B in the form of a trust distribution.
(4) The payment is not income of B or of the trustees.

Solution (1) seems sensible but is inconsistent with the source doctrine which states that one cannot receive income (for tax purposes) unless one has a source of income: B has no interest in the company. (B's interest in the discretionary trust is not an interest in the company.) A radical House of Lords could (and perhaps should) reform the source doctrine to reach this result, but subject to that, solution (1) is not available.

It is considered that solution (2) is to be preferred. The reason that B receives the distribution is that B is a beneficiary of the trust, so the result is like any other trust distribution of an income nature.

Appropriate documentation would of course bring the matter into class (3) but in the absence of a payment to the trustees, it is artificial to regard them as in receipt of income.

Solution (4) is arguable but a court may regard it as too good to be true.

In these cases IHT needs to be considered: see ss.94, 99 IHTA. CGT and the transactions in securities code may also need to be considered.

## 19.7 Dividends from UK company to treaty non-resident person

Article 10 OECD Model provides:

> 1. Dividends paid by a company which is a resident of a Contracting State to a resident of the other Contracting State may be taxed in that other State.
> 2. However, such dividends may also be taxed in the Contracting State of which the company paying the dividends is a resident and according to the laws of that State, but if the beneficial owner of the dividends is a resident of the other Contracting State, the tax so charged shall not exceed:
> a) 5 per cent of the gross amount of the dividends if the beneficial owner is a company (other than a partnership) which holds directly at least 25 per cent of the capital of the company paying the dividends;
> b) 15 per cent of the gross amount of the dividends in all other cases.
> ...

Actual treaties vary considerably, particularly in the terms of art 10(2).

Persons within (a) are sometimes described as **"direct investors"** and those within (b) as **"portfolio investors"**, though the effective meaning of those terms depend on the requirements of the treaty concerned.

In practice, non-resident individuals and non-resident companies do not need treaty relief.[9] They qualify for non-residents IT relief which restricts the tax on dividends to an amount which is covered by the effective tax credit. The relief is relevant to:

(1) Non-resident trusts (if they do not qualify for non-residents income tax relief, because of having UK resident beneficiaries).[10]
(2) Individuals who are UK domestic-law resident, but treaty non-resident.

Some older treaties give the treaty non-resident a right to be repaid surplus tax credit. However:

(1) The number of treaties with a provision of this kind is small, and is diminishing as new treaties replace the older ones.
(2) The reduction in the amount of the tax credit to one ninth usually means that there is nothing to be repaid.

The International Manual provides:

**343510. Background** [March 2007]
...Since 6 April 1973, dividends have not had income tax deducted but have an amount attached to them (not paid to the shareholder at the time of the dividend) called a tax credit. See Section 231 ICTA 1988. Some DTAs provide for payment of tax credit. You need to check the details of each DTA. There are two types of investor

- portfolio investors (someone who owns less than 10% of the total number of issued shares in a UK company) – the dividend article usually provides that the investor is entitled to a tax credit equal to that to which a UK resident individual would be entitled had he received the dividend. Any excess of the tax credit above a deduction of 15% of the aggregate of the dividend and the tax credit is payable..
- direct investors (where a company controls 10% or more of the voting power of the UK company paying the dividend) – the dividend articles of a small number of DTAs provide that the investor is entitled to a tax credit equal to one-half of that to which a UK resident individual would be entitled had he received the dividend. The relief allowable is a payment of that half tax credit minus 5% or 10% of the aggregate of the dividend plus the half tax credit.

**343520. Portfolio Investors** [March 2007]
The expression "portfolio investors" describes the great majority of shareholders. They include individual persons, pension funds, companies and others who have invested money in shares issued by the UK company. The number of shares owned by each investor may range from single figures to several million shares. If a shareholder owns 10% or more of the total number of voting shares that have been issued by a UK company they are called a "direct investor". See INTM343540.
Some Double Taxation Agreements (DTAs) contain provisions that allow a portfolio shareholder to claim payment of part of the tax credit. In these treaties the dividend

9 See 37.1 (Non-residents IT relief).
10 See 3.5 (Trusts: UK beneficiary rule).

article usually provides that the amount payable is equal to the tax credit minus 15% of the aggregate of the dividend and the tax credit.
Where the DTA does not provide for payment of tax credits and the shareholder is an individual (a person) see INTM343530.
... For dividends paid on or after 6 April 1999 the rate of tax credit that is attached to a UK dividend is one ninth of the dividend. The effect of this rate of tax credit is that there is no amount for a portfolio investor to claim (see Section 30(10) F(No2)A 1997).
***Example***
Dividend £1,000
Tax credit (one ninth) £111.11
Dividend plus tax credit £1,111.11
15% retained in the UK £166.66
Because the amount to be retained in the UK is greater than the original tax credit there is nothing to pay. £111.11 less £166.66 equals nothing.
**343540. Direct investors** [March 2007]
A "direct investor" may be defined as a company that controls 10% or more of the voting shares of the UK company that is paying the dividend. Many Double Taxation Agreements (DTAs) that provide for payment of tax credits specifically exclude companies that either alone or together with associated companies control 10% or more of the voting power in the company that is paying the dividend. The claim forms contain a question that will allow you to identify these cases.
However, some DTAs contain provisions that specifically allow for payment of part of the tax credit to direct investors. The amount of relief that may be claimed by the non-resident shareholder is one half of the tax credit a UK resident would be entitled to minus 5% or 10% of the aggregate of the dividend plus half the tax credit.
The treaties that contain these special provisions that allow a direct investor to claim payment of part of the tax credit are
• Belgium see example 1.
• Canada, but no amount is payable for dividends paid on or after 6 April 1999 – see example 2.
• Italy see example 1.
• Luxembourg see example 1.
• Netherlands see example 1.
• Sweden see example 1.
• Switzerland see example 1.
• USA see example 1. Because the treaty changed there is no relief for any dividend paid on or after 1 May 2003 unless a specific election is made.
***Example 1***
Dividend paid on or after 6 April 1999 rate of tax credit is one ninth of the dividend.
Dividend £1,000,000
Tax credit £111,111.11
Dividend plus half tax credit £1,055,555.55
5% of dividend plus half tax credit £52,777.77
Payment is calculated as half tax credit (£55,555.55) less 5% of dividend plus half tax credit (£52,777.77) equals £2,777.78.
***Example 2***
(Direct investor company resident in Canada.) Dividend paid on or after 6 April 1999 rate

of tax credit is one ninth of the dividend.
Dividend £1,000,000
Tax credit £111,111.11
Dividend plus half tax credit £1,055,555.55
10% of dividend plus half tax credit £105,555.55
Because the amount to be retained in the UK is greater than the original tax credit there is nothing to pay. £55,555.55 less £105,555.55 equals nothing (see F(No2)Section 30(10) A 1997.

### 19.7.1 *"Dividends"*

Article 10(3) defines dividends:

> The term "dividends" as used in this Article means income from shares, "jouissance" shares or "jouissance" rights, mining shares, founders' shares or other rights, not being debt-claims, participating in profits, as well as income from other corporate rights which is subjected to the same taxation treatment as income from shares by the laws of the State of which the company making the distribution is a resident.

See Avery-Jones et al "The Definitions of Dividends & Interest in the OECD Model: Something Lost in Translation?" [2009] BTR 406.

### 19.7.2 *Dividends paid through PE*

Article 10(4) provides:

> 4. The provisions of paragraphs 1 and 2 shall not apply if the beneficial owner of the dividends, being a resident of a Contracting State, carries on business in the other Contracting State of which the company paying the dividends is a resident through a permanent establishment situated therein and the holding in respect of which the dividends are paid is effectively connected with such permanent establishment. In such case the provisions of Article 7 shall apply.

### 19.7.3 *Dividends to treaty non-resident company*

Article 10(4) provides:

> Where a company which is a resident of a Contracting State derives profits or income from the other Contracting State, that other State may

not impose any tax on the dividends paid by the company, except insofar as such dividends are paid to a resident of that other State or insofar as the holding in respect of which the dividends are paid is effectively connected with a permanent establishment situated in that other State, nor subject the company's undistributed profits to a tax on the company's undistributed profits, even if the dividends paid or the undistributed profits consist wholly or partly of profits or income arising in such other State.

CHAPTER TWENTY

# ROYALTIES

## 20.1 Royalties - Introduction

This chapter considers the taxation of royalties and deduction of tax at source rules for royalties. I use the term **"royalty income"** to mean royalties and all other receipts from intellectual property.

The topic requires a book to itself, and I focus on matters closest to the themes of this book.

I do not consider corporation taxation of royalties or the EU interest and royalties directive 2003/49/EC of 3rd June 2003 which applies to interest and royalty payments made between associated companies of different member states. Each of those would require long books to themselves.

## 20.2 Classification of royalty income for tax

Royalty income is classified for tax purposes in one of three ways. Statute does not provide much terminology, so I use the following terms:

(1) **Trading royalties**: royalties which constitute a receipt of a trade or profession (including a post-cessation receipt).
(2) **Non-trading royalties**: royalties which are not trading royalties. These may be:
(a) **Annual payment royalties**: royalties which are annual payments
(b) **Non-annual payment royalties**.

The three categories are recognised in *Noddy Subsidiary Rights v IRC* 43 TC 458 at p.474:

> It seems to me that, where you have this position, that a person owns an asset of any kind, whether physical or not, and grants licences under it, the activities which he carries on in connection with the grant of those

> licences may amount to a trade and then Case I of Schedule D applies. On the other hand, at the other end of the scale, the activities may amount to the mere holding of an investment, so that the receipt of income is in the nature of pure income profit and then Case III of Schedule D applies. There may be intermediate cases in which Case VI of Schedule D might apply.

ITTOIA has changed the terminology but not the underlying categorisation.

## 20.3 Trading royalties

The recipient of trading royalties has income of a dual character. The recipient has what must be classified as trading profits but in general the receipt is also classified as "royalties" within the usual sense of the word.

### 20.3.1 *Position of recipient of royalties*

Although the income has a dual character, there is only one charge to tax. The charge on trading profits under part 2 ITTOIA has priority over the charge on royalty income in part 5 ITTOIA, see s. 575 ITTOIA.

For the purpose of taxing the trading royalties the question whether the trading income has a UK source is naturally to be decided according to the rules which apply to trades/professions. Thus a UK resident trader has UK source trading profits even if the royalties come from abroad, since the trade is at least in part carried on in the UK.

What about trading income arising to a non-resident? There is commonwealth authority. In *Millin v IRC* Mrs Millin received royalties from publishers in respect of works which were written by her in South Africa, but printed and published in England and the USA. The Appellate Division held that the income arose wholly from a source within South Africa:

> ... the source of the whole amount received for royalties was in the Union. It is true that in this case no capital in the ordinary sense of that term was employed by Mrs. Millin. It was the exercise of her wits and labour that produced the royalties. They were employed in the Union,

> and it matters not, on the analogy of the *Overseas Trust* case,[1] that the grant to her publishers of the right to publish her book was contained in a contract made in England. Her faculties were employed in the Union both in writing the book and in dealing with her publishers, and, therefore, on the test applied in the cases cited, the source of the whole of her income would be in the Union.[2]

### 20.3.2 *Position of payor of royalties*

If the royalties have a UK source, and the payee is not in the UK, the deduction at source rules in principle apply. This is so even if:

(1) The receipt is a trading receipt of the recipient. The mere fact that the recipient of the royalties is trading does not prevent the payment from being "royalties".

(2) The trading income is subject to UK tax. Withholding tax applies if the royalties are taxable, whether taxable as royalties or as trading income.

(The same applies of course to interest.)

### 20.3.3 *Credit for foreign tax on foreign royalties*

Conversely, foreign tax may be deducted from foreign royalties received from a person subject to UK tax. ESC B8 provides:

> **B8 Double taxation relief: income consisting of royalties and "know-how" payments**
>
> Payments made by a person resident in an overseas country to a person carrying on a trade in the UK as consideration for the use of, or for the privilege of using, in the overseas country any copyright, patent, design, secret process or formula, trademark or other like property
>
> [1] may in law be payments the source of which is in the UK,
>
> [2] but are nevertheless treated for the purpose of credit (whether under double taxation agreements or by way of unilateral relief) as income arising outside the UK except to the extent that they represent consideration for services (other than merely incidental services) rendered in this country by the recipient to the payer.

1 *Overseas Trust Corporation v IRC* [1926] AI 444, 2 SATC 71.

2 [1928] AD 207 at p.216.

[1] is wrong or poorly expressed. The payments are not "payments the source of which is in the UK". They are receipts of a trade, and the *trading profits* (which are entirely distinct from the payments) are profits whose source is in the UK.
[2] is law and not concession, but it does not matter.
INT Manual expands on this:

> **161130. The source rule – concessions** [January 2011]
> *(B) Extra-Statutory concession ESC/B8 - DTR: royalties and 'know how' payments*]
> A UK resident may receive income consisting of royalties or 'know how' payments from a foreign resident. While in particular cases there may be special circumstances which will require to be taken into account, in general such income should be dealt with as follows.
> a) Payments made by a person resident in a foreign country to a person carrying on a trade in the UK as consideration for the use of, or for the privilege of using, in the foreign country any copyright, patent, design, secret process or formula, trademark or other like property may be treated for the purpose of credit (whether under double taxation agreements or by way of unilateral relief) as income arising outside the UK, except to the extent that they represent consideration for services (other than merely incidental services) rendered in this country by the recipient to the payer.
> b) Traders resident in the UK are not entitled to claim credit for any tax which is levied in the foreign country in respect of payments for services which are rendered in the UK and are not merely incidental services. In any such case the net amount of the payment (after deduction of any foreign tax borne by them on the payments) is included in the computation of profits for UK tax purposes.
> The prohibition on credit for foreign tax charged on payments for services rendered in the UK may be overruled by the terms of those double taxation agreements which have a royalties Article which includes technical services in the definition of royalties (see INTM153130) or a separate technical fees Article (see INTM153140) and those agreements deem the source of such payments to be in the country of which the payer is a resident. In such cases, even though the services are rendered in the UK, credit is due for the foreign tax charged on these payments.

### 20.3.4 *Professional author*

The International Manual has an important comment here:

> **342590. Professional authors** [June 2004]
> Copyright royalties that are payable to an author/originator of a literary, dramatic, musical or artistic work that has been created in the ordinary course of his profession (an "author by profession") fall into the same category as fees for professional services and do not come under [what is now s.906 ITA]. Payments that are made to an author by profession who usually lives overseas are therefore not subject to deduction of UK income tax at source. This follows the decisions in *Carson v Cheyney's Executor* (38 TC 240) and *Hume v Asquith* (45 TC 251) ...
> A Professional Author can be classed as such if he is clearly the originator of the work(s) concerned. If the claimant is not the originator of the work but has acquired the rights from that person they may not be treated as a professional author.

This practice goes back to a Parliamentary statement in 10 November 1949. Roy Jenkins (then Chancellor of the Exchequer) said

> "I am advised that [the deduction at source rule] does not apply to payments made to those who are authors by profession... "

Payments to a professional author are fees for services and not "royalties". This is odd, though the oddity is long-established and based on decisions of the highest authority. In practice it only matters where the author is resident in a jurisdiction without a DTA conferring relief. That would be fairly unusual, which may be the reason why the rule has survived.

The same rule must apply to post-cessation receipts. Contractual payments which are exempt from deduction at source (because they are not "royalties") continue to be exempt after the death of the author.

## 20.4 Non-trading royalties

After the (somewhat unnecessary) introduction in accordance with the principles of plain English drafting, s.579(1) ITTOIA provides the charge to tax:

> Income tax is charged on royalties and other income from intellectual property.[3]

Section 580 ITTOIA provides:

> (1) Tax is charged under section 579 on the full amount of the income arising in the tax year.
> (2) Subsection (1) is subject to Part 8 (foreign income: special rules). ...

This incorporates the remittance basis for foreign source royalty income.

Non-trading royalties are taxable under chapter 2 part 5 ITTOIA. This is so whether or not the royalties are annual payments or non-annual payments. The distinction between (non-trading) royalties which are annual payments and those which are not (former DVI income) is important, because:

(a) If the royalties are "annual payments" no expenses are deductible;
(b) If royalties are "other than annual payments" then expenses are deductible. Section 582 ITTOIA provides:

> (1) This section applies for calculating the amount of income charged under section 579 other than annual payments.
> (2) Expenses wholly and exclusively incurred for the purpose of generating the income are deductible...

"Annual payment" is an opaque and unhelpful label for a technical term whose meaning is discussed in a large and in parts difficult body of case

3 Section 579(2) ITTOIA defines intellectual property:
"In this section "intellectual property" means—
(a) any patent, trade mark, registered design, copyright, design right, performer's right or plant breeder's right,
(b) any rights under the law of any part of the UK which are similar to rights within paragraph (a),
(c) any rights under the law of any territory outside the UK which correspond or are similar to rights within paragraph (a), and
(d) any idea, information or technique not protected by a right within paragraph (a), (b) or (c)."

law,[4] which cannot be discussed here.

## 20.5 Where is the source of non-trading royalties?

Foreign source royalties are outside the scope of withholding tax and (unless trading royalties) only taxed (if at all) as RFI so the question of source matters to both payor and recipient.

What is the test to determine the source of non-trading royalties? The INT manual provides:

> **342520. Copyright royalties** [March 2007]
> If the copyright is exploited in the UK the royalty payment will be regarded as having a UK source and therefore within the provisions of [what is now s.906 ITA]. This is irrespective of the law governing the contract.

The same view is expressed in "Payments for the use of computer software and the deduction of income tax therefrom" Hughes & Payne [2000] BTR 5 at p.10. It is considered that this is correct.

Another passage in the INT Manual offers a different test:

> **161130. The source rule – concessions** [March 2007]
> ... If the owner of a right such as a patent, trademark or copyright is not engaged in any trade to which the right relates but derives income by exploiting that right, the source of the income may be regarded for the purpose of credit as located in the country where the right is enforceable.

But as a result of developments in private international law, the place of enforcement is no longer a useful connecting factor for tax[5] (even though in many cases it will be the same as the place of exploitation).

## 20.6 Withholding tax

Section 906 ITA provides:

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4 Section 582(7) ITTOIA specifies one rule: "The frequency with which payments are made is ignored in determining whether they are annual payments for the purposes of subsection (1)."

5 See 17.4.5 (Impact of modern private international law).

(1) This section applies to any payment made in a tax year if—

(a) it is a payment of any royalties, or sums payable periodically, in respect of a relevant intellectual property right (see section 907),[6]

(b) it is one that is charged to income tax or corporation tax, and

(c) condition A or B is met.

## 20.6.1 *Withholding tax conditions A and B*

Section 906(2) provides:

> Condition A is that the usual place of abode of the owner of the right is outside the UK.

See 17.8 (Usual place of abode). Note the test is the place of abode of the owner of the right. Condition B is an anti-avoidance rule. Section 906(3) ITA provides:

> Condition B is that—
> (a) a person ("the seller") has assigned the right to another person,
> (b) the usual place of abode of the seller is outside the UK,
> (c) the seller is entitled to periodical payments in respect of the right, and
> (d) the payments are in respect of that entitlement.

Section 906(4) ITA provides one exception:

> But this section does not apply if the payment is made in respect of copies of works, or articles, which have been exported from the UK for distribution outside the UK.

Section 906(5) ITA imposes the obligation to withhold tax:

> The person by or through whom the payment is made must, on making it, deduct from it a sum representing income tax on it at the basic rate in

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6 Section 909(3) ITA slightly extends the concept of "payment of royalties":
(3) Section 906—
(a) applies to payments on account of royalties as it applies to payments of royalties, and
(b) applies to payments on account of sums payable periodically as it applies to payments of sums payable periodically.

force for the tax year. ...

Section 907 ITA defines "relevant intellectual property right":

> (1) In section 906 "a relevant intellectual property right" means—
> (a) a copyright,
> (b) a right in a design, or
> (c) the public lending right in respect of a book.
> (2) In this section—
> "copyright" does not include copyright in—
> (a) a cinematographic film or video recording, or
> (b) the sound-track of a cinematographic film or video recording, except so far as it is separately exploited,
> "a right in a design" means the design right in a design, or the right in a registered design.

This definition takes film royalties outside the deduction of tax at source regime.

### 20.6.2 *Miscellaneous*

Section 908 ITA provides:

> **908 Royalty payments etc made through UK resident agents**
> (1) If—
> (a) a payment to which section 906 applies is made through an agent who is UK resident, and
> (b) the agent is entitled as against the owner of the right to deduct a sum as commission for services provided,
> section 906(5) and Chapters 8 (deduction at special rates), 15 and 16 (collection) apply as if the amount of the payment were the amount net of the sum deductible as commission.
> (2) But if the person by or through whom the payment is made does not know the commission is payable, or does not know its amount—
> (a) the sum representing income tax required to be deducted under section 906 must be calculated in the first instance on the total amount of the payment, and
> (b) the return to be made under Chapter 15 or the account of the payment under Chapter 16, must be based on that total amount.

Section 909(1) ITA is a timing provision:

> A payment to which section 906 applies is treated for all income and corporation tax purposes as made when it is made by the first person who makes it, not when it is made by or through any other person.

Section 909(2) ITA prevents contracting out:

> If, under section 906, a sum representing income tax must be deducted from a payment, any agreement to make the payment without deduction of that sum is void.

## 20.7 DT defence to deduction at tax at source

Art 10.1 OECD model treaty provides:

> Royalties[7] arising in a Contracting State and beneficially owned by a resident of the other Contracting State shall be taxable only in that other State.

Art 10.3 and 10.4 contain two exceptions not discussed here.[8]
The UK operates a self-certification system. Section 911 ITA provides:

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7 Article 10.2 defines royalties:

> The term "royalties" as used in this Article means payments of any kind received as a consideration for the use of, or the right to use, any copyright of literary, artistic or scientific work including cinematograph films, any patent, trade mark, design or model, plan, secret formula or process, or for information concerning industrial, commercial or scientific experience.

8 3. The provisions of paragraph 1 shall not apply if the beneficial owner of the royalties, being a resident of a Contracting State, carries on business in the other Contracting State in which the royalties arise through a permanent establishment situated therein and the right or property in respect of which the royalties are paid is effectively connected with such permanent establishment. In such case the provisions of Article 7 shall apply.
4. Where, by reason of a special relationship between the payer and the beneficial owner or between both of them and some other person, the amount of the royalties, having regard to the use, right or information for which they are paid, exceeds the amount which would have been agreed upon by the payer and the beneficial owner in the absence of such relationship, the provisions of this Article shall apply only to the last-mentioned amount. In such case, the excess part of the payments shall remain taxable according to the laws of each Contracting State, due regard being had to the other provisions of this Convention.

> (1) This section applies if—
> (a) a company pays a royalty from which it is required to deduct a sum representing income tax under Chapter 6 or 7,
> (b) the income tax in respect of the payment is collectible under Chapter 15 or 16, and
> (c) the company reasonably believes that, at the time the payment is made, the payee is entitled to relief in respect of the payment under double taxation arrangements.
> (2) The company may calculate the sum to be deducted from the payment under Chapter 6 or 7 by reference to the treaty rate.
> (3) But, if the payee is not at the time entitled to such relief, this Part has effect as if subsection (2) had never applied in relation to the payment.
> (4) In this section "the treaty rate" means the rate of income tax appropriate to the payee under the arrangements.

This only applies to company payors. Section 912 allows HMRC to require withholding:

> (1) This section applies if an officer of Revenue and Customs is not satisfied that the payee will be entitled to relief under double taxation arrangements in respect of one or more payments of royalties that a company is to make.
> (2) The officer may direct the company that section 911 is not to apply to the payment or payments.
> (3) A direction under subsection (2) may be varied or revoked by a later direction.
>
> 913 Interpretation of sections 911 and 912
> (1) In sections 911 and 912 "royalty" includes—
> (a) a payment received as consideration for the use of, or the right to use, a copyright, patent, trade mark, design, process or information, and
> (b) the proceeds of the sale of the whole or part of any patent rights.
> (2) In sections 911 and 912 "payee" means the person beneficially entitled to the income in respect of which the payment is made.

## 20.8 Films and sound recordings

Special rules apply to the exploitation of films and sound recordings. Section 609 ITTOIA provides:

> (1) Income tax is charged on income from a business involving the exploitation of films or sound recordings where the activities carried on do not amount to a trade.
> Such a business is referred to in this Chapter as a "non-trade business".
> (2) Expressions which are used in this Chapter and in Chapter 9 of Part 2 (trade profits: films and sound recordings) have the same meaning in this Chapter as they do in that Chapter.

Section 610 ITTOIA provides:

> (1) Tax is charged under this Chapter on the full amount of the income arising in the tax year. ...
> (3) This section is subject to Part 8 (foreign income: special rules).

The charge applies to UK and foreign source income, but this incorporates the remittance basis for foreign source income.

Section 612 ITTOIA provides:

> (1) This section applies for calculating the amount of income charged under this Chapter.
> (2) Expenses wholly and exclusively incurred for the purpose of generating the income are deductible. ...
>
> 613 Application of trading income rules to non-trade businesses
> The provisions of Chapter 9 of Part 2 apply in relation to non-trade businesses as they apply in relation to trades but as if—
> (a) references to a basis period were to a tax year, and
> (b) references to anything not constituting trading stock of a trade were omitted.

CHAPTER TWENTY ONE

# PENSION INCOME

## 21.1 Pension Income – Introduction

The income taxation of pensions requires a book to itself. In this chapter I only touch on the matters closest to the themes of this book.

The legislation is in part 9 ITEPA. After the usual outline in accordance with the principles of plain English drafting, which does not need to be considered here, there follows a cascade of definitions which need to be considered briefly.

### 21.1.1 *"Pension income"*

This term is defined in s.566(2) ITEPA:

> "Pension income" means the pensions, annuities and income of other types to which the provisions listed in subsection (4) apply.
> This definition applies for the purposes of the Tax Acts.

Section 566(4) sets out 13 categories of income of which the first two are the most important (and the only ones discussed here):

These are the provisions referred to in subsection (2)—

| **Provision** | **Income** | **Chapter (of this Part)** |
|---|---|---|
| Section 569 | UK pensions | Chapter 3 |
| Section 573 | Foreign pensions | Chapter 4 |
| Section 577 | UK social security pensions | Chapter 5 |
| Section 579A | Pensions under registered pension schemes | Chapter 5A |
| Section 609 | Annuities for the benefit of dependants | Chapter 10 |
| Section 610 | Annuities under sponsored superannuation schemes | Chapter 10 |
| Section 611 | Annuities in recognition of another's services | Chapter 10 |
| Section 615 | Certain overseas government pensions paid in the UK | Chapter 11 |
| Section 619 | The House of Commons Members' Fund | Chapter 12 |

| | | |
|---|---|---|
| Section 629 | Pre-1973 pensions paid under OPA 1973 | Chapter 14 |
| Section 633 | Voluntary annual payments | Chapter 15 |
| Section 636B | Pensions treated as arising from payment of trivial commutation lump sums and winding-up lump sums under registered pension schemes: | Chapter 15A |
| Section 636C | Pensions treated as arising from payment of trivial commutation lump sum death benefits and winding-up lump sum death benefits under registered pension schemes: | Chapter 15A |

### 21.1.2 *"Taxable pension income" and "Net taxable pension income"*

These terms are defined in s.567 ITEPA. "Net" taxable pension income brings in rules for deductions, not discussed here. The legislation brings pension income into charge by classifying it as "taxable pension income".

## 21.2 UK pension

Section 569 ITEPA provides:

> (1) This section applies to any pension[1] paid by or on behalf of a person who is in the United Kingdom.
> (2) But this section does not apply to a pension if any provision of Chapters 5 to 14 of this Part applies to it.
> (3) For pensions paid by or on behalf of a person who is outside the United Kingdom, see Chapter 4 of this Part.

I refer to this as "**a UK pension**". Section 571 ITEPA provides:

> If section 569 applies, the taxable pension income for a tax year is the full amount of the pension accruing in that year irrespective of when any amount is actually paid.

Thus a UK pension is taxed on an arising basis.

1 "Pension" for the taxation of UK pensions is defined in 570 ITEPA. The definition (perhaps for historic rather than cogent reasons) is different from the definition which applies for foreign pensions, in s.574 ITEPA.

## 21.3 Foreign pension

Section 573 ITEPA provides:

> **Foreign pensions**
> (1) This section applies to any pension[2] 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"**.

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).

The significance of treating the income as RFI is that the income can qualify for the remittance basis.

An arising basis taxpayer is allowed a 10% deduction from foreign 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 remittance basis taxpayer whose pension is taxed on the remittance basis. One relief was thought to suffice; fair enough. The

2 See above fn.

individual may always choose to be taxed under an arising basis.

## 21.4 Canadian RRSP and RRIF

The HMRC view was set out in the former Inspectors Manual:

> **1622. Canadian RRSPs** Published: 9/95
> Canadian Registered Retirement Savings Plans (RRSPs) are tax-deferral vehicles commonly used by taxpayers working in Canada to provide an income or lump sum on retirement. The plan holder is permitted to set aside a certain proportion of his income (on which relief from Canadian tax is received) for investment either directly by the individual or, more usually, through a financial institution such as a bank or insurance company. On retirement or earlier, the taxpayer may withdraw a lump sum from the Plan or roll-over the proceeds into the purchase of an annuity. A lump sum withdrawal is subject to Canadian income tax, but if the proceeds are reinvested in an annuity, only the annuity is taxed.
> The tax consequences for a UK-resident holder of an RRSP are as follows:
> 1) income invested in the Plan is not eligible for UK tax relief;
> 2) the Plan is treated as 'fiscally transparent', that is income arising within the Plan is taxable in the UK as if the Plan did not exist, notwithstanding the tax-free accrual of income in Canada.
> 3) a lump sum withdrawal from the Plan is not taxable as such but the disposal of assets held within the Plan to effect the withdrawal may produce a UK tax charge. For example, a disposal of chargeable assets held within the Plan might produce a capital gains tax charge.
> 4) if an annuity is purchased the non-capital element will be taxable under Case V of Schedule D (see AP896 onwards). A purchased life annuity should be submitted to Financial Institutions Division 1 for determination of the proportion of the annuity which should be regarded as capital.
> 5) Canadian withholding tax at a rate of 25 per cent is deducted from withdrawals made by Plan holders who are not-resident in Canada. No tax credit relief is available in the UK for this tax where a tax charge arises in the UK (see (3) above), because the Canadian tax is imposed on a lump sum withdrawal from the Plan, whereas UK tax is imposed on gains resulting from the disposal of assets held within the Plan.
> 6) under Canadian domestic law, tax at 10 per cent may be withheld from payments of annuities derived from RRSPs, but it is understood that the Canadian tax authorities take the view that where such annuities are paid to UK-residents they will be exempt from Canadian tax under Article 17(1) of the Canada/UK Double Taxation Convention. If a taxpayer claims credit for Canadian tax paid on an annuity he should be advised to seek repayment from Revenue Canada and credit relief will not be allowable in the UK.
>
> **1623. Canadian RRIFs** Published: 9/95
> When an RRSP (see IM1622) matures, the Plan holder may, as an alternative

to withdrawing the funds or buying an annuity, use the property held within the Plan to establish a Registered Retirement Income Fund (RRIF).
An essential feature of an RRIF is that a minimum amount, arrived at by dividing the fair market value of the property held within the Fund at the beginning of the year by the difference between 90 and the age of the Fund holder at the beginning of the year, must be paid out to the investor each year. In this way, cash benefits are provided each year up to age 90. If, in any particular year, additional funds are required, these may be withdrawn, so long as the total does not exceed the value of the property held in connection with the Fund immediately before the withdrawal.
Income arising within an RRIF is tax-free in Canada, but there is a Canadian tax charge on withdrawals from the Fund.
For UK tax purposes, the treatment of RRIFs follows that for RRSPs indicated at IM1622(2), (3) and (5). It is understood that Revenue Canada regards the payments made each year as pension income and treats them as exempt from Canadian tax where paid to a UK-resident, under Article 17(1) of the UK/Canada Double Taxation Convention. The Canadian concept of 'periodic pension income' has no relevance, however, in the UK, where it is the income earned by the Fund's investments which is taxable, while withdrawals do not themselves attract a UK tax charge.

## 21.5 US IRAN

The Inspectors Manual also dealt with US IRANs:

**1625. United States Individual Retirement Annuities** Published: 9/95
Under Individual Retirement Annuities (IRANs), contributions are used to purchase an annuity from a life assurance company. No UK tax liability arises until the annuity becomes payable, when the annuity payments become chargeable under Case V of Schedule D.
If an IRAN life annuity was paid for partly or wholly by an employer, the whole of each annuity payment will be taxed as income, but if there was no employer's contribution the provisions of ICTA, s 656 apply so as to exclude the capital element. Any annuity within ICTA, s 656 should be submitted to Business Tax (Technical) for determination of the capital element.

## 21.6 US Pensions and IRAs

The DTR Manual provides:

**19876. Pensions: US Social Security Act**
...Article 17(3) now specifically provides for exclusive residence-country taxation of social security benefits. Like the old Agreement it provides that payments made by one of the Contracting States under the provisions of its social security or similar legislation to a resident of the other Contracting State will be taxable only in the other Contracting State. The result is precisely the

same as in the old Agreement.

Pensions paid by the United States government to former members of the US armed forces (or to their surviving spouses or dependent children) in respect of their period of service continue to regarded as paid for services rendered to the United States. Such pensions therefore come within Article 19 (Government Service) of the agreement and are exempt from United Kingdom tax unless, exceptionally, the recipient is both a national and a resident of the United Kingdom in which case the pension is taxable only in the United Kingdom

**19876A. Pensions from 2003[October 2007]**

Article 17 in the new Agreement is a fairly standard pensions article, which provides for the taxation of pensions and other similar remuneration only in the state of residence of the beneficial owner. But there are two provisions that have generated particular interest. The new Agreement applies from 1st January 2004 for US taxes and 6th April 2003 for UK Income Tax.

Paragraph 1(a) sets out the general rule above. For this purpose, a payment is treated as a pension or other similar remuneration if it is a payment under a pension scheme, as defined at Article 3(1)(o).

***IRAs***

However, the residence state, under paragraph 1(b), must exempt from tax any amount of such pensions or other similar remuneration that would be exempt from tax in the State in which the pension scheme is established if the recipient were a resident of that State. Thus, for example, a distribution from a US "IRA" to a UK resident will be exempt from tax in the UK to the same extent the distribution would be exempt from tax in the US.

An IRA 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 IRA are tax deductible in the United States and the funds can be invested in a wide range of investments. IRA funds can be withdrawn at any time, but if withdrawals are made before the taxpayer reaches the age of 591/2 he must pay an additional penalty tax of 10% unless he is disabled.

...

***IRAs: Year 2003/04 et seq.***

... The new Agreement takes precedence and this will mean that no liability will arise until it would have done so under US tax law. Under US law, this will be when distributions are made. As indicated above, this will generally not be before age 591/2 but must be before age 701/2. The important point to note is that income will no longer be assessable in the UK on the basis of income arising within the IRA.. Any case of doubt or difficulty should be referred to HMRC, Customs & International, Tax Treaty Team.

***Lump Sums***

Under the old Agreement, a lump-sum payment from a pension scheme was taxable only in the country of residence. So if an individual moved from the US to the UK before receiving a lump sum from a US pension scheme, they would be taxable on the lump sum neither in the US (because of the treaty) nor in the UK (which does not tax lump sums anyway).

The new provision prevents this occurring by providing that a lump-sum payment derived by a resident of one State from a pension scheme established in the other State shall be taxable only in that other State.

The provision preserves the exemption from income tax of a lump sum relevant benefit where it is paid by a UK approved pension scheme to a beneficial owner who is a US resident. However, Article 1(4) will apply in respect of US citizens as the provisions of Article 17(2) are not amongst those listed at Article 1(5). So the US are able to tax lump sums received by US citizens from UK schemes.

**19876B. Pension Contribution**

The new Agreement which applies from 1st January 2004 for US taxes and 6th April 2003 for UK Income Tax contains an Article dealing with pension contributions. It also touches on the taxation of the income, profits and gains accruing to pension schemes.

The term "pension scheme" is defined for the purposes of the treaty at Article 3(1)(o). This means that Treaty benefits are for approved schemes only. As section 615 ICTA 1988 schemes, which are UK established trusts for non-residents, are not approved they do not come within the definition of "pension scheme" in Article 3(1)(o) because they are not "generally exempt from income taxation in that State". They are therefore not included in the list in the Exchange of Notes.

So called US section 401(k) plans are included within the definition of a pension scheme as they are within the definition of a pension scheme in Article 3(1)(o) because they are a type of section 401(a) plan.

It is a feature of several UK treaties from 2003 onwards that pension contributions made in one country are recognised for tax purposes in the other. The general premise of these is that if a member of a pension scheme established in one country goes to work (as an employee or in a self-employed capacity) in the other country, the state of residence will not tax the scheme member on income earned by the scheme unless it is paid to him (or for his benefit). Nor will tax be payable if income is transferred to another pension scheme until the benefits are actually received.

Under the new Agreement, contributions to the scheme by that member (or those paid on his behalf) will be tax-deductible in the state of residence. In the same way, benefits accrued under the scheme, or employer contributions to the scheme, will not be treated as part of his taxable income and those contributions will be tax-deductible for the employer. The reliefs available cannot exceed those allowed by the state of residence for contributions of the same amount to a scheme established in the state of residence.

The conditions for getting the relief are as follows

- contributions were made by or on behalf of the individual or (in the case of an employee) his employer to the pension scheme (or to a similar scheme for which it was substituted) before the individual began to exercise an employment or self-employment in the other contracting state, and
- the competent authority of the other State agrees that the pension scheme generally corresponds to a pension scheme established in that other State.

Where someone comes to work in the UK we will regard the first condition as

having been met if the individual was a member of the US scheme before beginning to exercise an employment or self-employment in the UK.
The types of scheme that would be accepted as "generally corresponding" are those listed in the Exchange of Notes.
Relief will be restricted where contributions to a pension scheme are deductible or excludable in computing a person's taxable income in the host country if he is subject to tax there not on his total income but only on amounts remitted to that country. Relief is available only on a corresponding proportion of the pension contributions.

*An example*

| | |
|---|---|
| Individual's total income, profits and gains | £100,000 |
| Income, profits and gains remitted to the UK | £90,000 |
| Individual's contributions to US pension scheme | £5,000 |

Contributions deductible in computing individual's UK taxable income - £4,500 (i.e. 90% of individual's total contributions).

CHAPTER TWENTY TWO

# DISCRETIONARY TRUSTS: INCOME TAX

## 22.1 Discretionary trusts – introduction

This chapter is concerned with the income taxation of discretionary trusts. The topic requires a book to itself. This chapter focuses on the matters closest to the theme of this work but it is necessary to review the general rules to understand these matters in their context.

In outline, there are three tiers of IT charges.

*Tier (1): Charge on trustees on the receipt of income.*

At this tier it is necessary to distinguish resident and non-resident trustees:

(a) UK resident trustees charged on all their income

(b) Non-resident trustees charged on UK source income only.

*Tier (2): Charge on trustees on making a discretionary income payment.*

At this tier it is also necessary to distinguish resident and non-resident trustees:

(a) UK resident trustees pay this charge.

(b) Non-resident trustees do not pay this charge.

*Tier (3): Charge on beneficiaries on receiving a discretionary income payment.*

At this tier it is necessary to distinguish resident and non-resident beneficiaries:

(a) UK resident beneficiaries: charge on all trust income

(b) Non-resident beneficiaries: charge on UK source trust income (ie UK resident trusts) only.

Two sets of tax credits (more or less) eliminate the triple taxation which would otherwise result.

(1) Tax paid at tier (1) enters a "tax pool" and is allowed as a credit for the tax at tier (2) so that no additional tax may be paid at that tier. I refer to this as **"the trustees tax pool credit"**.

(2) The tax at tier (2) is a credit for the tax at tier (3), and beneficiaries who are not top rate taxpayers or who are entitled to some reliefs may reclaim this tax. I refer to this as **"the beneficiary's tax credit"**.

Where the trustees tax pool credit fails to provide relief, there are further statutory and concessionary reliefs.

I use the term **"discretionary income payment"** to refer to a payment made from a trust to a beneficiary at the discretion of trustees, which is income (not capital) in the hands of the beneficiary. The statutory term is "discretionary payment" (it is assumed, though not expressly stated, that the payment has an income nature).

Section 462 ITA provides an overview of the layout of the legislation:

> (1) This Part [part 9 ITA] sets out special rules about settlements and trustees.
> (2) Chapter 2 contains general provision about settlements and trustees, for example, definitions of expressions relating to settlements.
> (3) Chapter 3 provides for income tax to be charged at the dividend trust rate or at the trust rate on certain amounts included in the net income of the trustees of a settlement.
> (4) Chapter 4 provides—
> (a) for expenses of the trustees of a settlement to be set against the trustees' trust rate income (see section 463(2)), and
> (b) consequentially, for the amount of the trust rate income to be reduced.
> (5) Chapter 5 qualifies section 479 (which is in Chapter 3) in the case of the trustees of an approved share incentive plan.
> (6) Chapter 6 provides that the first slice of the trust rate income of the trustees of a settlement is not to be charged at the dividend trust rate or at the trust rate.
> (7) Chapter 7 deals with the treatment of payments made by the trustees of a settlement in the exercise of a discretion ...

I do not consider trustees expenses (chapters 4 and 8), share incentive plans (chapter 5) or the relief for the first (small) slice of income (chapter 6). I do not consider the position of corporate beneficiaries.

In this chapter when I refer to a trust, I am referring to a discretionary trust, and assume that the trust is not settlor-interested (or if it is, that s.624 does not apply).

## 22.2 Tier 1: charge on trustees on receipt of income

There are special rules, primarily dealing with the rates of tax on trusts. However the charge on receipt of income arises under the usual charging provisions: there is no special charging provision for trusts. Accordingly:
(1) UK trustees are subject to tax on all their income
(2) Non-resident trustees are subject to tax on UK source income (except so far as non-residents income tax relief is available).
The trustees can qualify for the usual reliefs. Insofar as non-resident trustees qualify for reliefs, the position is straightforward, but if UK trustees qualify for (for instance) DT reliefs[1] this affects the tax pool credit system, which therefore has to be supplemented with further reliefs.

### 22.2.1 *Accumulated or discretionary income*

The TSE Manual provides a rough summary:

> **3015 Amount of trust income chargeable** [November 2008]
> Trustees are chargeable at the basic rate on trust income without any deduction for trust management expenses.
> Accumulation or discretionary trust
> If the trust is within Section 479 ITA, the trustees are liable to tax at the special trust rates. These are the dividend trust rate in respect of dividend type income and the trust rate in respect of other income. TSEM3020 explains which trusts are within Section 479 ITA.
> The amount of trust income chargeable at the special trust rates is the gross trust income, minus the total of:
> [a] income which before distribution ranks as the income, for tax purposes, of a person other than the trustees
> [b] for years to and including 2005-06 only income which is treated, for any purposes of the Taxes Act, as that of the settlor (from 6 April 2006 the exemption for settlor- interested settlements to the special trust rates no longer applies) and
> [c] allowable trust management expenses (TSEM8300+).

Section 479 ITA provides:

> (1) This section applies if—

1 See 22.12 (Are discretionary trusts "beneficial owners" for DTA purposes?)

> (a) accumulated or discretionary income arises to the trustees of a settlement, and
> (b) the income does not arise under a trust established for charitable purposes only.
> (2) Income tax is charged on the income at the rates referred to in this section instead of at the rates which would otherwise apply (for which see Chapter 2 of Part 2 (rates at which income tax is charged)).
> (3) Income tax is charged on the income at the dividend trust rate so far as the income is dividend income.
> (4) Otherwise, income tax is charged on the income at the trust rate.

The rates are the top income tax rates (the Blair/Brown administration disapproved of trusts). For 2011/12, s.9 ITA provides:

> (1) The trust rate is 50%.
> (2) The dividend trust rate is 42.5%.

The key term is "accumulated or discretionary income". Section 480 ITA provides:

> (1) Income is accumulated or discretionary income so far as—
> (a) it must be accumulated, or
> (b) it is payable at the discretion of the trustees or any other person,
> and it is not excluded by subsection (3).
> (2) The cases covered by subsection (1)(b) include cases where the trustees have, or any other person has, any discretion over one or more of the following matters—
> (a) whether, or the extent to which, the income is to be accumulated,
> (b) the persons to whom the income is to be paid, and
> (c) how much of the income is to be paid to any person.

This covers common form discretionary trusts.

### 22.2.2 *Exception for settlor-interested trusts*

Section 480 continues with 3 exceptions of which only the first is relevant here. Section 480(3) ITA provides:

> Income is excluded for the purposes of subsection (1) so far as—
> (a) before being distributed, it is the income of any person other than the trustees...

I would have thought that this applies to the income of settlor-interested trusts so far as s.624 ITTOIA applies, but HMRC do not agree: see TSE Manual quoted above at [b].

### 22.2.3 *Other income taxed at top rates*

Section 481 ITA provides:

> (1) This section applies if—
> (a) the trustees of a settlement are liable for income tax on an amount of a type set out in section 482,
> (b) the trustees are not trustees of a unit trust scheme, and
> (c) the amount is not income arising under a trust established for charitable purposes only.
> (2) Income tax is charged on the amount at one of the rates referred to in this section instead of at the rate which would otherwise apply (for which see Chapter 2 of Part 2 (rates at which income tax is charged)). This is subject to subsection (5).
> (3) If the amount is within Type 1 as set out in section 482, income tax is charged on the amount at the dividend trust rate.
> (4) Otherwise, income tax is charged on the amount at the trust rate.

This applies to all trusts, IP as well as discretionary, but it is convenient to deal with it here. Section 481 continues with 4 exceptions:

> (5) Income tax is not to be charged as mentioned in subsection (2) so far as the amount—
> (a) is accumulated or discretionary income,
> (b) would be accumulated or discretionary income apart from section 480(3)(a) or (c), or
> (c) is income from property within subsection (6).
> (6) Property is within this subsection if it is held for the purposes of a superannuation fund to which section 615(3) of ICTA (superannuation funds relating to undertakings outside the UK) applies.

Section 482 specifies 11 types of income, mostly fairly exotic categories, which constitute capital for trust purposes but income for tax purposes:

> The types of amount referred to in section 481 are as follows.
> *Type 1* A payment—

(a) which is made to the trustees or to which the trustees are entitled, and
(b) which is made by way of qualifying distribution by a company on the redemption, repayment or purchase of shares in the company or on the purchase of rights to acquire such shares.
*Type 2* Accrued income profits treated as made by the trustees under section 628(5) or 630(2).
*Type 3* Income treated as arising to the trustees under regulation 17 of the Offshore Funds (Tax) Regulations 2009.
*Type 4* Income which the trustees are treated as receiving under section 68(2) or 71(4) of FA 1989 (which relate to employee share ownership trusts).
*Type 5* A sum to which Chapter 4 of Part 3 of ITTOIA 2005 (which provides for certain amounts to be treated as receipts of a property business) applies.
*Type 6* A profit in relation to which the trustees are liable for income tax under section 429 of ITTOIA 2005 (profits from deeply discounted securities).
*Type 7* A gain in relation to which the trustees are liable for income tax under section 467 of ITTOIA 2005 (gains from contracts for life insurance etc), other than a gain to which subsection (7) of that section applies.
*Type 8* A profit or gain in relation to which the trustees are liable for income tax under section 554 of ITTOIA 2005 (transactions in deposits).
*Type 9* A profit or gain—
(a) in relation to which the trustees are liable for income tax under section 557 of ITTOIA 2005 (disposals of futures and options), and
(b) which does not meet any of conditions A to C in section 568 of ITTOIA 2005.
*Type 10* Proceeds in relation to which the trustees are liable for income tax under section 573 of ITTOIA 2005 (sales of foreign dividend coupons).
*Type 11* Income treated as arising to the trustees under Chapter 3 of Part 13 of this Act (tax avoidance: transactions in land).

## 22.3 Tier 3: Discretionary income payment: charge on beneficiary

Section 683(1) ITTOIA imposes the tax charge on discretionary income payments:

> 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. ...

"Annual payment" is an opaque label for a technical term whose meaning is discussed in a large and in parts difficult body of case law.[2] It is not necessary to discuss that here, as it is well established that income payments from discretionary trusts are annual payments and so are charged under this section.

### 22.3.1 *Beneficiary a remittance basis taxpayer*

Section 684 ITTOIA provides:

> (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).

This brings in the ITA remittance basis if the income payments have a foreign source.

### 22.3.2 *Non-resident beneficiary*

Section 577 ITTOIA provides the necessary exemption for non-residents:

> (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...

The wording is the same as the equivalent exemption for savings and investment income, in part 4 ITTOIA; for a discussion see 16.4 (Why does location of source matter?).

### 22.3.3 *Discretionary trust payment: what is the source?*

Where the trust is a common form discretionary trust and a beneficiary

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2 Section 683(3) ITTOIA provides one statutory rule: "The frequency with which payments are made is ignored in determining whether they are annual payments for the purposes of this Chapter."
ITTOIA EN explains: Subsection (3) rewrites "or whether the same is received and payable half-yearly or at any shorter or more distant periods".

receives trust income in the exercise of the trustees' discretion, the trust is the source (not the underlying trust assets) and the beneficiary's income is categorised as annual payments (regardless of the type of income received by the trustees). See *Memec v IRC* 71 TC 77 at p.95:

> A discretionary trust ... is not transparent. No beneficiary is entitled unless and until the trustees exercise their discretion in his or her favour, and the trustees' exercise of discretion is regarded as ... creating a new source of income...[3]

HMRC agree. The TSE Manual provides:

> **3756. Individual beneficiary receives discretionary income payment from a resident trust: trust not settlor-interested** [February 2011]
> In the case of trusts or settlements that are not settor-interested a discretionary income payment is treated as an amount that is net of tax at the trust rate. The beneficiary's income is the net amount grossed at the trust rate applicable. It carries tax credit at that rate. It is available for relief or repayment.
> The gross amount is an annual payment. It is a new source of income, usually not identified with the underlying trust income. *Cunard's Trustees v CIR* (27 TC 122) supported the view that when the trustees exercised their discretion, a new source of income came into existence.

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3 The same point was made in *IRC v Berrill* 55 TC 429 at p.444.
Robert Venables QC disagrees: Venables, "*Memec v IRC* and the Source of Discretionary Income Payments from Trusts" PTPR (1999) Vol. 7 p.87; *Non-Resident Trusts*, (8th ed 2000), 16.3 (Taxation of Beneficiary):

> "Where there are discretionary trusts of income ...and the trustees distribute income in the exercise of their discretion, the taxability of the recipient beneficiary is a matter of some controversy. My own opinion is that in exercising their discretion the trustees simply perfect the settlor's gift so that the position at the end of the day is the same as if the trust instrument had expressly provided that the beneficiary should receive the income. Thus, the income which the beneficiary receives is the same income as that which the trustees received, the beneficiary's source is the same as the trustees' source and any tax paid by the trustees is to be treated as having been paid on account of the beneficiary."

This was assumed to be correct in *Drummond v Collins* 6 TC 525 though the point was not directly considered. Before 1973 this view was (I think) generally held though the point was not formally decided. However the FA 1973, imposing the additional rate of tax (now chapter 7 part 9 ITA), clearly assumes that a discretionary trust is a separate source, and so provides a statutory basis (if needed) to support the view that discretionary trusts are not transparent.

…

If a discretionary trust becomes interest in possession in form, the trustees' discretion over income in principle comes to an end and the source has ceased: *IRC v Berrill* at p.444. But the cessation of a source is not now significant for tax purposes.

In *Memec*, Walker LJ also considers annuities:

> Similarly, the rights of an annuitant under a trust are regarded as a source of income distinct from that of the underlying trust investments.[4]

However annuities are not now found, so this is of academic interest only.

### 22.3.4 *Discretionary trust payment: location of source*

Where the trust is the source, how does one decide its location? There are (as usual) a variety of possible connecting factors, including: the residence of the trustees, the country in whose courts the trust will be enforced, the place where the discretion is exercised. It is suggested that trustee residence is the deciding factor, and this is consistent with s.493(1)(b) ITA. Normally all these factors will point the same way so the issue will not arise.

### 22.3.5 *Time income arises*

The TSE Manual provides:

> **3759. Beneficiary receives discretionary payment from a resident trust: when payment made** [November 2008]
> For tax purposes the beneficiary receives a payment on
> • The date the trustees made the payment or
> • The date the beneficiary became legally entitled to require the trustees to pay over the income. This could be when the payment indefeasibly vested, following the trustees' resolution.
> Tax cases: *Cunard's Trustees v CIR* 27 TC 122

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

### 22.3.6 *Entering discretionary trust income in beneficiary's tax return*

HMRC Helpsheet 262 (2010/11) provides:

> If you have received a discretionary payment from the non-UK resident trust, enter all of the income in box 41 unless the situation mentioned in the next paragraph applies. ...
> If part or all of the income distribution has already been charged to tax in the UK on the settlor of the trust, see page TN 1 of the Trusts etc. notes. Instead of entering the amount so charged in box 41 include it in the Trusts etc. pages in box 2. Tax equivalent to 40% of this sum is allowable as a non-payable tax credit. If you are the settlor and already chargeable on the income arising to the trustees, there is no need to include in box 41 or box 2 on the Trusts etc. pages any discretionary payments made to you by the trustees. The amount to be entered either in box 41 or in box 2 of the Trusts etc. pages should take account of the effects of your residence/domicile status.

## 22.4 Beneficiaries tax credit

### 22.4.1 *UK resident trusts*

The tax credit is in s.494 ITA, which is introduced by s.493 ITA:

> (1) Sections 494 and 495 apply for income tax purposes if—
> (a) in a tax year the trustees of a settlement make an annual payment to a person ('the beneficiary') in the exercise of a discretion (whether exercisable by the trustees or any other person),
> (b) the trustees are UK resident for the tax year, and
> (c) condition A or condition B is met.

The usual case is condition A. Section 493(2) ITA provides:

> Condition A is that what is paid to the beneficiary is, only because of the payment, income of the beneficiary for income tax or corporation tax purposes. 'Income' does not include employment income.

Condition B relates to payments to minor children of the settlor,[5] a topic not considered here.

Section 494 ITA provides the beneficiaries tax credit and grossing up. Grossing up comes first:

> (1) The discretionary payment is treated as if it were made after the deduction of a sum representing income tax at the trust rate on the grossed up amount of the discretionary payment.
> (2) The grossed up amount of the discretionary payment is the actual amount of the discretionary payment grossed up by reference to the trust rate.

Then the beneficiaries tax credit:

> (3) The person mentioned in subsection (4) is treated as having paid income tax of an amount equal to the sum deducted as mentioned in subsection (1).
> (4) That person is—
> (a) if condition A in section 493 is met, the beneficiary, and
> (b) if condition B in section 493 is met, the settlor.

Condition B (payments to minor children of the settlor) is not considered here.

### 22.4.2 *Non-resident trusts*

The beneficiary's tax credit (along with the tier 2 charge on trustees) only apply if the trustees are UK resident: s.493(1)(b) ITA.

EN ITA Change 89 provides:

> This change makes it explicit that the Chapter dealing with the taxation of discretionary payments by trustees applies only to payments made and tax suffered while the trustees are UK resident.
> Section 687 of ICTA contains rules regarding the liabilities of the trustees and the beneficiary when the trustees make a payment to a

5 Section 494(3) ITA provides: "Condition B is that the payment is treated for income tax purposes as the income of a settlor under section 629 of ITTOIA 2005 (income paid to relevant children of settlor)."

beneficiary in the exercise of a discretion. The rules can only operate sensibly where the payment is chargeable on the beneficiary as an annual payment under Chapter 7 of Part 5 of ITTOIA and it is well established that those provisions only apply where the payment arises in the UK.

The question can arise as to whether that test is satisfied in cases where UK resident trustees exercise discretion abroad or non-UK resident trustees exercise discretion in the UK. The approach adopted in practice is that section 687 of ICTA applies only to payments by UK resident trustees. Accordingly, section 493 contains the condition that it only applies to UK resident trustees. It follows that where a payment is made by non-UK resident trustees:

- the payment does not carry any tax credit in the hands of the beneficiary; and
- the trustees are not liable for any tax in respect of the payment.

As a corollary to the provisions of section 687 of ICTA not applying to non-UK resident trustees, tax only enters the trustees' tax pool if it is tax suffered on income arising while the trustees are UK resident - see section 497.

This change does not affect the operation of ESC B18, which enables UK resident beneficiaries who receive discretionary payments to have a credit for the tax paid by non-UK resident trustees on UK source income.

## 22.5 Tier 2: Charge on trustees making discretionary income payment

Section 496 ITA provides the charge on trustees:

(1) Income tax is charged for a tax year if—

(a) in the tax year the trustees of a settlement make payments as a result of which income tax is treated as having been paid under section 494, and

(b) amount A is greater than amount B.

(2) Amount A is the total amount of the income tax treated under section 494 as having been paid.

(3) Amount B is the amount of the trustees' tax pool available for the tax year (see section 497).

(4) The amount of the tax charged under this section is equal to the difference between amounts A and B.

(5) The trustees are liable for the tax.

## 22.6 Trustees tax pool credit

Section 497(1) ITA deals with the trustees' tax pool:

> Take the following steps to calculate the amount of the trustees' tax pool available for a tax year ('the current tax year').
> This is subject to subsections (2) and (3).
> *Step 1* Take the amount of the trustees' tax pool available for the previous tax year and deduct from that amount (but not so that it goes below nil)—
> (a) the total amount of income tax treated under section 494 as having been paid as a result of payments made by the trustees in the previous tax year, and
> (b) the amount to which the trustees are entitled under section 496B in respect of the previous tax year.
> *Step 2* Add together all amounts of income tax for which the trustees are liable for the current tax year and which are of a type set out in section 498.
> *Step 3* Add the sum calculated at Step 2 to the amount resulting from Step 1.

Section 497(2)(3) ITA deal with the special cases of immigrant trusts and new trusts:

> (2) If the trustees were non-UK resident for the previous tax year, references in subsection (1) to the previous tax year are to be read as references to the last tax year prior to the current tax year for which the trustees were UK resident.
> (3) If—
> (a) the current tax year is the tax year during which the settlement is established, or
> (b) the trustees have been UK resident for no tax year prior to the current tax year,
> ignore Steps 1 and 3 and, accordingly, the trustees' tax pool available for the current tax year is the sum calculated at Step 2.

Section 498 ITA provides the list of types of income which qualify fall within the tax pool. It is in short all the tax paid by the trustees. In full detail:

(1) The types of amount referred to at Step 2 in section 497 are as follows.
*Type 1* The amount of any tax on income (other than income of a kind mentioned below in relation to Type 2, 3 or 3A) charged at the dividend trust rate or at the trust rate.
*Type 2* The amount of tax at the nominal rate on any income which is—
(a) chargeable under Chapter 3 of Part 4 of ITTOIA 2005 (dividends etc from UK resident companies),
(b) chargeable under Chapter 5 of that Part (stock dividends from UK resident companies), or
(c) chargeable under Chapter 6 of that Part (release of loan to participator in close company),
and on which tax is charged at the dividend trust rate as a result of section 479.
*Type 3* The amount of tax at the nominal rate on any income on which tax is charged at the dividend trust rate as a result of section 481.
*Type 3A* The amount of tax at the nominal rate on any amount in respect of which—
(a) the trustees are liable to income tax under section 467 of ITTOIA 2005 (gains from contracts for life insurance etc),
(b) the trustees are liable to income tax at the trust rate by virtue of section 482 above, and
(c) tax at the basic rate is treated as having been paid by virtue of section 530 of ITTOIA 2005 (life insurance).
*Type 4* The amount of any tax on income on which tax is charged at the basic rate …2 as a result of section 491.
*Type 5* The amount of tax on any income determined in accordance with section 26 of FA 2005 (special tax treatment for trusts for the benefit of vulnerable persons).
(2) In relation to Types 2 and 3, references to the nominal rate are references to a rate equal to the difference between the dividend trust rate and the dividend ordinary rate.
(2A) In relation to Type 3A, the reference to the nominal rate is a reference to a rate equal to the difference between the trust rate and the basic rate.
(3) In relation to Types 1 to 4, references to income do not include income the tax on which is reduced in accordance with section 26 of FA 2005.

## 22.6.1 *Effect of trustees DTA relief on tax pool*

The TSE manual provides:

**3670 Discretionary trust** [March 2009]
These instructions apply to taxed overseas income received by a discretionary or accumulation trust. The trustees can claim double taxation relief in respect of overseas tax that qualifies for relief. The trustee's marginal rate is the rate applicable to trusts, or where it applies, the dividend trust rate. INTM367780+ onwards has instructions about calculating relief.
A paying agent may have allowed provisional tax credit relief on overseas income. The computation of double taxation relief must reflect this.
Tax pool
The Section 687 ICTA 1988 tax pool must contain only UK tax paid or suffered by deduction. It must not include UK tax covered by credit for overseas tax.
Section 687(3)(a) ICTA 1988 effectively withdraws the double taxation relief when the trustees make a discretionary payment to a beneficiary.

### 22.6.2 *Transitional rule for pre-2008 income*

ITA 2007 Sch 2 para 104 provides:

(1) Section 497 applies with the following modifications in relation to the trustees of a settlement established prior to the tax year 2007–08 if the current tax year is the tax year 2007–08.
(2) It also so applies if—
(a) the current tax year is a tax year subsequent to the tax year 2007–08, and
(b) the trustees have been UK resident for no tax year prior to the current tax year or the last tax year prior to the current tax year for which they were UK resident is a tax year prior to the tax year 2007–08.
(3) It applies as if in subsection (1) for Step 1 there were substituted—
'Step 1
Take the amount of the trustees' final section 687(3) tax pool and deduct from that amount (but not so that it goes below nil) the total of all tax (if any) treated under section 687(2)(a) of ICTA as being paid as a result of payments made by the trustees in the tax year 2006–07.
'The amount of the trustees' final section 687(3) tax pool' is the total amount—
(a) available to the trustees under section 687(3) of ICTA for setting against tax assessable on them under section 687(2)(b) of that Act for the tax year 2006–07, or

(b) which would have been so available had tax been so assessable.'
(4) It applies as if subsections (2) and (3) were omitted.

## 22.7 HMRC example

The TSE Manual provides an example:

**3024B. The tax pool - trustees calculate maximum discretionary payment** [August 2010]
In this example, in the tax year 2010-2011 a trustee of a discretionary trust receives a net dividend of £1,350 (tax credit £150. The trustee is chargeable at 42.5%, which is partly covered by the 10% non-payable tax credit.

| **Description** | **Amount** | **Amount** | **Amount** |
|---|---|---|---|
| Dividend received | £1,350 | | |
| Plus non-payable tax credit | £150 | | |
| Gross income | £1,500 | | |
| Tax at 10% on first £1,000 (standard rate band) | | £100 | |
| Tax at 42.5% on the remainder (£500×42.5% | | £212.50 | |
| Total tax | | £312.50 | |
| Less non-payable tax credit | | (£150) | |
| Tax payable by trustee - goes into tax pool | | £162.50 | |
| Net income after tax | | | £1187.50 |

The trustee now has net income of £1,187.50 (net dividend of £1,350 less tax paid of £162.50). Only £162.50 of the total tax goes into the tax pool because the £150 dividend tax credit is not payable.
If the trustee pays the net income of £1,187.50 to the beneficiary, the tax credit of 50% on that net payment is £1,187.50 (gross amount of £2,375 at 50%). But if the tax pool has nothing brought forward from the previous year and there is no other income on which tax has been paid, the tax pool of £162.50 will not cover the tax credit of £1,187.50 on the payment made. Under Section 496 the trustee would have to pay £1,187.50 less £162.50 = £1,025, bur there are no funds available.
Instead, the trustees can calculate the maximum amount of discretionary payment as follows:-

| Description | Amount | Amount |
|---|---|---|
| Net income after tax | £1,187.50 | |
| Add tax in tax pool | £162.50 | |
| Total amount to cover payment to beneficiary & tax credit at 50% | £1,350.00 | |
| Tax credit at 50% | £675.00 | £675.00 |
| Less tax paid in tax pool | | £162.50 |
| Additional tax to be paid by trustee | | £512.50 |
| Net payment to beneficiary | £675.00 | |

The beneficiary is paid net income of £675 with a tax credit of £675, which is equivalent to gross income of £1,350 with tax credit at 50%. The trustee pays a total of £675 tax to HMRC, £162.50 tax on the dividend received and the additional £512.50 under Section 496. So if the trustee is relying on the dividend income to fund both the payment to the beneficiary and the additional tax there are sufficient funds to release only 50% of the actual dividend, that is £1,350×50% = £675.

HMRC also offer an online tax pool calculator to do the computations, in simple cases: *www.hmrc.gov.uk/tools/trusts/calculator.htm*.

## 22.8 Payment from discretionary trust: income or capital?

The question whether a trust distribution is an "annual payment" (ie, income) or not (ie, capital) matters for many purposes. In particular:

(1) The IT charge on a beneficiary receiving the distribution (tier 3) only applies if the distribution is income.
(2) The IT charge on trustees making the distribution (tier 2) only applies if the distribution is income.
(3) Section 87 and section 731 only apply if the distribution is capital.

The position depends on the terms of the power under which the payment is made.

### 22.8.1 *Power over income*

A common form discretionary trust[6] provides this type of power over trust income:

6 For a discussion of the drafting, see Kessler & Sartin, *Drafting Trusts & Will Trusts* (10th ed., 2010), Chap 15 (Discretionary Trusts).

> 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.

### 22.8.2 *Power over capital*

A common form discretionary trust also provides this type of power over trust capital:

> The Trustees may pay or apply the capital of the Trust Fund to or for the advancement or benefit of any Beneficiary.

If trustees make a payment under such a power the receipt is capital and not income. This is still the case even if:
(1) the payments are made to satisfy an "income purpose", eg maintenance of a beneficiary; and
(2) the payments are recurrent (eg annual or even monthly).
This follows from *Stevenson v Wishart*.[7]

### 22.8.3 *Accumulated income paid out as income*

A common form discretionary trust allows trustees to accumulate income, and add it to trust capital. However, trustees usually have power "to apply the accumulations as if they were income arising in the then current year". If trustees make a payment out of trust capital under such a power the receipt is an income receipt of the beneficiary. The important point is that the terms of the relevant provision of the settlement link the payment with an income interest of a beneficiary. See the comment of Knox J in *Stevenson v Wishart* 59 TC 740 at 757D.

It might perhaps be clearer if the trust accounts recorded an

7 59 TC 740. The judgment of Knox J is clearer on this point than the Court of Appeal; this view is adopted in *Pierce v Wood* [2010] WTLR 253 at [29] "An appointment or advance of trust capital, in exercise of a power over capital, even if it were to meet an income need of the beneficiary, is normally a capital receipt in the beneficiary's hands."

"Accumulated Income Fund" (instead of recording accumulated income as increasing the capital fund). However, this is not necessary.

### 22.8.4 *Accumulated income paid out as capital*

Suppose, lastly:

(1) trustees accumulate income and add it to capital; and

(2) the trustees pay that capital to a beneficiary in exercise of a power like that in para 22.8.2 (Power over capital).

The receipt is still capital and not income. This follows from *Stevenson v Wishart.* In that case the distributions which HMRC sought to tax as income represented original trust capital and not accumulated income. It is considered that this makes no difference. *Stevenson v Wishart* is authority for the proposition that the income/capital question is governed by the terms of the power concerned.[8]

It might be different in an extreme case, where for tax planning reasons there was an arrangement under which:

(1) income was accumulated;

(2) the trustees pay that capital to a beneficiary (by exercise of a common form power of advancement or appointment) shortly afterwards.

HMRC would have an attractive argument that the receipt should be regarded as income under general principles (or under the rule in *Furniss v Dawson* but it would not be necessary to fall back on that).

In practice it should be possible to avoid this by ensuring that advances of capital are not neatly identifiable with accumulated income.

### 22.8.5 *HMRC view*

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

> **3758. Discretionary payment from trust capital** [January 2008]
> A discretionary payment made out of trust capital, including a payment out of accumulated income or out of a capital receipt that is deemed to be income for tax purposes, is usually not regarded as the income of the beneficiary. This view was supported in the case of *Stevenson v Wishart*

8 Provisions such as ss.631(1)(2) and 633 ITTOIA assume this is correct (deeming payments out of accumulated income to be treated as income).

> (59 TC 740).[9]

The same point is made in the HMRC Trust & Estate Tax Return Guide (form SA950) for the year ended 5 April 2010:

> **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.

## 22.9 Discretionary trusts treated as transparent to allow beneficiary reliefs

In some cases discretionary trusts are treated as transparent in order to confer some relief.

### 22.9.1 *DT relief for UK resident discretionary trust*

Section 111 TIOPA provides:

> **When payment to beneficiary treated as arising from foreign source**
> (1) Subsection (6) applies if each of conditions A to D is met.
> (2) Condition A is that a payment is made by trustees of a settlement.
> (3) Condition B is that income tax is treated under section 494 of ITA 2007 (treatment of discretionary payments by trustees) as having been paid in relation to the payment.

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9 For completeness: the Manual continues:
"Exceptionally, payments out of capital are treated as the income of the beneficiary where, by the terms of the trust instrument, payments out of capital are required to be made, or may be made, in order to supplement income. For example, the trustees may or have to make income up to a fixed amount or a certain defined level as in *Cunard's Trustees v CIR* (27 TC 122)"
This is correct but academic since trusts are not nowadays drafted in those terms.

This restricts the relief to UK resident trusts.[10]

> (4) Condition C is that the income arising under the settlement includes taxed overseas income.[11]
> (5) Condition D is that the trustees certify—
> (a) that the payment is one made out of income consisting of, or including, taxed overseas income of an amount, and from a source, stated in the certificate, and
> (b) that that amount of taxed overseas income arose to the trustees not earlier than 6 years before the end of the tax year in which the payment is made.

Where these conditions are satisfied, s.111(6) TIOPA provides the relief:

> The person to whom the payment is made may claim that the payment, up to the certified amount, is to be treated for the purposes of this Part [Part 2 TIOPA headed Double Taxation Relief] as income received by the person—
> (a) from the certified source, and
> (b) in the tax year in which the payment is made.

The TSE Manual provides:

> **3675. Relief for overseas tax: expenses of discretionary trust**
> If trustees are claiming relief for overseas tax they will usually regard expenses as paid out of UK income. This means they can certify the overseas income to the beneficiaries under s.809 ICTA (TSEM3680).
> They may sometimes regard expenses as paid from overseas income. This could be because there is not sufficient UK income to cover the expenses. Or maybe certification is not advantageous to the beneficiary. Trustees cannot certify, under s.809, the overseas income they set against the expenses.
> **3680. Trustee's certificate of overseas taxed income**
> The income of a discretionary or accumulation trust may include overseas taxed income. The trustees can certify that discretionary payments they made to beneficiaries included income from the taxed

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10 See 22.4 (Beneficiaries tax credit).

11 This term is defined in s.111(7) TIOPA: "In this section "taxed overseas income", in relation to a settlement, means income in respect of which the trustees are entitled to credit under this Part for tax under the law of a territory outside the UK."

overseas sources. The certificate must state how much of the payment refers to the overseas income. Trustees issue the certificates under the provisions of s.809(1)(b) ICTA. There is no prescribed wording for the certificate.

Limits of the amounts certified

The trustees must ensure that:

- the amounts they certify do not exceed the gross equivalent of the payments they made
- the gross amounts they certify do not exceed, in the aggregate, the gross income they received.

Trustees can accumulate, for future certification, overseas income that they have not paid out. Income ceases to be available for certification six years after the start of the tax year in which it arose.

**3685. Relief for overseas tax: mixed trust**

A mixed trust has both a discretionary interest and an interest in possession.

The trustees may claim double taxation relief in respect of overseas tax that qualifies for relief. The instructions at TSEM3655 apply to income that the beneficiary is entitled to receive. The instructions at TSEM3670 apply to the balance of the income.

### 22.9.2 *Concessionary relief for UK resident trust*

ESC B18 provides:

**UK resident trusts**

A beneficiary may receive from trustees a payment to which [what is now s.494(1) ITA] applies.[12] Where that payment is made out of the income of the trustees in respect of which, had it been received directly, the beneficiary would—

[1] have been entitled to exemption in respect of FOTRA securities issued in accordance with [what is now s.714 ITTOIA]; or

[2] have been entitled to relief under the terms of a double taxation agreement; or

[3] not have been chargeable to UK tax because of their not resident and/or not ordinarily resident status

the beneficiary may claim that exemption or relief or, where the beneficiary would not have been chargeable, repayment of the tax

12 This reference restricts the relief to UK resident trusts. See 22.4 (Beneficiaries tax credit).

treated as deducted from the payment (or an appropriate proportion of it).

For this purpose, the payment will be treated as having been made rateably out of all sources of income arising to the trustees on a last in first out basis.

There are three distinct classes of reliefs here:

(1) Relief for interest on FOTRA securities (beneficiary not ordinarily resident)
(2) DTA relief (beneficiary treaty-resident outside the UK)[13]
(3) Exemptions for non-resident beneficiary

ESC B18 goes on to specify the conditions for the relief:

> Relief or exemption, as appropriate, will be granted to the extent that the payment is out of income which arose to the trustees not earlier than six years before the end of the year of assessment in which the payment was made, provided the trustees—
> [1] have made trust returns giving details of all sources of trust income and payments made to beneficiaries for each and every year for which they are required, and
> [2] have paid all tax due, and any interest, surcharges and penalties arising; and
> [3] keep available for inspection any relevant tax certificates.
> 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 received the payment from the trustees.

The INT Manual expands on B18 and provides a worked example. The Manual is not up to date, and in example tax rates are those before the increase to the 50% rate in 2010/11; I omit text referring to the position before 2004.

> **367790. What methods of relief are available on discretionary payments from UK resident trustees** [April 2004]
> The way in which relief is calculated will depend on the terms of the treaty under which relief is claimed.
> - Under an "other income" article which does not exclude payments from trusts, relief is given in full....

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13 But s.111 TIOPA covers this.

- Where there is no other income article or the article excludes trust income, relief is given by "looking through" to the underlying sources of the income. The way in which we "look through" is determined by Extra Statutory Concession (ESC) B18
- Because payments are made at the discretion of trustees, it is not possible to allow relief at source to a beneficiary of a discretionary trust.

...

**367820. Extra Statutory Concession B18** [March 2007]

Under ESC/B18, income underlying a discretionary payment is treated as arising from the sources of income received by the trustees in the tax year that the payment is made. Income is considered as arising rateably from the sources of income. By rateably we mean the beneficiary's payment contains the same proportion of each strand of income as the total received by the trustees.

If there is not enough income arising in the year the payment is made to fund all of the payments made by the trustees (that is, if the trustees are drawing on accumulations – that is, income received by trustees in excess of payments out of trust income – made in previous years) we need to apply the proportions of trustees' income from the year(s) in which the accumulations were made. This is known as "spreading back" (see INTM367910).

**367830. ESC/B18 and dividends taxed at the dividend trust rate** [March 2007]

When the Schedule F trust rate (now the dividend trust rate) was introduced in 1999/2000 at 25%, the wording of ESC/B18 was revised to exclude the element of tax credit included in that tax. For example, where trustees receive a dividend of £90, with a tax credit of £10, their liability is £15 (that is, £25 less £10 tax credit). However, when applying a beneficiary's share of dividends to a dividend article of a treaty, the tax credit is excluded from the calculation. Therefore for the purposes of ESC/B18, the 'gross' to which the restriction in the dividend article is applied is £90, the tax £15, and the net £75.

A dividend article with a 15% restriction would apply to the dividend element underlying a beneficiary's distribution as follows:

- Restriction: £90 × 15% = £13.50
- Tax £15 less restriction £13.50 = £1.50

**367840. ESC/B18 and trustees' tax returns** [March 2007]

It is a condition of ESC/B18 that in order to allow a beneficiary's claim to repayment, the trustees must have made their tax return for the year of the distribution, and paid over any tax due to HMRC.

It is therefore possible that a beneficiary's claim form can be received before the conditions of ESC/B18 are satisfied.

**367850. ESC/B18 and Self Assessment** [April 2004]

As the conditions for relief under ESC/B18 include actions by trustees, we do not consider a claim as being valid until these actions have been carried out. We cannot accept that the beneficiary has made a valid claim until the trustees have met the conditions set out in ESC/B18.

In practical terms this means that a beneficiary's claim is not valid until the trustees have sent in their tax return for the year in which the distribution was made and paid any tax due.

**367860. Dealing with claims by non-resident beneficiaries of UK discretionary trusts under ESC/B18** [March 2007]

***How to identify a repayment claim***

The claim will usually be supported by a tax certificate on form R185, or an equivalent certificate prepared by the payer, showing tax deducted from the payment at 40%...

If the tax certificate is missing, the schedule will show that tax on the income is at 40% ...

Exceptionally, you may receive a claim on a payment from a UK discretionary trust where tax is not shown as having been paid at the Rate Applicable to Trusts (see INTM367950).

***Procedure***

You will need to request the trust file (the UTR for this should be quoted on the tax certificate) together with the trustees' tax return for the year of the distribution and all earlier years in date for time limit purposes during the year of distribution (you will need these if a 'spreadback' calculation is necessary).

You will need to advise the claimant or their agent that you have requested information from the trust's tax office to enable you to deal with the claim.

**367870. Calculating relief due under ESC/B18** [July 2005]

When the trust file is received the information concerning trust income and distributions provided by the trustees in their returns is extracted and used to calculate the relief due to the beneficiary.

Due to the complexity of the calculations, a computer program is used to apportion the trust income to the beneficiary's share.

(This text has been withheld because of exemptions in the Freedom of Information Act 2000)

If necessary a calculation can be made manually (INTM367890).

**367880. How to manually calculate relief due under ESC/B18** [March 2007]

Although the apportionment of the income will normally be performed using a computer program, if necessary the calculation can be performed manually, as follows:

1. Deduct any expenses and other obligations, for example Trust Management Expenses (see INTM367920) and annuities (see INTM367770), from the income received by the trustees.
2. For each income source (after deductions at 1 above) calculate the net amount available for distribution, that is the amount after deduction of tax at the rate applicable to trusts or the dividend trust rate as appropriate.
3. Calculate the total net distribution made to the discretionary beneficiaries.
4. Check that the total net distribution made to the discretionary beneficiaries is less than (or equal to) the total net available for distribution. If it is greater than the total net available for distribution, you will need to apply a 'spreadback' calculation (see INTM367910).
5. Allocate the net amount of each source of income arising to the trustees to the beneficiary's net distribution, by the following formula (each source of income must be treated separately because of the different tax rates to which the trust income is subjected):

(a ÷ b) × c =beneficiary's share of income source, where

- a = net income from source
- b = total income available to distribute
- c = beneficiary's net distribution

6. Calculate the beneficiary's gross share of each income source by reference to ESC/B18. For UK dividends the calculation for 2004–05 onwards is

(a ÷ 67.5) × 90 = beneficiary's gross share of dividends for the purposes of ESC/B18, where

- a = beneficiary's share of dividends

...

For other income (including foreign dividends) the calculation for 2004–05 onwards is

(a ÷ 60) × 100 = beneficiary's gross share of dividends for the purposes of ESC/B18, where

- a = beneficiary's share of income

...

7. Calculate the tax applying to each income source under ESC/B18 by deducting the net (calculated at 4) from the gross (calculated at 5).

8. Calculate the repayment due by reference to the relevant treaty articles, and/or UK legislation allowing relief to non-residents. Where repayment is restricted under a double taxation agreement, calculate the amount to restrict as a percentage of the ESC/B18 gross (calculated at 5) and deduct it from the tax (calculated at 6).

**367890. T applications and claims: Non-resident beneficiaries of UK trusts**
[March 2007]

***Example of a manual calculation under ESC/B18***

In the tax year 2004–2005 a trust had income from the sources shown below (gross except for dividends paid). The trustees made net distributions of £1000 each to one beneficiary in Canada (who has made a claim to us) and to one beneficiary in the UK. [Trust income is:]

- UK dividends paid £1292
- UK interest £1000
- Rents £500
- Foreign dividends £880
- Foreign interest £1000

Trustees net management expenses were £500

First, deduct trust management expenses from dividends: 1292 less 500 = 792

Then calculate income available for distribution:

| | |
|---|---|
| Dividends | 792 |
| plus (tax credit at one ninth of the dividend) | 88 |
| less (dividend trust rate 25%) | (220) |
| | 660 |

| | |
|---|---|
| Interest | 1000 |
| less (tax at rate applicable to trusts 34%) | (340) |
| | 660 |

| | |
|---|---|
| Rents | 500 |
| less (tax at rate applicable to trusts 34%) | (170) |
| | 330 |

| | |
|---|---|
| Foreign dividends | 880 |
| less (tax at dividend trust rate 25%) | (220) |
| | 660 |

| | |
|---|---|
| Foreign interest | 1000 |
| less (tax at rate applicable to trusts 34%) | (340) |
| | 660 |

Total available for distribution: 2970

Distribution: (2 × 1000) = 2000; this is less than the total available for distribution, so no spreadback required

Allocation to beneficiary:

Dividends: (660 ÷ 2970) × 1000 = 222.22
Interest: (660 ÷ 2970) × 1000 = 222.22
Rents: (330 ÷ 2970) × 1000 = 111.11
Foreign dividends: (660 ÷ 2970) × 1000 = 222.22
Foreign interest: (660 ÷ 2970) × 1000 = 222.22

Grossing up and deducting net to find tax attributable under ESC/B18:

Dividends: (222.22 ÷ 75) × 90 = 266.66 – 222.22 = tax 44.44
Interest: (222.22 ÷ 66) × 100 = 336.70 – 222.22 = tax 114.48
Rents: (there is actually no need to calculate this, as there is no relief, but the calculation would be as follows)
(111.11 ÷ 66) × 100 = 168.35 – 111.11 = tax 57.24
Foreign dividends: (222.22 ÷ 66) × 100 = 336.70 – 222.22 = tax 114.48
Foreign interest: (222.22 ÷ 66) × 100 = 336.70 – 222.22 = tax 114.48

***Calculating the repayment due***

In this example the claimant is claiming under the Double Taxation Convention with Canada on dividends and interest, and under UK legislation applying to non-residents on foreign income. Under the treaty there is a 15% restriction on dividends and a 10% restriction on interest.

| | | |
|---|---|---|
| Dividends: Gross 266.64 × 15% = 40 restriction | Tax 44.44 less 40 = | 4.44 |
| Interest: Gross 336.70 × 10% = 33.67 restriction | Tax 114.48 less 33.67 = | 81.21 |
| Foreign dividends: Gross 336.70 | Tax | 114.48 |
| Foreign interest: Gross 336.70 | Tax | 114.48 |
| Total repayment | | 314.61 |

This text has been withheld because of exemptions in the Freedom of Information Act 2000.

**367900. Notes on types of underlying income in a discretionary trust** [March 2007]

UK dividends: includes stock dividends.

UK interest

Dividends and interest are the most common types of income that you will see in discretionary trusts. With the exception of UK dividends, all of the tax associated with a particular source is considered for the purposes of ESC/B18 to be tax on that source. You may also see:

– Foreign income: relief is given under domestic legislation. Although foreign dividends are taxed in the hands of the trustees at the dividend trust rate of 32.5% ... the beneficiary is treated as having been taxed at 40% ....
– Rental income: there are no double taxation agreements that allow relief to individuals on rental income. No repayment is due on any part of the tax applicable to rental income.
– Accrued income: income returned under the ‘accrued income’ scheme cannot be relieved under double taxation agreements.
– Royalties: these are unusual in discretionary trusts. Relief is given at the appropriate agreement rate.
– FOTRA securities: you may be considering relief under an agreement which has an interest article that restricts relief. However, income shown on the trust return as interest may be derived from FOTRA securities on which full relief is available to non-residents. As there is no indication in the trust return that income is derived from FOTRA securities, you will not usually be able to consider repayment on this as a separate source from interest. However, if there is any indication of the amount of FOTRA securities in the papers submitted with the return, or in figures originating from the trustees and provided by the claimant or their agent, you should use these to allow relief on the FOTRA securities.

**367910. What happens if the total net distributed in a year exceeds the total net available for distribution (‘overdistribution’)** [June 2004]

It the trustees have distributed more money in one year than is available to distribute from the income received in that year, you will need to analyse the balance from undistributed income arising in earlier years.

This is known as a ‘spreadback’ calculation. The income arising in earlier years can be analysed using the trust report program.

When spreading back we start with the most recent year in which income has been accumulated. If the trustees have over-distributed in earlier years we may have already made a spreadback calculation and used income accumulated in an earlier year. It is important that we do not use that accumulation again in the current spreadback. You cannot go back more than six years before the year in which the distribution was made. So if the trustees have made an excess distribution in 2003/04 you can only go back to 1998/99. But you only go back to accumulations made in that year if you have used up all the income accumulated in 2002/03, then 2001/02 and so on. The residence position of the beneficiary in the year(s) that the income was accumulated is not relevant.

## 22.9.3 *Confidentiality*

The INT Manual provides:

**367630. Claims by non-resident beneficiaries of non-resident discretionary trusts** [March 2007]

...

*Confidentiality when advising a beneficiary or agent about a payment*

A beneficiary of a discretionary trust has no rights against the income of the trust. Trustees may favour one potential beneficiary rather than another. Therefore, to provide information to a beneficiary about the income of a trust that you have used to calculate relief due under ESC/B18 will infringe the confidentiality of the trustees.

Because of this we cannot provide a breakdown of the underlying income comprising the repayment. The claimant (and their agent) only has a right to the final figure of the repayment we have calculated. However, if the beneficiary obtains the written permission of a trustee we can release information concerning the underlying trust income.

Sometimes a trustee will act as the nominated agent of the beneficiary. In that case you can release details of the computation to the trustee without seeking further written permission. If you are providing this information, you will need to show a full calculation. If the original apportionment of income was calculated using the computer program, you will need to make a full manual calculation (see INTM367890).

### 22.9.4 *Disclosure of ESC B18 claim on tax return*

HMRC Helpsheet 262 (2010/11) provides:

> If you wish to make a claim under Extra Statutory Concession B18, you should phone HMRC CAR Trusts & Estates Nottingham on 0845 604 6455. In addition, you should advise your tax office that you are making a claim under Extra Statutory Concession B18 and, in the 'Any other information' box of your tax return, enter details of the name of the trust from which the income payment was received and the tax reference of the trust

It is not clear why more than a note in the tax return "other information" box is needed.

## 22.10 ESC B18 relief for non-resident trust

ESC B18 provides:

> **Non-resident trusts**
> A similar concession will operate where a beneficiary receives a payment from discretionary trustees which is not within [what is now s.494(1) ITA] (ie where non-resident trustees exercise their discretion outside the UK).
> [1] Where a non-resident beneficiary receives such a payment out of income of the trustees in respect of which, had it been received directly, it would have been chargeable to UK tax, then the beneficiary—
> [a] may claim relief under s.278 ICTA (personal reliefs for certain non-residents); and
> [b] may be treated as receiving that payment from a UK resident trust but claim credit only for UK tax actually paid by the trustees on income out of which the payment is made.
> [c] The beneficiary may also claim exemption from tax in respect of FOTRA securities issued in accordance with [what is now s.714 ITTOIA] to the extent that the payment is regarded as including interest from such securities.
> [2] A UK beneficiary of a non-resident trust may claim appropriate credit for tax actually paid by the trustees on the income out of which the payment is made as if the payments out of UK income were from a UK resident trust and within s.687(1) ICTA.

There are three distinct sets of reliefs here:
(1) Personal reliefs for non-resident beneficiaries.
(2) Credit for tax paid by the trust as if the trust were UK resident; this only applies if the trust wishes to comply with UK tax requirements and pay trust rate tax on UK source income.
(3) Relief for interest on FOTRA securities: I suspect that this is in practice academic, though strictly it applies if:
 (a) the trust receives income from FOTRA securities;
 (b) the trustees are outside the FOTRA exemption for trustees;[14]
 (c) the income is paid to a beneficiary who is not ordinarily UK resident and so is within the FOTRA exemption; and
 (d) the trust wishes to comply with UK tax requirements.

ESC B18 goes on to specify the conditions for the relief, which are similar to the conditions for UK resident trusts:

14 Because there are UK beneficiaries: see 18.6.2 (Discretionary trust).

This treatment will only be available where the trustees—

– have made trust returns giving details of all sources of trust income and payments made to beneficiaries 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.

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 received the payment from the trustees.

No credit will be given for UK tax treated as paid on income received by the trustees which would not be available for set off under s 687(2) if that section applied, and that tax is not repayable (for example on dividends). However, such tax is not taken into account in calculating the gross income treated as taxable on the beneficiary under this concession.

### 22.10.1 *Who makes the claim?*

After considering the case of a settlor-interested trust[15] the International Manual continues:

> **339550. Claims by non-resident trustees of discretionary trusts** [March 2007]
> You may receive a claim or application from non-resident trustees of a discretionary trust. ...
> ***What to do if one or more beneficiaries of the trust has a residential address in the UK***
> If the completed form 4467(trustee)/FD shows any beneficiaries with UK residential addresses, Technical Advice Group will refer the papers to CNR (Non-resident trusts) in Bootle, who will consider whether the trustees will need to make UK tax returns. Any claims will need to be made by the non-resident beneficiaries under ESC/B18 (see INTM367630).
> ***What to do if all of the beneficiaries are resident in the same country as the trustees and the settlor of the trust is excluded from benefit***
> If all of the beneficiaries of the trust are resident in the same country as the trustees and the settlor of the trust is excluded from benefit, you can

15 See 50.11.3 (Settlor treaty-resident outside the UK).

allow relief to the trustees.

## 22.11 UK trust - non resident beneficiary: DTA relief

### 22.11.1 *DTAs with OECD model "other income" article*

SP 3/86 provides:

> **Payments to a non-resident from UK discretionary trusts or UK estates during the administration period: double taxation relief**
> **Introduction**
> 1 This statement explains how relief from UK tax under double taxation agreements will be given in respect of payments made to a non-resident [from] a UK discretionary trust or a UK estate.
> **Background**
> ***Discretionary trusts***
> 2 Generally speaking, a non-resident beneficiary receiving payments from a UK discretionary trust is not entitled to repayment of the tax paid by the trustees on the trust income. However, under concession B18 (which embodies a longstanding practice) HMRC 'looks through' the trust income to the underlying component parts of that income. The purpose of this 'looking through' is to allow the recipient of the income any relief that would have been available to him under the Taxes Acts had the income come to him direct instead of through the trustees.
> 3 Where the beneficiary is resident in a country with which the UK has a double taxation agreement, further relief under the 'looking through' principle may be due. Thus, for example, if the agreement provides for a withholding rate on interest of 15 per cent and interest liable to UK tax formed part of the trust income which had suffered tax at 40 per cent (ie the rate applicable to trusts) then, under the 'looking through' principle, the beneficiary would be repaid the amount of tax suffered in excess of the withholding rate, in this case 25 per cent.
> 4 Some of the UK's double taxation agreements include an 'other income' Article. The purpose of this Article is to determine in which country income not expressly dealt with elsewhere in the agreement should be taxed. In the UK's agreement the article sometimes gives sole taxing rights in respect of such income to the recipient's country of residence.

It is in fact standard OECD model form to give sole taxing rights in respect of such income to the recipient's country of residence. OECD

Model Article 21(1) provides:

> Items of income of a resident of a Contracting State, wherever arising, not dealt with in the foregoing Articles of this Convention shall be taxable only in that State.

This wording would apply to income from a discretionary trust.

> 5 It has been the practice of HMRC to apply the 'looking through' principle to all cases where relief in respect of the discretionary payment was sought and to refuse claims where full repayment of UK tax was claimed under the provision of [the] 'other income' Article in the agreement.
>
> [Para 6 deals with estates: see 68.17 (Non-resident beneficiary of UK estate: DTA relief).]
>
> **Change of practice**
>
> 7 Following a review of their practice in these two areas, HMRC have accepted that if a payment made by trustees out of a UK discretionary trust falls to be treated as a net amount in accordance with TA 1988 s 687(2) [now s.494 ITA], the 'looking through' principle is not appropriate where the beneficiary is resident in a country with which the UK has a double taxation agreement and the 'other income' Article gives sole taxing rights in respect of such income to that country. (This will usually be the case where income from trusts is not specifically excluded from the Article.) This means that tax paid by the trustees in respect of the discretionary payment will be repayable to the beneficiary, provided that any conditions set out in the 'other income' Article are met. For example, the recipient may be required to show that he is subject to tax on the income in his country of residence.
>
> 8 [this deals with estates]
>
> 9 Where the 'other income' Article does not give sole taxing rights to the country of residence in respect of the trust or estate income or there is no double taxation agreement with the country concerned, the existing 'looking through' practice will continue to be applied where it is to the advantage of the beneficiary.

The DTAs which confer relief under the "other income" article on discretionary payments made by UK resident trustees are mostly the older generation of treaties. I think the reason is that before 1973, discretionary trusts were regarded as transparent, so distributed income of discretionary trust was not regarded as falling under the "other income" article.[16] DTAs made from the 1980's onwards usually exclude trust and estate income from the "other income" article. However not all new DTAs do this (eg Hungary, 2007; was that an oversight or intended, and if so, why?)

The International Manual sets out a list of the countries whose DTAs provide relief for discretionary payments made by UK resident trustees. It is not however up to date and for convenience I divide it into two parts:

> **INTM367800 - DT applications and claims: Non-resident beneficiaries of UK trusts**
> **DTAs where relief is available under the 'other income' article on discretionary payments made by UK resident trustees** [March 2007]
>
> The DTTs which currently confer relief under the "other income" article on discretionary payments made by UK resident trustees are:
>
> Austria
> Barbados
> Bosnia Herzegovina*
> Portugal
> Romania
> Croatia*
> Egypt
> Hungary
> Ivory Coast
> Israel
> Jamaica
> Kenya
> Montenegro*
> Morocco
> Namibia
> Serbia*
> Spain
> Sudan
> Swaziland
> Tunisia
> Zambia

* Bosnia-Herzegovina, Croatia, Montenegro, Serbia: relief is given under the terms of the old UK/Yugoslavia DTT: see SP 3/07.
In the following former USSR states, DTT relief ceased in 2002: Armenia, Belarus, Georgia, Kyrgyzstan, Lithuania, Moldova, Tajikistan, Turkmenistan; see SP 4/01 [2002] STI 32.

The following countries are still mentioned in the INT Manual list but should be deleted following new treaties (date of treaty in brackets):

16 See 22.3.3 (Discretionary trust payment: what is the source?).

France (2008, in force, 2010)
Germany (2010, in force 2011)
Macedonia (2007)
Poland (2006)
Slovenia (2007)
South Africa (2002)

### 22.11.2 *DTAs with restrictions on "other income" article*

UK DTAs from the 1980's onwards mostly exclude trust and estate income from the "other income" article. Art 23(1) of the France/UK DTA is typical:

> Items of income beneficially owned by a resident of a Contracting State, wherever arising, which are not dealt with in the foregoing Articles of this Convention, *other than income paid out of trusts or the estates of deceased persons in the course of administration,* shall be taxable only in that State.

This leaves relief to be claimed under ESC B18.[17]

Interestingly, the new UK/Germany treaty (2010) deals with the point expressly. Article 21 provides:

> 1) Items of income beneficially owned by a resident of a Contracting State, wherever arising, which are not dealt with in the foregoing Articles of this Convention shall be taxable only in that State.
> 2) Notwithstanding the provisions of paragraph 1, the following provisions shall apply with respect to income paid out of trusts or the estates of deceased persons in the course of administration:
> Where such income is paid to a beneficiary who is a resident of Germany

17 The US/UK DTA has this exclusion and the Exchange of Notes on that DTA comments:"With reference to paragraph 1 of Article 22 (Other income) - it is understood that the purpose of the exclusion from the paragraph for income paid out of trusts or the estates of deceased persons in the course of administration is to allow a recipient of such income the relief that would have been available to him under the provisions of the Convention had they received the income direct instead of through the trust or estate." More accurately, the purpose is to prevent the recipient of such income from receiving *more than* the relief that would have been available to a person under the provisions of the Convention and ESC B18 had they received the income direct instead of through the trust or estate. But it comes to the same thing.

> by trustees or personal representatives who are residents of the UK out of income received by those trustees or personal representatives which would, if those trustees or personal representatives had been residents of Germany, have fallen within other Articles of this Convention, the beneficiary shall be treated as having received an amount of the income received by the trustees or personal representatives corresponding to the income received by him and any tax paid by the trustees or personal representatives on that amount shall be treated as having been paid by the beneficiary.

Why? Presumably the German authorities do not like German residents to be taxed by law and untaxed by HMRC extra-statutory concessions such as ESC B18 and A14. Those who believe that tax law should be statutory and not concessionary will say: quite right too.

It is curious that the present campaign to legislate ESCs, which has legislated many trivial ESCs, has not covered the important ESC B18. No explanation has been given, so it is tempting to speculate. Perhaps it has been filed as too difficult; perhaps HMRC are planning changes to the law; perhaps legislation will come eventually.

## 22.12 Are discretionary trusts "beneficial owners" for DTA purposes?

### 22.12.1 *Meaning(s) of "beneficial ownership"*

The expression "beneficial ownership" has (at least) three possible meanings:

(1) The English law/trust law meaning, where it may be contrasted with bare legal ownership and is synonymous with equitable ownership.[18]
(2) An international tax law meaning, in the context of DTAs.
(3) A meaning (or set of meanings) in the context of money laundering.[19]

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18 See 53.5 (Beneficial ownership of FOTRA securities). This is not of course to say that the expression always has this meaning in English statutes, as the context governs the sense.

19 See (1) reg.6 Money Laundering Regulations 2007 (Meaning of beneficial owner). This is too long to set out in full, but it includes "the class of persons in whose main interest the trust is set up or operates."
(2) The Glossary to the Financial Action Task Force's 40 Recommendations defines beneficial owner as: "the natural person(s) who ultimately owns or controls a customer and/or the person on whose behalf a transaction is being conducted. It also incorporates those persons who exercise ultimate effective control over a legal person

These are all quite distinct and discussion of the meaning in one context has almost no relevance to the meaning in other contexts. It would have been better to have three distinct expressions, but the usages are now far too well established to alter that, and the context will generally show which meaning is intended.

A full discussion would require three long chapters.

## 22.12.2 *Discretionary trusts: beneficial owners for DTA purposes*

Relief under DTAs is frequently limited to the beneficial owner.

It is clear that the trustees are the "beneficial owner" of income of a discretionary trust in the DTA sense and so can qualify for DT relief.

The OECD are at present consulting on a revised commentary which will make this clearer. The proposed commentary is as follows (the point is made in the footnote but the entire passage is important):

> **Commentary on Article 10 (Dividends)**
> 12. The requirement of beneficial owner was introduced in paragraph 1 of Article 10 to clarify the meaning of the words "paid ... to a resident" as they are used in paragraph 1 of the Article. It makes plain that the State of source is not obliged to give up taxing rights over dividend income merely because that income was paid direct to a resident of a State with which the State of source had concluded a convention.
> 12.1 Since the term "beneficial owner" was added to address potential difficulties arising from the use of the words "paid to ... a resident" in paragraph 1, it was intended to be interpreted in this context and not to refer to any technical meaning that it could have had under the domestic law of a specific country (in fact, when it was added to the paragraph, the term did not have a precise meaning in the law of many countries). The term "beneficial owner" is therefore not used in a narrow technical sense (such as the meaning that it has

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or arrangement." See *www.fatf-gafi.org/glossary/0,3414,en_32250379_32236930_35433764_1_1_1_1,00.html#34276864*.

(3) OECD "Behind the Corporate Veil: Using Corporate Entities for Illicit Purposes", (2001) *www.oecd.org/dataoecd/0/3/43703185.pdf*, p.14 has a related definition: In this Report, "beneficial ownership" refers to ultimate beneficial ownership or interest by a natural person. In some situations, uncovering the beneficial owner may involve piercing through various intermediary entities and/or individuals until the true owner who is a natural person is found. With respect to corporations, ownership is held by shareholders or members. In partnerships, interests are held by general and limited partners. In trusts and foundations, beneficial ownership refers to beneficiaries, which may also include the settlor or founder."

under the trust law of many common law countries[20]), rather, it should be understood in its context, in particular in relation to the words "paid … to a resident", and in light of the object and purposes of the Convention, including avoiding double taxation and the prevention of fiscal evasion and avoidance. This does not mean, however, that the domestic law meaning of "beneficial owner" is automatically irrelevant for the interpretation of that term in the context of the Article: that domestic law meaning is applicable to the extent that it is consistent with the general guidance included in this Commentary.

12.12 Where an item of income is paid to a resident of a Contracting State acting in the capacity of agent or nominee it would be inconsistent with the object and purpose of the Convention for the State of source to grant relief or exemption merely on account of the status of the direct recipient of the income as a resident of the other Contracting State. The direct recipient of the income in this situation qualifies as a resident but no potential double taxation arises as a consequence of that status since the recipient is not treated as the owner of the income for tax purposes in the State of residence.

12.3 It would be equally inconsistent with the object and purpose of the Convention for the State of source to grant relief or exemption where a resident of a Contracting State, otherwise than through an agency or nominee relationship, simply acts as a conduit for another person who in fact receives the benefit of the income concerned. For these reasons, the report from the Committee on Fiscal Affairs entitled "Double Taxation Conventions and the Use of Conduit Companies"concludes that a conduit company cannot normally be regarded as the beneficial owner if, though the formal owner, it has, as a practical matter, very narrow powers which render it, in relation to the income concerned, a mere fiduciary or administrator acting on account of the interested parties.

12.4 In these various examples (agent, nominee, conduit company acting as a fiduciary or administrator), the recipient of the dividend is not the "beneficial owner" because that recipient does not have the full right to use and enjoy the dividend that it receives and this dividend is not its own; the powers of that recipient over that dividend are indeed constrained in that the recipient is obliged (because of a contractual, fiduciary or other duty) to pass the payment received to another person. The recipient of a dividend is the "beneficial owner" of that dividend where he has the full right to use and enjoy the dividend unconstrained by a contractual or legal obligation to pass the payment received to another person. Such an obligation will normally derive from relevant legal documents but may also be found to exist on the basis of facts and circumstances showing that, in substance, the recipient clearly does not have the full right to use and enjoy the dividend; also, the use and enjoyment of a dividend must be

20 [Footnote original] For example, where the trustees of a discretionary trust do not distribute dividends earned during a given period, these trustees, acting in their capacity as such (or the trust, if recognised as a separate taxpayer), could constitute the beneficial owners of such income for the purposes of Article 10 notwithstanding that the relevant trust law might distinguish between legal and beneficial ownership.

distinguished from the legal ownership, as well as the use and enjoyment, of the shares on which the dividend is paid.
12.5 The fact that the recipient of a dividend is considered to be the beneficial owner of that dividend does not mean, however, that the limitation of tax provided for by paragraph 2 must automatically be granted. This limitation of tax should not be granted in cases of abuse of this provision (see also paragraphs 17 and 22 below). As explained in the section on "Improper use of the Convention" in the Commentary on Article 1, there are many ways of addressing conduit company and, more generally, treaty shopping situations. These include specific treaty anti-abuse provisions, general anti-abuse rules and substance-over-form or economic substance approaches. Whilst the concept of "beneficial owner" deals with some forms of tax avoidance (i.e. those involving the interposition of a recipient who is obliged to pass the dividend to someone else), it does not deal with other cases of treaty shopping and must not, therefore, be considered as restricting in any way the application of other approaches to addressing such cases.
12.6 The above explanations concerning the meaning of "beneficial owner" make it clear that the meaning given to this term in the context of the Article must be distinguished from the different meaning that has been given to that term in the context of other instruments1that concern the determination of the persons (typically the individuals) that exercise ultimate control over entities or assets. That different meaning of "beneficial owner" cannot be applied in the context of the Article. Indeed, that meaning, which refers to natural persons (i.e. individuals), cannot be reconciled with the express wording of subparagraph 2 a), which refers to the situation where a company is the beneficial owner of a dividend. Since, in the context of Article 10, the term beneficial owner is intended to address difficulties arising from the use of the word "paid" in relation to dividends, it would be inappropriate to consider a meaning developed in order to refer to the individuals who exercise "ultimate effective control over a legal person or arrangement"....
12.7 Subject to other conditions imposed by the Article, the limitation of tax in the State of source remains available when an intermediary, such as an agent or nominee located in a Contracting State or in a third State, is interposed between the beneficiary and the payer but the beneficial owner is a resident of the other Contracting State (the text of the Model was amended in 1995 to clarify this point, which has been the consistent position of all Member countries). States which wish to make this more explicit are free to do so during bilateral negotiations.[21]

See "Beneficial Ownership and the OECD Model" [2001] BTR 27; [2006] BTR at p.747; Prebble, "Trusts and Double Taxation Agreements"

21 OECD, "Clarification of the Meaning of "Beneficial Owner" in the Oecd Model Tax Convention Discussion Draft", (29 April 2011) accessible *www.oecd.org/dataoecd/49/35/47643872.pdf.*

ejournal of Tax Research (2004) vol 2 no 2 p192, accessible *www.atax.unsw.edu.au/ejtr/content/issues/previous/paper3_v2n2.pdf*; OECD, "Report of the Informal Consultative Group on the Taxation of Collective Investment Vehicles" (2009) Annex 1: Background Regarding the Meaning of "Beneficial Owner" in Tax Treaties, accessible *www.oecd.org/dataoecd/34/26/41974553.pdf*.

CHAPTER TWENTY THREE

# IP TRUSTS: INCOME TAX

## 23.1 Taxation of life tenant

### 23.1.1 *What is source of income of beneficiary?*

The life tenant is of course subject to tax on income received from the trust if it is UK source income or if the life tenant is UK resident. For this purpose it is necessary to identify the source. The choice is between:
(1) regarding the trust as the source of trust income; or
(2) regarding the trust assets as the source, in which case one "looks through" the trust and it is described as "transparent".[1]
The answer depends on the terms of the trust, construed in accordance with the proper law of the trust.

Similar issues arise for unit trust income, see 35.1 (Unit Trusts).

### 23.1.2 *England and other "Baker" jurisdictions*

The source of the life tenant's 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.[2] In other words, an IP trust is transparent for IT purposes.

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1 See 72.1.1 ("Transparent" and "opaque").

2 *Baker v Archer-Shee* 11 TC 749. This issue has given rise to considerable academic debate ever since the House of Lords reached its 3:2 decision in *Baker*. See Waters, "The Nature of the Trust Beneficiary's Interest" (1967) 45 Can Bar Rev 219; Schabe, "The Trust Conduit Principle: A Foundationless Theory?" [1999] JlATax 17 accessible *www.austlii.edu.au/au/journals/JATax/1999/17.html*.

Rather surprisingly, this applies even if the life interest is subject to an annuity: *Nelson v Adamson* 24 TC 36. But in practice annuities are not used so the point is only of academic interest.

For completeness: it has been suggested, tentatively and *obiter,* that this does not apply to trading income, at least for the purposes of DTAs;[3] however there is no sound basis for that distinction and the correct view is that the transparency principle applies generally.

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 them "a balance" of net income.[4] Then the trust (not the underlying assets) will be the source. In practice this is not normally done.[5]

### 23.1.3 *New York and other "Garland" jurisdictions*

Common form interest in possession type trusts governed by some foreign trust laws 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 and the beneficiary's income is classified as an annual payment (regardless of the type of income arising to the trustee).

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.

### 23.1.4 *Scots trusts*

It is generally accepted that a liferent (a scottish equivalent of a life

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3 *R on the application of Huitson v HMRC* 2010] STC 715 at [54]. The point was not considered on appeal, see [2011] EWCA Civ 893. At the time of writing it remains to be seen if the case goes on to the supreme court.

4 *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.

5 Except perhaps unit trusts: see 35.3 (Unauthorised unit trust: foreign trustees).

interest) under a Scots trust in common form is not transparent.[6]

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

> (1) This section applies if—
> (a) income arises to trustees under a trust having effect under the law of Scotland,
> (b) the trustees are UK resident, and
> (c) a beneficiary under the trust ("B") would have an equitable right in possession to the income if the trust had effect under the law of England and Wales.
> (2) B is treated for income tax purposes as having an equitable right in possession to the income (even though B has no such right under the law of Scotland).

It is difficult to see why the statutory rule only applies to UK resident trusts. It is difficult to see why it applies to Scotland and not other *Garland* jurisdictions. The reason is that it is not part of a coherent regime for the taxation of trusts but a late Finance Bill amendment to deal with a narrow domestic anomaly.[7] In practice it will not often matter.

One can create a transparent Scots law trust with appropriate wording.[8]

### 23.1.5 *Commentary*

The UK rules strictly require one to ask whether every trust jurisdiction is:
(1) a *Baker* jurisdiction (where the life tenant of a standard form IP trust

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6 "There is no difference between the law of Scotland as regards the beneficiary's rights and the law which is admitted in the record to be the law of the State of New York." *Inland Revenue v Clark's Trustees* [1939] SC 11 at p.24 accessible *www.kessler.co.uk* approved by Lord Fraser in *Leedale v Lewis* 56 TC at p.538. See too Discussion Paper on the Nature and the Constitution of Trusts para 2.5:

> "The beneficiary has a … right to compel the trustee to administer the trust funds in accordance with the provisions of the declaration of trust. This is a personal right. It is axiomatic that in Scots law the beneficiaries do not have a real right or a quasi-real right in the trust property. They have no proprietary interest in the trust fund."

Scottish Law Commission 2006 accessible *www.scotlawcom.gov.uk*.

7 See Discussion Paper on Apportionment of Receipts and Outgoings para 4.5, Scottish Law Commission, 2003, accessible *www.scotlawcom.gov.uk/download_file/view/49/*.

8 "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.

has a right to income as it arises); or

(2) a *Garland* jurisdiction (where the life tenant only has a right against the trustee).

That is a somewhat metaphysical question as it is difficult to pin down any practical consequence (other than tax) which arises from the answer.

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 concession. This could be done quite easily by extending s.464 ITA to apply to all *Garland* trusts.

### 23.1.6 *Credit for tax paid by trustees*

The TSE Manual provides:

> **3762. Beneficiary entitled to trust income - mandated income** [February 2011]
> Sometimes the trustees mandate trust income to a beneficiary. If the trustees mandate income to a beneficiary, it means that the beneficiary receives it and the trustees do not. So in such a case there is no statutory basis (see TSEM3761) for taxing the trustees as being in receipt of the income. The beneficiary both receives the income and is entitled to it.
> The trustees exclude the income from the Trust and Estate Tax Return, even if it is untaxed. The beneficiary's trust income is
> • a share of the net taxed income as calculated on normal basis, and
> • the gross amount of untaxed income directly chargeable on him.
> The beneficiary (or, where the settlor has retained an interest, the settlor) includes the income on his personal return.
> **3763. Beneficiary entitled to trust income - grossing up** [November 2006]
> If the trustees receive income that is taxed at source, or if they pay tax on it under self assessment, the beneficiary will receive a net amount. But he or she is entitled to the gross amount. Consequently he or she is taxable on the gross amount.
> For example, the trustees have gross bank interest of £1,000 on which tax is deducted at source £200.They pay £800 to the beneficiary. The beneficiary is entitled to the gross amount £1,000, and is taxable on that amount.
> **3764. Beneficiary entitled to trust income - credit for trustees' tax** [February 2011]
> If the trustees have paid tax or have received income with tax taken off, the beneficiary is given credit for that tax.

For example, in 2009-10 the trustees have gross rental income of £2,000 on which they pay tax £400. They pay £1,600 to the beneficiary. The beneficiary is entitled to the gross amount £2,000, and is taxable on that amount. He or she is given credit for the £400 tax paid by the trustees. If the beneficiary is a higher rate taxpayer, he or she will have further tax to pay see example in TSEM3765. If the beneficiary is a non-taxpayer, he or she may claim a repayment.

The beneficiary is given credit for trustees' tax only if the beneficiary is taxable on the same item. If the IIP trustees receive an amount that is capital in trust law and deemed to be income for tax purposes (see TSEM3201 and TSEM3767), the beneficiary is not given credit for the trustees' tax. The IIP beneficiary would not be entitled to such a receipt, as it would not be trust income, and would not be taxable on the receipt.

***Settlements legislation***

Different rules apply where the income of the IIP beneficiary is treated as that of the settlor under the settlements legislation. Examples of this area where the IIP beneficiary is a spouse, civil partner or minor child of the settlor. See TSEM4512.

**3765. Beneficiary entitled to trust income - grossing up and credit for trustees' tax example** [February 2011]

An IIP trust where the Settlements legislation does not apply (see TSEM3764) receives income in 2009-2010: rental income £2,000 and bank interest £800 (basic rate tax of £200 has been deducted at source).

***Trustee's position***

| | Rent | interest |
|---|---|---|
| gross income | 2,000 | 1,000 |
| tax due | 400 | 200 |
| net income | 1,600 | 800 |

The trustee receives credit for the tax deducted at source from the bank interest (£200) so has to pay £220 tax.

***Beneficiary's position***

| | | Rent | interest |
|---|---|---|---|
| net income (as above) | 1600 | 800 | 800 |
| grossed up (@ 20%) | | 2,000 | 1,000 |

***Beneficiary is a higher rate taxpayer***

| | | |
|---|---|---|
| tax at 40% | 800 | 400 |
| less credit | 400 | 200 |
| further tax to pay | 400 | 200 |

For an example involving TMEs, see TSEM8485.

**3766. Beneficiary entitled to trust income - form R185 (Trust Income)** [August 2010]
In the example in TSEM3765 the entries on the form R185 (Trust Income) given by the trustees to the beneficiary would be:

| Net amount | | tax credit | | taxable amount | |
|---|---|---|---|---|---|
| 7.4 | 1600 | 7.5 | 400 | 7.6 | 2,000 |
| 7.7 | 800 | 7.8 | 200 | 7.9 | 1,000 |

The beneficiary uses the information on form R185 (Trust Income) to make his or her tax return or to claim repayment. The beneficiary is taxable on the gross amounts at boxes 7.6 and 7.9 at his or her marginal rate, and given credit for the amounts at 7.5 and 7.8.

## 23.2 Taxation of IP trustees

Trustees are in principle subject to tax on income arising to them if it is UK source income or if they are UK resident. This applies even to trustees of transparent IP trusts. There are however a number of exceptions for trustees of IP trusts (which I call **"IP trustees")** as exemptions for life tenants also enure for the benefit of the trustees.

### 23.2.1 *Income mandated to life tenant*

The TSE Manual provides:

**3040. Trust income mandated to a beneficiary** [February 2011]
Trustees of interest in possession trusts (IIPs) (TSEM1105) exclude from the Trust and Estate Tax Returns income mandated to beneficiaries. The beneficiaries include this on their personal returns.
This practice has been extended to trustees of settlor interested trusts (TSEM4000+) where the settlor (or the settlor's spouse or civil partner) is also an IIP beneficiary and the trust income is mandated to them.[9]

9 On this point see 24.10 (Taxation of trustees of settlement within s.624).

### 23.2.2 *Life tenant non-resident*

The taxation of UK trustees of an IP trust (assuming they have not mandated the income to a life tenant) is affected by the residence of the life tenant. TSE Manual provides:

> **3160. Resident trustees with trust income from abroad: beneficiary is not resident** [February 2011]
> 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

The point is also made in form SA904(Notes) Notes on Trusts & Estate Foreign for the year ended 5 April 2010.

### 23.2.3 *Life tenant remittance basis taxpayer*

The taxation of UK trustees of an IP trust (assuming they have not mandated the income to the life tenant) similarly depends on whether the life tenant is a remittance basis taxpayer. TSE Manual provides:

> **3165. Resident trustees with trust income from abroad: beneficiary is resident but not domiciled** [April 2010]
> These instructions apply only if the beneficiary has an absolute interest in trust income (TSEM6204). This includes a life tenant and an annuitant.
> The trustee' income tax liability is based on the beneficiary's domicile. The beneficiary must make a claim for any year that the remittance basis is to apply.
> If in any year the beneficiary claims the remittance basis the trustees' liability on the share of income from abroad payable to the 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.
> If in any year the beneficiary does not claim the remittance basis the trustees are assessable on the amount arising.
> [See] *Williams v Singer & others* 7 TC 387

> **3170. Resident trustees with trust income from abroad - beneficiary is resident but not ordinarily resident** [February 2011]
> These instructions apply only if the beneficiary:
> • has an absolute interest in trust income (TSEM6204). This includes a life tenant and an annuitant;
> • is a citizen of the Commonwealth or the Republic of Ireland.[10]
> The trustees' income tax liability is based on the beneficiary's not ordinarily resident status.
> The beneficiary must make a claim for any year that the remittance basis is to apply.
> If in any year the beneficiary claims the remittance basis the trustees' liability on the share of other income from abroad payable to the 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.
> If in any year the beneficiary does not claim the remittance basis the trustees are assessable on the amount arising.
> [See] *Williams v Singer & others* 7 TC 387

The point is also made in form SA904(Notes) Notes on Trusts & Estate Foreign for the year ended 5 April 2010.
This form also directs:

> If the beneficiary(ies) of the trust has an absolute interest in the trust (including a life tenant) and it is known that he/she will make a claim for the tax year to be taxed only on the amount of their foreign income and gains that is remitted to the UK, include foreign savings income on Page TF2 (not Page TF1).
> Add up all the dividends and distributions from overseas sources included in column E on Page TF2. Use the 'Additional information' box 4.39 on Page TF5 to make the following declaration.
>> The amount in box 4.4 on Page TF2 includes a total of £ (x) in dividends and distributions from overseas sources.

The reason for this is that where dividend income is taxed on a remittance basis the rate of tax on trustees is the basic rate and not the dividend ordinary rate. Section 14 ITA provides:

---

10 The manual is out of date here: the requirement to be a citizen of the Commonwealth or the Republic of Ireland does not apply from 2005/06.

(1) Income tax is charged at the dividend ordinary rate on the income of persons other than individuals which—
(a) is dividend income,
(b) would otherwise be charged at the basic rate, and
(c) is not relevant foreign income charged in accordance with section 832 of ITTOIA 2005 (relevant foreign income charged on the remittance basis).

This is consistent with the statutory rules for the taxation of individuals: see 41.4 (Rates of tax on dividend income). It is somewhat impractical for trustees to know whether income has been remitted.

It is an interesting question whether trustees are liable where income is remitted in a year after receipt. In practice I expect tax is paid by the life tenant and such income is not entered on the trust tax return.

### 23.2.4 *Life tenant entitled to tax credit relief*

The TSE manual provides:

> **3655. Relief for overseas tax: Beneficiary entitled to trust income** [March 2009]
> These instructions apply to taxed overseas trust income that is treated as a beneficiary's income as it arises.
> The trustees can claim, and receive, tax credit relief on behalf of the beneficiary. The amount is based on the beneficiary's marginal rate and residence status. INTM367730+ onwards has instructions about tax credit relief.
> If the trustees do not claim relief, the overseas income chargeable is the net amount after deduction of overseas tax.
> A paying agent may have allowed provisional tax credit relief on overseas income. If that provisional relief is excessive, the beneficiary accounts for the excessive relief.

The Manual continues with a comment on annuities, but that is so rare in practice it is not set out here.

## 23.3 DT reliefs

In relation to trusts, three states may be concerned:
(1) The state where the income arises

(2) The state where the trustees are resident
(3) The state where the beneficiary is resident

In this book I only consider the matter from a UK perspective: it will be necessary to consider foreign law viewpoints but that is outside the scope of this book.

In this chapter "beneficial ownership" is used in the treaty sense.

### 23.3.1 *Reliefs where beneficial ownership of income is required*

Article 10 OECD model convention provides:

> 1. Dividends paid by a company which is a resident of a Contracting State to a resident of the other Contracting State may be taxed in that other State.
> 2. However, such dividends may also be taxed in the Contracting State of which the company paying the dividends is a resident and according to the laws of that State, but if the beneficial owner of the dividends is a resident of the other Contracting State, the tax so charged shall not exceed:
> a) 5 per cent of the gross amount of the dividends if the beneficial owner is a company (other than a partnership) which holds directly at least 25 per cent of the capital of the company paying the dividends;
> b) 15 per cent of the gross amount of the dividends in all other cases.

Thus relief for UK dividends requires that the beneficial owner of the dividends is treaty-resident in the foreign jurisdiction.

Article 11 OECD model convention provides:

> 1. Interest arising in a Contracting State and paid to a resident of the other Contracting State may be taxed in that other State.
> 2. However, such interest may also be taxed in the Contracting State in which it arises and according to the laws of that State, but if the beneficial owner of the interest is a resident of the other Contracting State, the tax so charged shall not exceed 10 per cent of the gross amount of the interest.

Thus relief for UK interest similarly requires that the beneficial owner of the interest is treaty-resident in the foreign jurisdiction.

Article 12(1) OECD model convention provides:

> Royalties arising in a Contracting State and beneficially owned by a resident of the other Contracting State shall be taxable only in that other State.

Thus relief for UK royalties similarly requires that the beneficial owner of the royalties is treaty-resident in the foreign jurisdiction.

In some treaties beneficial ownership is added as a requirement even where it is not in the OECD model.

### 23.3.2 *Baker trusts*

In the case of Baker trusts, for the purposes of DT reliefs:

(1) The trust is transparent ie the underlying trust income is regarded as the income of the beneficiary.
(2) The life tenant is the beneficial owner of the trust income payable to the life tenant. So if the trust receives (say) interest income, the income of the beneficiary is classified as interest, and if the beneficiary is treaty-resident in a treaty jurisdiction with an article providing exemption from UK source interest, the income qualifies for this DT relief.
(3) The trustees (if otherwise taxable) qualify for DT relief to the extent that the beneficiary qualifies for the relief. This is another case of the trustees enjoying reliefs applicable to life tenants.
(4) The position is different for a receipt which is income for tax purposes and capital for trust law purposes: in that case the trustees are the beneficial owner of the income.

HMRC agree. International Manual provides:

> **339540. Baker and Garland Trusts** [June 2004]
>
> **...**
>
> ***Baker trusts***
>
> Where 'Baker' applies, you cannot treat the trustees as being beneficial owners of a trust's income as it arises. Instead it is the beneficiaries who are the beneficial owners.

That is correct. The manual continues:

> Strictly, each beneficiary should claim in his or her own right.

This is not strictly correct. A trustee could claim indirect DT relief in a case where a beneficiary failed to do so. But nothing turns on that since HMRC do not apply what they identify as the strict law:

> In practice it is acceptable to allow relief to the trustees, provided that you can be satisfied that the beneficiaries are entitled to relief under the same double taxation agreement as that under which the trustees have claimed. If this is not the case you may allow partial relief to the trustees by reference to the percentage of the interests that are relievable under the same DTA as the trustees. The beneficiaries who are not resident in the same country as the trustees will need to make their own claims against the income distributed to them.

### 23.3.3 *Garland trusts*

In the case of Garland trusts, for the purposes of DT reliefs:

(1) The trustee is the beneficial owner of the trust income.
(2) The income of the beneficiary will qualify for DT relief under the "other income" article in the OECD model form (but not under the UK preferred form): see 22.11 (UK trust – non-resident beneficiary: DTA relief).
(3) Point (2) would cause great difficulties. However by concession HMRC will regard a Garland trust as transparent Baker trust for DT purposes. I refer to this as **"the Garland concession"**.

International Manual provides:

> **339540. Baker and Garland Trusts** [June 2004]
>
> **...**
>
> ***Garland trusts***
>
> Where 'Garland' applies, you can, for the purposes of the double taxation agreement, treat the trustees as the beneficial owners of trust income as it arises and allow relief. This treatment is given because we consider that the beneficiary's right to income from the trust is against the trustees, rather than in the underlying assets held in trust. However, you should still establish the identity and residence of the beneficiaries. If any beneficiary is in the UK you should notify their tax inspector.

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.
> **166040. Foreign tax**
> Where foreign tax has been paid on trust income (including, in the case of dividends, any underlying tax where, exceptionally credit for such tax is due under the terms of an agreement – see INTM164410), it is the practice, in the case of a trust of a type referred to in INTM166030, to allow credit relief to beneficiaries, other than annuitants, for that foreign tax. Credit relief is given in the same way and to the same extent as if each beneficiary were entitled to his proportionate share of the underlying investments of the trust.

## 23.4 Baker or Garland trust jurisdiction?

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. In practice HMRC have helpfully published a list which would constitute evidence on which (in the absence of other evidence) a tribunal should be expected to rely.[1] This list only represents the HMRC view and could be challenged on the basis of expert evidence. The list assumes the trust has standard form wording. It is in principle possible to draft a non-transparent trust in a *Baker* jurisdiction. It may be possible to draft a transparent trust in a *Garland* jurisdiction by using non-standard wording.

The HMRC list is as follows. The endnotes are my own.

| | | | |
|---|---|---|---|
| Argentina | No Trust Law | Latvia | Baker |
| Australia[2] | | Liechtenstein | Garland[10] |
| New South Wales | Baker | Lithuania | Baker |
| Queensland | Baker | Luxembourg | Baker |
| South Australia | Baker | Malaysia | Baker |
| Victoria | Baker | Malawi | Baker |
| Western Australia | Baker | Malta[11] | No Trust Law |
| Bahamas | Baker | Monaco | No Trust Law |
| Barbados | Baker | Montserrat | Baker |
| Belgium | No Trust Law | Namibia | Garland |
| Belize | Baker | Netherlands | No Trust Law[12] |
| Canada[3] | | New Hebrides | Baker |
| British Columbia | Baker | New Zealand | Baker |
| Nova Scotia | Baker | Nigeria | Baker |
| Ontario | Baker | Norway | Garland |
| Saskatchewan | Baker | St Helena | Baker |
| Quebec[4] | Garland | St Vincent | Baker |
| Cayman Islands | Baker | Singapore | Baker |
| Denmark | Garland | South Africa[13] | Garland |
| Egypt | Baker | South Yemen | Baker |
| Estonia | Baker | Spain | No Trust Law |
| Fiji | Baker | Sri Lanka | Baker |
| France[5] | No Trust Law | Sweden | Garland |
| Ghana | Baker | Trinidad & Tobago | Baker |
| Gibraltar | Baker | Uganda | Baker |
| Guernsey | Baker | USA[14] | |
| Guyana | Baker | New York | Garland |
| Hong Kong | Baker | Minnesota | Garland |
| Hungary | Baker | Montana | Garland |
| India[6] | Garland | North Dakota | Garland |
| Ireland, Republic of[7] | Baker | South Dakota | Garland |
| Isle of Man | Baker | Wisconsin | Garland |
| Italy[8] | No Trust Law | All other states[15] | Baker |
| Japan | No Trust Law | Zambia | Baker |
| Jersey[9] | Baker | Zimbabwe | Garland |
| Kenya | Baker | | |

1 Accessible *www.hmrc.gov.uk/cnr/nr_trusts.htm# lctable*.

2 The list omits Tasmania, Northern Territory and Australian Capital Territory. It is considered that these are *Baker* jurisdictions.

3 This seems correct: see *Minister of National Revenue* [1956] SCR 49 especially [1953] Ex CR 292 at p.297, accessible *www.kessler.co.uk*. The list of Canadian jurisdictions omits Alberta, Manitoba, New Brunswick, Newfoundland and Labrador, Northwest Territories, Nunavut, Prince Edward Island and Yukon. It is suggested that these are the same as the other Canadian common law jurisdictions, i.e. *Baker* jurisdictions.

4 This seems well founded in Art. 1261 Code Civil Québec: "The trust patrimony, consisting of the property transferred to the trust, constitutes a patrimony by appropriation, autonomous and distinct from that of the settlor, trustee or beneficiary *and in which none of them has any real right*". See also Gretton, "Trusts without Equity" ICLQ 49, No.3 (July 2000).

5 France was omitted (accidentally?) from the version of the list published 1 April 2008, but the comment in the earlier version of the list is printed here as it is correct.

6 *Duncan's Executors v Adamson* (1935) 14 ATC 22 so held. This seems soundly based on s.3 [India] Trusts Act 1882: "The 'beneficial interest' or 'interest' of the beneficiary is his right against the trustee as owner of the trust-property."

7 The list omits Northern Ireland: this is a *Baker* jurisdiction.

8 This is wrong: Italy does have a trust law.

9 Paul Matthews agrees: *Jersey Law of Trusts*,(3rd ed., 1994) para 1.21.

10 It is not clear whether HMRC are referring to a Stiftung or a Treuhandschaften; see 72.6 (Liechtenstein Foundation: Stiftung); 72.8 (Liechtenstein Treuunternehmen).

11 This is wrong: Malta does have a trust law.

12 This is wrong: The Netherlands does have a trust law.

13 Honoré agrees: *South African Law of Trusts*, (4th ed. 1991), para 349.

14 New York was (rather implausibly) found to be a *Garland* jurisdiction in *Garland v Archer-Shee* 15 TC 693. The finding of fact in *Garland* was also made in *Timpson's Executors v Yerbury* 20 TC 155 at p.157, and was accepted as common ground in *Astor v Perry* 19 TC 255. See "Taxing Foreign Income from Pitt to the Tax Law Rewrite – The Decline of the Remittance Basis", John Avery Jones in *Studies in the History of Tax Law*, 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.

15 This may not be correct for all the other states. In particular, Ohio and New Jersey have been found to be *Garland* jurisdictions. See *The Marchioness of Ormond v Brown* 17 TC 333 at p.341, *Kelly v Rogers* 19 TC 692 at p.696. But see the above footnote. In *Lawson v Rolfe* 46 TC 199 it was common ground that California was a *Baker* jurisdiction.

CHAPTER TWENTY FOUR

# SETTLOR-INTERESTED TRUSTS

## 24.1 Settlor-interested trusts – Introduction

Chapter 5 Part 5 ITTOIA contains a code of anti-avoidance provisions known as the Settlement Provisions. The most important is s.624(1) ITTOIA which provides:

> Income 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.

### 24.1.1 *Cross-references*

On the definition of "settlor", see 69.1 (Who is the settlor?).
"Settlement" for this purpose means settlement-arrangement; see 69.2 (Definitions of settlement).

For following types of income/gains accruing to settlor-interested trusts, see these references:

Chargeable event gains: see 30.7 (Section 624 & chargeable event gains).
Offshore income gains: see 32.7.2 (UK resident settlor-interested trust) and 32.9.1 (Non-resident settlor-interested trust).
Accrued income profits: see 33.14 (Settlor-interested trusts).
Deeply discounted security income: see 33.14.1 (UK resident settlor-interested trust) and 34.11 (Non resident trust).

See too 41.5 (Settlor-interested trust: rates of tax on settlor).

This chapter considers the IT rules. For CGT see 44.1 (Gains of trusts - introduction).

## 24.2 Meaning of "income arising under a settlement"

Section 648(1) ITTOIA provides:

> References in this Chapter to income arising under a settlement include— [1]
> (a) any income chargeable to income tax by deduction or otherwise, and
> (b) any income which would have been so chargeable if it had been received in the UK by a person domiciled, resident and ordinarily resident there.

The points made in 25.14 (The amount of income of person abroad) and 25.13 (Capital receipts deemed to be income) apply also for the purposes of ascertaining what is the "income arising under a settlement".

### 24.2.1 *Income of company, unit trust or partnership held by trustees*

In this discussion, income arising to a company held by trustees (not arising to trustees directly) is called "company income". Company income is not "income arising under a settlement". This follows from the repeal by Sch 17 FA 1989 of s.681(2)(b) ICTA (which formerly brought company income into the scope of that expression).[2] This view is also supported by reference in the definition to "income chargeable to *income* tax". Company income would normally be chargeable to corporation tax.

It is considered that income of a unit trust held by trustees is similarly not "income arising under the settlement" (unless the unit trust is transparent in which case its income passes through to the trustees).

It is suggested that the position is different where trustees have an interest in a partnership. Insofar as income is distributed by the partnership to the trust it obviously constitutes income arising under the settlement. But even if income is retained by the partnership, it is still income of the trustees since a partnership is transparent for IT.

Income of a company or unit trust which is not income arising under the settlement may fall within s.720 ITA.

---

1 The context suggests this is an exhaustive definition, ie the word "include" really means "mean".

2 This was part of the repeal of the close company apportionment provisions.

### 24.2.2 *Income of life tenant (not the settlor)*

Income payable under the trust to a life tenant is "income arising under a settlement". Admittedly, such income is usually regarded for tax purposes 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 69.2.3 (Settlement-arrangement 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 argued that such income falls outside the scope of s.624 ITTOIA.

### 24.2.3 *Income of life tenant settlor*

Where the settlor has an interest in possession, trust income actually received by the settlor is not within s.624 ITTOIA. It is subject to income tax under general principles.[4] But from 2006/07 the rates of tax are the same in either case,[5] so the issue does not now arise.

### 24.2.4 *Property business income*

Property Income Manual 1045 [February 2007] discusses how one calculates property income for the purposes of the Settlement Provisions:

> **1045. Life interest trusts** [February 2007]
> *Trusts and the settlor - losses*
> ... 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 s.619(1)

3 See 23.1 (Taxation of life tenant).

4 The point was discussed in the 4th ed. of this book at 11.4.3. Trust income not received by the life tenant settlor is within s.624 ITTOIA. That applies to income used for trust expenses and income for tax purposes which is capital for trust law purposes.

5 See 41.5 (Settlor-interested trust: rates of tax on settlor).

> ITTOIA. Where the income is property income, the normal property income rules apply in calculating the income. (S.623 ITTOIA).

This is correct. It follows that interest paid by the trustees is in principle deductible in computing the quantum of property income for s.624 purposes.

### 24.2.5 *Property business losses*

The Property Income Manual then considers the treatment of losses:

> **1045. Life interest trusts** [February 2007]
> *Trusts and the settlor - losses*
> The more common case is where the trustees carry on the rental business but the settlor is caught by Section 619(1). Under these circumstances the settlor can't set any trust rental business losses against personal rental business income.
> Similarly the settlor can't merge personal rental business losses and the trust rental business profits which are deemed to be the settlor's income and charged under Section 619(1). Thus:
> - Where the trustees have a rental business loss and the settlor has a personal rental business profit, the trust loss is carried forward and the settlor is taxed on their personal rental business profit; the amount of the trustees' rental business profit charged on the settlor in the following year under Section 619(1) will be reduced by the trust loss carried forward.
> - Where the trustees have a rental business profit and the settlor has a personal rental business loss, the settlor is taxed on the trust rental business profit under Section 619(1); the settlor's personal rental business loss can't be merged with the trust profit; but, as a separate matter, the settlor may in some cases be able to set a personal rental business loss sideways against other income, including any Section 619(1) income deemed to arise from the trustees' rental business; see PIM 4205.
>
> The position is different where the taxpayer is:
> - the settlor; and
> - the life tenant; and
> - carries on the rental business.
>
> Under these circumstances the settlor can merge their personal property losses with the deemed income from the trust and vice versa.

This is thought to be correct. See too 14.4 (Losses of overseas property business).

### 24.2.6 *Trustee expenses*

Section 624(1A) ITTOIA provides:

> If the settlement is a trust, expenses of the trustees are not to be used to reduce the income of the settlor.

ITA EN provides:

> 3323.New subsection (1A) makes it explicit that trustees' expenses are not taken into account in measuring the income of a settlor under section 624 of ITTOIA. This follows from the fact that it is the income arising that is deemed to be the settlor's and the income arising is the gross amount out of which the trustees may pay expenses.

### 24.2.7 *Settlor's deductions and reliefs*

Section 623 ITTOIA provides:

> For the purpose of calculating liability to tax under this Chapter (but for no other purpose), a settlor shall be allowed the same deductions and reliefs as if any amount treated under this Chapter as income of the settlor had actually been received by the settlor.

As far as I can see, this is not needed (except perhaps for the avoidance of doubt). Deductions and reliefs should be available in any event under general principles, and there are none which would otherwise be disallowed on the basis that the settlor did not actually receive the income arising under the settlement. However that may not have been the case in 1938 when the provision was first introduced. Thus it survives mainly for historical reasons, and, perhaps, for the avoidance of doubt. The same applies to the equivalently worded provision in s.746 ITA 2007 which originated in 1936.

### 24.2.8 *Income arising under the settlement must be identifiable*

Section 624 assumes that one can *identify* the amount of income which arises under the settlement. If that identification is not possible then it is considered that s.624 does not operate.[6] In straightforward cases this is not an issue. Where an individual provides funds indirectly to a settlement made by another, for instance by way of interest-free loans, guarantees, payments of trust expenses, etc that person may become a settlor, but s.624 still does not apply unless it is possible to identify the income arising under *that* settlement-arrangement, ie arising from that individual's act of bounty.

## 24.3 Meaning(s) of "settlor-interested"

### 24.3.1 *The concepts of "settlor-interested"*

The term "settlor-interested", first coined in the FA 2000, is used in connection with various provisions of which the most important are:
(1) The IT settlement provisions (discussed in this chapter).
(2) Section 86 TCGA.[7]
Consistent with the patchwork nature of UK tax, these provisions have significant differences, though they share a common framework. "Settlor-interested" is a convenient label, but not a wholly accurate one.

### 24.3.2 *"Settlor-interested" for IT purposes*

Subject to minor exceptions not discussed here, s.625(1) ITTOIA provides:

> A settlor is treated for the purposes of section 624 as having an interest in property if there are any circumstances in which the property or any related[8] property—

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6 The same point applies to the TAA provisions; see 25.7.2 (Income arising must be identifiable).

7 See 44.6 (Settlor-interested condition). Other examples, not discussed in this book, are s.169F TCGA (restriction of holdover relief for settlor-interested trusts); Sch 4A TCGA (disposal of interest in settlor-interested trusts). In addition, "power to enjoy" for s.720 ITA is a similar concept, with a different label. GWR is a comparable but not identical concept.

8 "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,

(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.[9]

If an individual lends interest free (or at a low rate of interest) to a trust, the HMRC view is that the trust is settlor-interested as the individual may benefit by repayment of the loan (even if otherwise excluded):

> In *Jenkins v IRC* (26 TC 265) the Court of Appeal found that the making of an interest-free loan brought the settlement into what is now [s.624]. In the *Jenkins* case, the dispute was about whether certain income received by the trustees of the settlement could be assessed on the settlor under the provisions of FA 1938 s38(4). That provision contained an extended definition of retaining an interest in income that is in similar terms to the definition of retaining an interest in property or derived property found in [s.624].
> The effect of the decision in *Jenkins* was that a settlor who has made an interest-free loan to his/her trust has brought himself or herself within the scope of s38(4), and by implication [s.624] (albeit that there would be no charge unless income actually arose to the trustees).[10]

The contrary is faintly arguable[11] but for practical purposes this should be accepted as correct.

The IT settlement provisions only apply to income from property in which the settlor has an interest. So if the settlor is excluded from part of the trust fund, the IT provisions do not apply to that part.

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or of income from, that property or income from it.

9 For further discussion see Kessler & Sartin, *Drafting Trusts and Will Trusts* (10th ed., 2010) Chapter 13 (Settlor exclusion and default clauses).

10 Letter from HMRC to the Association of British Insurers, September 2004, accessible *www.kessler.co.uk*. A person who lends interest-free is a settlor: see 69.16 (Interest-free or back-to-back loan). For other issues arising on loans to trusts, see 24.14 (Settlor receives capital sum) and 26.11 (Transferor receives capital sum).

11 There is a discussion in the 2nd edition of Venables & Kessler, *Taxation of Charities* (1993) p.137.

## 24.3.3 *Meaning of "spouse"*

Section 625(4) ITTOIA gives the word "spouse" an artificial and slightly narrow meaning:

> In subsection (1) "the settlor's spouse or civil partner" does not include—
> (a) a spouse or civil partner from whom the settlor is separated under an order of a court or a separation agreement,
> (b) a spouse or civil partner from whom the settlor is separated where the separation is likely to be permanent,
> (c) the widow or widower or surviving civil partner of the settlor, or
> (d) a person to whom the settlor is not married but may later marry or a person of whom the settlor is not a civil partner but of whom the settlor may later be a civil partner.

The TAA provisions do not contain the same provision, which is anomalous, but that is the patchwork nature of UK tax. Fortunately it does not often matter.

## 24.3.4 *Settlement ceasing to be settlor-interested*

If the settlor originally had an interest in trust property but is later excluded (together with the settlor's spouse) then s.624 ITTOIA ceases to apply to income arising after the date of the exclusion.[12]

If the settlor is excluded from part of the trust fund, then they are within the scope of s.624 only on the income arising from the part in which they still have an interest.

## 24.3.5 *Transfer to new settlement*

If the trust fund is transferred to a new settlement from which the settlor is not excluded, then s.624(1) ITTOIA continues to apply. The old settlor is the settlor of the new trust.[13]

If the entire trust fund is transferred to a new trust from which the settlor

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12 Contrast 26.6 (Power to enjoy: Section 721 Condition A); 44.6 (Settlor-interested condition).

13 See 69.7 (Transfer from trust A to trust B by exercise of trustees' power).

(and spouse) are entirely excluded then s.624 ceases to apply, and if they are excluded from part, it ceases to apply in part.

## 24.4 Section 624 beneficiary relief

Section 685A ITTOIA avoids a double charge when income of a settlor-interested trust is paid to a beneficiary. I refer to this as **"s.624 beneficiary relief"**.

For completion of tax returns when this relief applies, see 22.3.6 (Entering discretionary trust income in beneficiary's tax return).

### 24.4.1 *Conditions for relief*

Section 685A(1) ITTOIA provides:

> This section applies if—
> (a) a person receives an annual payment in respect of income from the trustees of a settlement,
> (b) the payment is made in the exercise of a discretion (whether of the trustees of the settlement or any other person), and
> (c) a settlor is charged to tax under section 619(1) on the income arising to the trustees of the settlement (whether in the current year of assessment or in a previous year of assessment) out of which the annual payment is made.

The relief only applies to discretionary trusts. But if a trust confers an interest in possession (not on the settlor) then no relief is needed: the life tenant is not taxable as the income is the trust income of the settlor and of the settlor alone.

It is considered that a settlor is not charged to tax (within the meaning of (c)) if the s.624 remittance basis applies and the income is (un)taxed under the remittance basis. Where that relief applies, s.624 beneficiary relief is disapplied; but the contrary is arguable.

Section 685A(2) ITTOIA provides:

> This section applies only in respect of that proportion of the annual payment which corresponds to the proportion of the total income arising to the trustees of the settlement in respect of which a settlor is chargeable to tax under section 619(1).

Section 685A(2) may apply where:

(1) A settlement is partly settlor-interested (because there are two settlors or the only settlor is partly excluded).

(2) A non-resident settlor is charged on part of the trust income (UK source income only).

(3) A remittance basis taxpayer settlor is charged on part of the trust income (UK source and remitted income only).

### 24.4.2 *Relief for non-settlor-beneficiary*

Section 685A(3)–(6) ITTOIA confers the relief:

> (3) If and in so far as this section applies, the recipient of the annual payment shall be treated for the purposes of this Chapter as having paid income tax at the additional rate in respect of the annual payment.
> (4) But—
> (a) tax which the recipient is treated by virtue of this section as having paid is not repayable,
> (b) tax which the recipient is treated by virtue of this section as having paid may not be taken into account in relation to a tax liability of the recipient in respect of any other income of his...
> (5A) If the recipient of the annual payment is treated by subsection (3) as having paid income tax in respect of the annual payment, the amount of the payment is treated as the highest part of the recipient's total income for all income tax purposes except the purposes of sections 535 to 537 (gains from contracts for life insurance etc: top slicing relief).
> (5B) See section 1012 of ITA 2007 (relationship between highest part rules) for the relationship between—
> (a) the rule in subsection (5A), and
> (b) other rules requiring particular income to be treated as the highest part of a person's income.
> (6) Sections 494 and 495 of ITA shall not apply in relation to an annual payment if and in so far as this section applies.

EN FB 2008 explains subsections (5A)(5B):

> 7. The income of a 'settlor-interested' trust is deemed, for the purposes of income tax, to be the settlor's income as it arises.
> 8. In non settlor-interested discretionary trusts, where income payments are made to beneficiaries, the income constitutes a new source, and is taxed on the beneficiary. The tax paid by trustees is available to the beneficiaries in

the form of a tax credit.
9 . In a settlor-interested trust, an income payment to a beneficiary is still a new source of income taxable in the beneficiary's hands. However the tax paid by the trustees of such trusts is treated as paid on behalf of the settlor. Because the settlor has already been taxed on the whole amount, charging the beneficiary to additional tax would result in a form of double taxation.
10. Section 685A ITTOIA 2005 provides that income paid by trustees of a settlor-interested trust to (non-settlor) beneficiaries comes with a non-repayable 'notional' tax credit equal to the higher rate of tax (currently 40 per cent) which covers all the tax liability on that income.
11. However, under current statutory ordering rules income from a trust is charged before savings and/or dividend income. The result is that a beneficiary of such a trust who also has savings and/or dividend income may find that the non-trust income is pushed into higher rates so that more tax is due overall.
12. The measure amends this ordering rule, so that income from a settlor-interested trust is treated within section 1012 ITA 2007 as one of the highest slices of income instead of being treated as part of the lowest slice.
13. The amending legislation backdates the correct position to 6 April 2006 to ensure that those affected are not disadvantaged by the omission.

Two policy points arise from this which ought to raise serious questions about the rule of law in relation to the UK tax system. First the tax system is so complex that it took two years for the error in the FA 2006 to be noticed and corrected. (I confess I did not notice it myself.) Secondly, the error was corrected by casual retrospective legislation.

The TSE Manual provides:

**4570 Payments to beneficiary other than the settlor** [February 2011]
... 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.

### 24.4.3 *Relief for settlor-beneficiary*

Section 685A(5) ITTOIA provides:

> If the recipient of the annual payment is a settlor in relation to the settlement, if and in so far as this section applies the annual payment shall not be treated as his income for the purposes of the Income Tax Acts (and subsection (3) does not apply).

The TSE Manual provides:

> **4570 Payments to the settlor** [February 2011]
> 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 years up to and including 2005-06 the phrase in Section 687(1) 'but would not be his income if it were not made to him' means Section 687 does not apply to payments that fall to be treated as the income of the settlor under Section 624 ITTOIA. For 2006/07 onwards discretionary payments made by the trustees to the settlor are taken out of charge by Section 685A(5) ITTOIA.

The legislation distinguishes between non-settlor beneficiaries and the settlor. In the one case the beneficiaries are given a credit, and in the latter case the income is tax free. At first sight this seems strange, but a reason will emerge.

## 24.5 Section 624 remittance basis

Section 648 ITTOIA provides a relief which I call "**the s.624 remittance basis**".

The legislation uses the clumsy but effective drafting technique of restricting the definition of "income arising under a settlement". That term is defined in a commonsense way in s.648(1)[14] and s.648(3) then provides:

> And if, for a tax year, section 809B, 809D or 809E of ITA 2007 (remittance basis) applies to the settlor, references in this Chapter to income arising under a settlement include in relation to any relevant foreign income arising under the settlement in that tax year only such of it as is remitted to the UK (in that tax year or any subsequent tax year) in circumstances such that, if the settlor remitted it, the settlor would be chargeable to income tax.

14 See 24.2 (Meaning of "income arising under a settlement").

> (4) See Chapter A1 of Part 14 of ITA 2007 for the meaning of "remitted to the UK" etc.

This applies to "relevant foreign income" arising under the settlement. The drafter has overlooked the definition of RFI, which means foreign income chargeable under specified provisions. Foreign trust income is never RFI.[15] Taken literally, s.648(3) would never apply. But the context shows that "relevant foreign income" is a slip for "foreign source income".

> (5) Where subsection (3) applies the remitted income is treated for the purposes of this Chapter as arising under the settlement in the tax year in which it is remitted.

In short, foreign income qualifies in principle for the s.624 remittance basis if it is not remitted to the UK.

The charge under s.648(5) arises if two conditions are satisfied:

(1) The income "is remitted to the UK".
(2) We must ask: would the settlor be chargeable to income tax on the remitted income if the settlor remitted it?

In practice this mainly concerns settlor-interested discretionary trusts. Income of a trust where the settlor has an interest in possession is in principle outside the scope of s.624,[16] though s.624 could apply to a receipt which was income for tax purposes but capital for trust purposes.

### 24.5.1 *Trustees remit trust income to UK*

Suppose first the simplest case. A settlor ("S") has made a settlor-interested discretionary trust. S is a remittance basis taxpayer. The trustees receive foreign income, so the circumstances of s.648(3) ITTOIA are satisfied. Later the trustees remit the income to the UK (without transferring it to S).

We ask the question: if S remitted the income, would S be chargeable to income tax? In principle S is chargeable to tax on remitted income if S is UK resident when the income arises to the trustees and at the time of remittance.

In short, income which is outside the scope of s.624 ITTOIA because of

15 See 9.3.1 (Relevant foreign income).
16 See 24.2.3 (Income of life tenant settlor).

the s.624 remittance basis *prima facie* falls back within s.624 if it is remitted by the trustees.

Suppose trustees accumulate income and thus it becomes trust capital. That capital is then remitted. The charge on remittance still applies. Its status as income or capital for trust law purposes is irrelevant.[17]

Accordingly trustees of a settlor-interested trust within the s.624 remittance basis should not remit their foreign income to the UK. It is desirable for trusts within s.624 to segregate (1) foreign income and (2) capital. They can then remit capital (IT-free) rather than income (chargeable at IT rates). If they fail to do so then the mixed fund rules will apply.

### 24.5.2 *Income payment to beneficiary (not settlor) who remits to the UK*

Suppose:

(1) Trustees of a settlor-interested discretionary trust pay the income to a beneficiary ("B") (not the settlor) and

(2) B receives the sum out of the UK but remits the sum to the UK.

It is considered that the settlor is not charged under the s.624 remittance basis on the remittance. The reason is that what is remitted to the UK is not "foreign income arising under the settlement". It loses its nature as "income arising under the settlement" upon payment to B because it becomes the income of B. It would be surprising if there were a tax charge because the settlor may have no way of knowing whether the income is remitted by B.

It makes no difference whether or not B is a relevant person in relation to the settlor.[18]

If B is UK resident, B will in principle be subject to tax on the income payment (under ordinary principles or s.731 ITA). (B does not qualify for the s.624 beneficiary defence in this case, if my analysis is correct.)

### 24.5.3 *Income payment to settlor-beneficiary*

Suppose:

(1) trustees pay the income to the settlor (as the settlor's income); and

17 Compare 9.3.5 (Capital/income terminology in remittance basis context).

18 Except that if B is not a relevant person, it would be harder to have a remittance within the ITA definition.

(2) S remits the income.

This gives rise to a charge under the s.624 remittance basis. This must be why s.685A is worded differently for settlors and other beneficiaries. The argument above does not apply since the sum paid to S does not become the income of S. This may explain why s.624 beneficiary relief has different rules for the settlor and for other beneficiaries.

There is similarly a charge under the s.624 remittance basis if:

(1) the trustees accumulate the income;
(2) the trustees pay it to the settlor as capital; and
(3) the settlor receives the sum outside the UK but remits the sum to the UK.

Suppose the trustees use the income to repay an existing loan to S. The loan is repaid outside the UK. It is suggested that the income is not remitted, as the settlor's receipt represents the original money loaned, not the trust income.

Suppose the trustees use the income to make a loan to S. This will be caught if the borrowed money in the hands of S is regarded as derived from the trust income; see 10.14.5 (T lends to R).

### 24.5.4 *Transitional rule for pre-2008 trust income*

Para 86(4) Sch 7 FA 2008 provides (so far as relevant):

> ... in relation to an individual's income and chargeable gains for the tax year 2007–08 or any earlier tax year, section 809L has effect as if the references to a relevant person were to the individual.

This disapplies the relevant person rule for pre-2008 income.

This is extended by para 86(4A) inserted with retrospective effect by the FA 2009:

> For the purposes of sub-paragraph (4), section 648(2) to (5) of ITTOIA 2005 (and corresponding earlier enactments) do not apply (so that relevant foreign income which arose under a settlement in the tax year 2007-08 or any earlier tax year is to be treated as income for the tax year in which it arose).

The point is that pre-2008 trust income is only remitted if received/used/enjoyed by the settlor in the UK. Receipt (etc) by a relevant person does not count. See 10.8 (Relevant person transitional rule for pre-2008 income and gains). The RDR Manual provides:

> **31490 Relevant persons and foreign income and gains arising to a settlement before 6 April 2008** [March 2011]
> *Background*
> As explained in RDRM31480 s.809L ITA has introduced the concept of 'relevant person'RDRM33030 which, broadly, provides that a taxable remittance will occur when foreign income or gains are brought into or otherwise used in the UK by relevant persons.
> Where a settlor creates a settlement and retains an interest in the property in that settlement the income arising to the trust is treated, for income tax purposes, as the income of the settlor alone under s624 ITTOIA. This is the case even where the trust income is paid to someone other than the settlor. Refer to RDRM33590 Settlements: Chapter 5 Part 5 ITTOIA.
> Where a settlor claims to use the remittance basis, section 648 provides for the trust income to be treated as arising in the year in which it is remitted. Because of the narrower definition of remittance which applied before 6 April 2008 this would produce an inequitable result where relevant foreign income that arose to a settlement before 6 April 2008 is remitted and becomes chargeable on the settlor after 6 April 2008.
> *Transition*
> The transitional rule provides that in establishing whether there has been a remittance of an individual's income and gains for 2007-08 or any earlier year Conditions A and B, Condition C and Condition D at s.809L ITA (refer to RDRM33020 Meaning of Remittance) are applied as if references to 'relevant person' are to the individual.
> For the purpose of applying this transitional rule only, that is, for the purpose of determining whether there is any benefit under the provisions of paragraph 86(4) only the income is treated as arising in the year that it arose to the settlement.
> *Effect*
> This means that income arising under a settlement in tax years prior to 5 April 2008 but which is remitted after 6 April 2008 is not treated as remitted by the settlor unless it has been brought to, received by or used in the UK for his benefit.

## 24.6 S.624 remittance basis planning

Practical ways of avoiding the s.624 remittance basis 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.[19]
(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, the settlor does not remit that income.
(3) The trustees segregate trust income and trust capital and remit trust capital, not trust income. There is no charge under the s.624 remittance basis if trustees remit to the UK a sum which is not income arising under the settlement.

## 24.7 Non-resident settlor

The legislation again 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)[20] and s.648(2) then continues:

> But if, in a tax year, the settlor is not UK resident, references in this Chapter to income arising under a settlement do not include income arising under the settlement in that tax year in respect of which the settlor, if actually entitled to it, would not be chargeable to income tax by deduction or otherwise because of not being UK resident.

Where the settlor is non-resident, UK source trust income is within the scope of s.624, but foreign income is not.[21] Contrast s.720 ITA which does not apply at all unless the transferor is ordinarily resident.

### 24.7.1 *UK resident trust, non-resident settlor*

The trustees are taxed in full on foreign source income. This prevents s.624 applying where it might benefit the taxpayer.

However the settlor is taxed on UK source income. This is beneficial if the settlor's marginal rate is less than the top rate of income tax, or if non-

19 See 24.2.3 (Income of life tenant settlor).
20 See 24.2 (Meaning of "income arising under a settlement").
21 This is clear on the words of the section, but if authority is needed, see *IRC v Countess of Kenmare* 37 TC 383.

residents income tax relief applies.[22]

### 24.7.2 *Non-resident trust, non-resident settlor*

Neither the trustees nor the settlor are taxed on foreign source income. The settlor is taxed on UK source income. This is beneficial if the settlor's marginal rate is less than the top rate of income tax, or if the circumstances are that non-residents income tax relief is available to the settlor and not to the trustees, which could happen because of the UK beneficiary rule.[23]

### 24.7.3 *Remittance of trust income*

It does not matter for the non-resident settlor if trust income is remitted. Suppose:-

(1) Income arises to the trustees of a settlor-interested trust while the settlor is non-resident (**"non-resident period income"**).
(2) The income is remitted by the trustees when the settlor is resident and a remittance basis taxpayer.

Section 648 ITTOIA provides:

> (3) And if, for a tax year, section 809B, 809D or 809E of ITA 2007 (remittance basis) applies to the settlor, references in this Chapter to income arising under a settlement include in relation to any relevant foreign income arising under the settlement in that tax year only such of it as is remitted to the UK (in that tax year or any subsequent tax year) in circumstances such that, if the settlor remitted it, the settlor would be chargeable to income tax...
> (5) Where subsection (3) applies the remitted income is treated for the purposes of this Chapter as arising under the settlement in the tax year in which it is remitted.

It may seem at first sight that the non-resident period income is caught as it is treated under s.648(5) as arising in the year of remittance. That is however, not the case, for two reasons:

(1) The circumstances are not "such that, if the settlor remitted the non-

22 See 37.1 (Non-residents IT relief).
23 See 37.1 (Non-residents IT relief).

resident period income, the settlor would be chargeable to IT". Unless the settlor is UK resident when the income arises, the settlor would not be taxed on it when remitted later, even if it had been the settlor's income all along.
(2) Non-resident period income is not "income arising under the settlement" by virtue of s.648(2).
The result is sensible and consistent with rule that income of an individual arising during a non-resident period is not taxable if remitted during a resident period.[24]

## 24.8 Two or more settlors

Section 644 ITTOIA provides:

> (1) In the case of a settlement where there is more than one settlor, this Chapter has effect in relation to each settlor as if that settlor were the only settlor.
> (2) This works as follows.
> (3) In this Chapter, in relation to a settlor—
> (a) references to the property comprised in a settlement include only property originating from the settlor, and
> (b) references to income arising under the settlement include only income originating from the settlor.
> (4) For the purposes of sections 629, 631 and 632 only the following are taken into account in relation to a child of the settlor—
> (a) income originating from the settlor, and
> (b) in a case in which section 631 applies, payments which under that section (as adapted by subsection (5) below) are treated as payments of income.
> (5) In applying section 631 to a settlor—
> (a) the reference to income arising under the settlement includes only income originating from the settlor, and
> (b) the reference to any payment made in connection with the settlement includes only a payment made out of property originating from the settlor or income originating from the settlor.
> (6) See section 645 for the meaning of references in this section to property or income originating from a settlor.

24 See 9.20 (RFI/gains arising when non-resident, remitted when resident).

Section 645 ITTOIA (flagged unnecessarily by s.644(6)) defines "property originating from a settlor":

> (1) References in section 644 to property originating from a settlor are references to—
> (a) property which the settlor has provided directly or indirectly for the purposes of the settlement,
> (b) property representing property so provided, and
> (c) so much of any property which represents both property so provided and other property as, on a just and reasonable apportionment, represents the property so provided.
> (2) References in section 644 to income originating from a settlor are references to—
> (a) income from property originating from the settlor, and
> (b) income provided directly or indirectly by the settlor.
> (3) In this section references to property or income which a settlor has provided directly or indirectly—
> (a) include references to property or income which has been provided directly or indirectly by another person under reciprocal arrangements with the settlor, but
> (b) do not include references to property or income which the settlor has provided directly or indirectly under reciprocal arrangements with another person.
> (4) In this section references to property which represents other property include references to property which represents accumulated income from the other property.

## 24.9 Tax return disclosure

The TSE Manual provides:

> **4575 2006–2007 onwards** [February 2011]
> 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.

## 24.10 Taxation of trustees of settlement within s.624

This frustrating topic is not considered in this book. For an introduction see "Tax Charge Doubled!" Malcolm Gunn, *Taxation* 22 February 2007.

HMRC Trusts and Estates Newsletter (December 2010) provides:

**Trusts and Estates - mandated income of settlor-interested trusts**
*Step 1 of the Trust and Estate Tax Return (SA900)*
Sometimes the trustees of an interest in possession (IIP) trust mandate trust income to a beneficiary. If the trustees mandate income to a beneficiary, it means that the beneficiary receives it and the trustees do not. The guidance on this is at Trusts Settlements and Estates Manual (TSEM) 3761 to 3762.[25]
Step 1 of the Trust and Estate Tax Return (SA900 page 2) does not require a full return to be made, nor income tax to be paid, where all income is mandated to an IIP beneficiary. However, that practice does not currently apply where the trust is settlor interested. Following a review of that practice, HMRC has concluded that where income is mandated to an IIP beneficiary of a settlor-interested trust there is no statutory basis for taxing the trustees as being in receipt of the income. The settlor is taxed on any income (or income from property) in which he or she has a retained interest.
The SA900 for 2010-11 has been amended to reflect the change of view. HMRC will no longer require a fully completed return from trustees of settlor interested trusts in respect of income that is mandated to an IIP beneficiary. Where trustees have already received either a paper return or a notice to file a return for 2009-10 and all income is mandated, they should complete Step 1 accordingly.[26]

## 24.11 Taxation of life tenant (not settlor) of settlor-interested trust

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 defence or s.624 remittance basis.

## 24.12 Settlor indemnity

Section 646 ITTOIA provides:

(1) A settlor is entitled to recover from—

25 See 23.2.1 (Income mandated to life tenant).
26 *www.hmrc.gov.uk/cto/tep-newsletter12-10.pdf.*

(a) any trustee, or
(b) any other person to whom the income is payable in connection with the settlement,

the amount of any tax paid by the settlor which became chargeable on the settlor under section 624 or 629.

For the tax implications see 27.4.10 (Reimbursement of tax under statutory indemnity); 27.21 (Relevant income used to pay expenses) and 69.21 (Failure to exercise right of reimbursement).

## 24.13 Section 624 *v.* s.720: comparison and priority

Sections 624 ITTOIA and 720 ITA cover some similar ground. For a full comparison one would need to read all the relevant chapters in this book. It may be helpful to summarise the major differences:

| **Section 624** | **Section 720** |
|---|---|
| Applies to trusts | Applies to non-resident trusts *and companies* |
| No motive defence | Motive defence |
| Settlor indemnity | No indemnity for transferor |
| Applies generally | Applies to *ordinarily* resident transferor |

The rates of tax are slightly different, a (probably accidental) result of the FA 2006.[27]

Where both s.720 ITA and s.624 ITTOIA apply (or appear to apply), which has priority? It must be one or the other: the settlor/transferor cannot be taxed twice on (effectively) the same income. Section 720 originated in 1936, s.624 originated in 1938. But there is no reason why that distant historical priority should determine the issue. Income within s.624 is treated as income of the settlor "*and of the settlor alone*". Section 720 lacks those additional words. So it is considered that s.624 has priority over s.720. Where s.624 applies, the transfer of asset conditions are not satisfied, because if the income is that of the settlor alone, it is not the income of the person abroad.

27 See 41.5 (Settlor-interested trust: rates of tax on settlor).

## 24.14 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.

Section 634 ITTOIA defines capital sum and sums paid to the settlor, but is not sufficiently important to be worth discussing here.

The key term is "available income." Section 635 ITTOIA provides the definition:

> **635 Amount of available income**
> (1) For the purposes of section 633 the amount of income available up to the end of any tax year is, in relation to any capital sum paid as mentioned in subsection (1) of that section by the trustees of a settlement, calculated as follows.
> (2) Add together the amount of income arising under the settlement in that year and any previous year which has not been distributed.
> (3) Deduct from that figure—
> (a) the amount of that income taken into account under section 633 in relation to that sum in any previous year or years,
> (b) the amount of that income taken into account under section 633 in relation to any other capital sums paid to the settlor in any year before that sum was paid,
> (c) any income arising under the settlement in that year or any previous year which has been treated as income of the settlor under section 624 or 629 ...

Section 633 is generally irrelevant to settlor-interested trusts. The trust income will fall into one of two categories:

(1) It will be treated as accruing to the settlor under s.624, or
(2) (if the s.624 remittance basis applies or the settlor is non-resident) it will not be "income arising under the settlement".

In either case there is no "available income".

Section 633 is intended to catch capital sums paid to the settlor (or spouse) from a trust which is not settlor-interested. Accordingly I shall not discuss the section further here.

## 24.15 Interaction of s.624 and s.37 TCGA

Section 37(1) TCGA deals with the relationship between IT and CGT:

> There shall be excluded from the consideration for a disposal of assets taken into account in the computation of the gain any money or money's worth
> [a] charged to income tax as income of, or
> [b] taken into account as a receipt in computing income or profits or gains or losses of,
> the person making the disposal for the purposes of the Income Tax Acts…

Thus IT has priority over CGT.

The section does not work when s.624 applies as the income is treated for IT purposes as income of the settlor and not the trustees! HMRC suggest a creative application of s.32 TMA may solve the problem. CG Manual para 14304 provides:

> **14304. Sums chargeable as income**
> This exclusion does not apply to … situations where the income in question is not treated as the income of the person making the disposal. Typically this is a case of a settlor interested trust where the income is taxed on the settlor. If in this situation the settlor is assessable to both income tax and capital gains tax then relief may be available under s.32 TMA 1970.

Suppose a settlor-interested discretionary trust. Income accrues to the trustees. The settlor pays income tax. What stops the trustees realising a chargeable gain, on which the trustees may be chargeable if UK resident, or which may be s.2(2) amounts if the trust is not UK resident? Ths solution does not lie in s.32 TMA as it is not the case that the settlor is assessable to both IT and CGT. There is nothing obvious to stop the trustees realising a chargeable gain. But no-one suggests that there is a charge. The solution must be in a general implied rule that receipts of an income nature are not within the scope of CGT.

## 24.16 Corporate settlor

Section 624 ITTOIA does not apply to a UK company settlor even if (which is rare) the company is the settlor of a settlor-interested settlement-arrangement. That section only applies for the purposes of income tax and not for corporation tax.

For completeness, it is also considered that the section does not apply to a non UK company settlor, but in practice this issue is not likely to arise.

CHAPTER TWENTY FIVE

# TRANSFER OF ASSETS ABROAD: INTRODUCTION

## 25.1 TAA – Introduction

Non-resident trusts and companies pay no UK tax on foreign income. A non-resident company may pay less tax on UK income. These rules present an obvious means of income tax avoidance. HMRC's first answer to this is Chapter 2 Part 13 ITA, entitled "Transfer of assets abroad".

There are strictly three charging provisions – ss.720, 727 and 731 – but for practical purposes there are two, as s.727 is only a minor supplement to s.720. This chapter considers the requirements they have in common. The next two chapters consider them individually.

The discussion of the provisions in International Manual 600000 contains almost nothing significant, but *thirty eight* paragraphs are withheld "because of exemptions in the Freedom of Information Act 2000". Information may be withheld if disclosure would be likely to prejudice the assessment or collection of tax.[1] No doubt parts of the withheld text do fall into that category, identifying tax avoidance possibilities or procedures to detect evasion. I expect that the bulk of the withheld text is simply a discussion of the law. Disclosure only prejudices tax collection if one takes the view that uncertainty in the scope of anti-avoidance law is desirable. This is constitutionally wrong. The principle of legal certainty is an important aspect of the rule of law. (That is the basis on which the Manuals are published in the first place.) It is also pragmatically wrong. Legal certainty is in the interest of HMRC as well as private citizens. If HMRC are not prepared to state their view then

1 s.31(i)(v) Freedom of Information Act 2000. It is interesting to speculate whether some text might actually be withheld because it acknowledges that parts of RI 201 cannot seriously be defended as correct.

private citizens must do as best they can. They can hardly be guilty of neglect if they form wrong views in this difficult area in which HMRC are themselves not prepared to comment, and this is likely to lead to loss of tax. But there it is.

On 31 March 2009 HMRC published some guidance on the ITA remittance basis rules as they apply to the TAA provisions. This is headed TAH (= Transfer of Assets Handbook).

## 25.2 "Relevant transfer"

The key concept is "relevant transfer". The charges only apply if a relevant transfer occurs. Section 716(1) ITA provides:

> A transfer is a relevant transfer for the purposes of this Chapter if—
> (a) it is a transfer of assets, and
> (b) as a result of—
> (i) the transfer,
> (ii) one or more associated operations, or
> (iii) the transfer and one or more associated operations,
> income becomes payable to a person abroad.

This sets out the following basic conditions:

(1) *A transfer of assets*.
(2) *Income becomes payable to person abroad*.
(3) *Causation*: Condition (2) is caused by (i) the transfer, or (ii) associated operations, or (iii) both. I refer to this as "**the relevant transfer causation conditions (i), (ii) and (iii)**", or together "**the relevant transfer causation conditions**".

These basic conditions are the subject of this chapter. However the fact that there is a relevant transfer is not sufficient in itself to cause a tax charge. The further conditions in the various charging sections must be satisfied. These are considered in the next two chapters.

## 25.3 A "transfer" of "assets"

Section 716(2) ITA provides:

> In this Chapter "transfer", in relation to rights, includes the creation of the rights.

If two parties enter into a contract there are *two* transfers of assets as both parties acquire rights.

In *IRC v Brackett* 60 TC 134, T entered into a contract of employment with a person abroad, an offshore company in which he was interested. Rights under a contract of employment are an "asset". Entering into a contract of employment is a "transfer". So T was taxed on all income accruing to the company as a result of the transfer.

If B borrows from L there are two transfers of assets, for B acquires the money borrowed and L acquires a debt. If L is non-resident, then the interest is income accruing to a person abroad.

Note that there may be a "transfer of assets" in circumstances where there is no individual who is the "transferor".

## 25.4 Person abroad

Section 718(1) ITA provides:

> In this Chapter "person abroad" means a person who is resident or domiciled outside the UK.

### 25.4.1 *Foreign incorporated company*

Section 718(2) ITA provides:

> For the purposes of this Chapter, the following persons are treated as resident outside the UK—
> (a) a UK resident body corporate that is incorporated outside the UK.

This is otiose because a foreign incorporated company is domiciled outside the UK[2] and so even in the absence of this provision it is within the definition of a "person abroad".

The rule that a UK resident foreign incorporated company should fall within the definition of "person abroad" made sense before the introduction of corporation tax in 1965; until then, a UK resident foreign incorporated company was only taxed on the remittance basis. Since 1965 the rule is not appropriate because a UK resident company pays tax on its

2 See 2.16 (Domicile of company).

profits on an arising basis, even if foreign incorporated, so there is no need for the TAA provisions to apply. However s.3(1) CTA 2009 provides:

> **3 Exclusion of charge to income tax**
> (1) The provisions of the Income Tax Acts relating to the charge to income tax do not apply to income of a company if—
> (a) the company is UK resident, or
> (b) the company is not UK resident and the income is within its chargeable profits as defined by section 19.

It is considered that s.720 is a "provision of the income tax acts relating to the charge of income tax" so it does not apply to income of a UK resident company. It is considered that the same applies to s.731.

This makes good sense, because if the profits are subject to corporation tax, HMRC do not need the TAA provisions. This view is also supported by CTA 2009 EN:

> **Clause 3: Exclusion of charge to income tax**
> 46. This clause ensures that income of a company within the charge to corporation tax is not chargeable to income tax as well as corporation tax. It is based on section 6(2) of ICTA.

This argument was put in *IRC v Levy* but the judge expressed no view.[3] HMRC do not officially agree,[4] but they may not have considered this point.

One situation in which this issue arises is where a foreign incorporated company is accidentally UK resident, because of a failure to ensure that it is managed and controlled outside the UK. A second situation is where one deliberately uses a UK resident but foreign incorporated company. This may be done in order to obtain the IHT or CGT advantages of foreign situate property.[5] There may however be commercial reasons why it is desired that a foreign incorporated company should be managed and controlled in the UK, and the tax system should hardly aim to discourage that. If it were desired to restrict the tax advantages (such as they are) of

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3 56 TC 58 at [87]. HMRC's answer was to rely on s.9 ICTA 1988, but I cannot see how that helps. (Unfortunately the argument was not put in *R v Dimsey & Allen* 74 TC 263, but that should not preclude its being taken now.)

4 See 28.2.1 (Transferor's credit).

5 See 28.2 (Undistributed UK taxable income of offshore company).

UK resident foreign incorporated companies, the TAA provisions are certainly not the way to go about it.

It is considered that s.718(2) should be repealed and replaced by a rule that a UK resident company is not a "person abroad". If my analysis is right, the subsection is otiose, but if my analysis is wrong, it is undesirable if not pernicious.

### 25.4.2 *Trustees and PRs*

Section 718(2) ITA provides:

> For the purposes of this Chapter, the following persons are treated as resident outside the UK—
>
> ...
>
> (b) the person treated as neither UK resident nor ordinarily UK resident under section 475(3) (trustees of settlements), and
>
> (c) persons treated as non-UK resident under section 834(4) (personal representatives).

This is otiose because the statutory residence rules for trustees and PRs clearly state when they are regarded as resident outside the UK for IT purposes.

## 25.5 Income "becomes payable" to person abroad

The condition here is that income becomes payable to a non-resident or foreign domiciled person (the person abroad).

This condition is satisfied where the transfer is to a UK resident and domiciled person who later becomes non-resident or foreign domiciled.[6]

In *Latilla v IRC*[7] a partnership share was transferred to a company abroad which received its share of the partnership profits. It was argued that trading profits could not be described as income *payable* to the company. Trading "income" is the result of a computation in trading accounts. The gross receipts of the trade or gross rents are not the income. The House of

6 *Congreve v IRC* 30 TC 163 (a gift to a company which became non-resident), approved on this point in *IRC v Willoughby* 70 TC 57.

7 25 TC 107. I mention for completeness only that this was followed in *Brackett v Chater* 60 TC 143.

Lords rejected this argument and held that there was no difference between trading income and other types of income. It seems surprising today that this technicality was thought arguable, so far has the pendulum swung from literal to purposive construction.

Suppose T transfers money to a person abroad, and the person abroad uses the funds to repay a debt. In principle, no income arises to the person abroad as a result of the transfer, so the transfer does not satisfy the transfer of asset provisions.[8]

### 25.5.1 *Transfer from one person abroad to another*

Suppose assets are transferred from one person abroad to another, eg from offshore trustees to an offshore company. Can one argue that there is no relevant transfer because one cannot say that income *becomes* payable to a person abroad? It was payable to a person abroad even before the transfer! The argument is linguistically possible, but the context shows that it is wrong. If the argument was right then a transfer by a non-resident or foreign domiciled transferor would never be a relevant transfer, which is certainly not the case.

## 25.6 Situs of transferred assets

The heading "transfer of assets abroad" might suggest a requirement that UK situate assets must become non-UK situate, but that is obviously not the case.

It has been suggested that the assets must be UK situate at the time of the transfer. This was rightly rejected by the Special Commissioner in *IRC v Willoughby* 70 TC 57 at 79. The taxpayer wisely abandoned this point on appeal.

## 25.7 Transfer for full consideration

A relevant transfer may be made for full consideration and need have no element of "bounty" or gratuitous intent. (Contrast the settlement

8 The example is based on the facts of *Fynn v IRC* 37 TC 629 where this s.720 point was not argued, presumably, because the Revenue accepted this view was correct. For other issues raised by this case, see 26.12.3 ("Connected with any relevant transaction").

provisions.)[9]

### 25.7.1 *Purchase of asset from person abroad*

Suppose T buys an asset from a person abroad for cash ("the purchase price"). At first glance, the payment of the cash purchase price is a relevant transfer. The payment is a transfer of assets; as a result of the 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;[10]
(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 them, but T loses the income from the asset which they sell to T. If the two (broadly) cancel each other out, it cannot be said that any "income becomes payable" to the person abroad. If that is right, the transfer of asset conditions are not satisfied every time someone sells an asset to (or buys an asset from) a non-resident person. That would be a sensible result. If T sells assets to an offshore trust, say, or to an offshore company, it would be surprising if T's only defence to TAA was the motive defence.[11]

### 25.7.2 *Income arising must be identifiable*

The provisions assume that one can *identify* the amount of income which arises to the person abroad as a result of the transfer. If that identification is not possible then the transfer of asset provisions do not - indeed cannot - operate.

John Avery Jones raises this question:

> What about buying a ticket from a foreign airline, buying a meal or

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9 See 69.2.3 (Settlement-arrangement definition of settlement).

10 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.

11 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 T 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.

> 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?[12]

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.[13]

The question whether one can identify the income which arises to the person abroad as a result of a transfer sometimes overlaps with the question whether one can identify a transferor. In *IRC v Pratt* 57 TC 1 the taxpayers were held not to be transferors because one could not identify income arising to the person abroad from what each individual taxpayer had contributed or done.[14] But the two questions are in principle distinct. A person who subscribes for shares in Microsoft Inc is clearly a transferor, but one cannot identify what income accrues to Microsoft as a result of that transfer, so the transfer of asset provisions do not apply.

### 25.7.3 *Deposit in offshore bank account*

If T deposits money with a bank, the trading receipts of the bank are increased, though that may be reduced or 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.

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12 [1998] BTR 392.

13 Of course in practice considerations of materiality might also arise. An independent reason why the transfers of assets are not relevant transfers is that (maybe) that no income becomes payable as a result of them: see 25.5 (Income "becomes payable" to person abroad).

14 See 26.3.2 (Transfer procured by individual).

### 25.7.4 *Transfer for issue of shares or debentures*

Suppose T transfers an asset to a foreign company in exchange for the issue of shares or debentures in that company (set up for the purpose and wholly owned by a trust or structure set up by T). This may well be transfer for full consideration. It is nevertheless a relevant transfer. Indeed it is the archetypal TAA situation. Tax avoidance arrangements set up in the 1920s and 1930s typically involved the transfer of assets to a Canadian company in consideration of debentures issued by that company.

Contrast the position if T subscribes for shares or debentures in (say) a large quoted foreign company or collective investment scheme. This is not a relevant transfer as one cannot identify the income which arises as a result of the transfer.

### 25.7.5 *Transfer for issue of bond or life insurance policy*

The same applies if T subscribes for a bond or life insurance policy from 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.

### 25.7.6 *HMRC view*

EN FB 2006 states:

> [1] 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.
> [2] So the legislation would not apply where, for example,
> [a] a UK resident invests directly in an offshore bank account or
> [b] 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.[15]

Example [a] is the person who invests[16] in an offshore bank account. That person makes a transfer of assets to a person abroad (the bank). It is broadly[17] true that the income from such investments (ie bank interest) "remains liable to tax in the usual way". But while this explains why HMRC do not wish to apply s.720 ITA, it does not actually offer any defence to the provisions.[18] (This fact is relevant to the motive defence, but it would be surprising if the only defence to s.720 was the motive defence.)[19] 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 [b] is the person who buys shares on an overseas stock exchange. The example is misconceived. A person who buys shares does not make a relevant transfer of assets, 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.

## 25.8 Income accruing to person abroad: causation conditions

There is not a relevant transfer merely because there has been a transfer of assets and income has become payable to a person abroad. The income must become so payable as a result of the transfer (or associated operations). The test is one of causation.

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15 EN to s.79, para 63.

16 A lawyer would call this a loan or deposit, not an "investment", but nothing turns on that.

17 It is not strictly true that income from offshore investments remains liable to UK tax "in the usual way". A remittance basis taxpayer may invest in a foreign account to qualify for the remittance basis. An arising basis taxpayer obtains the tax advantage that tax is not deducted at source, and DTA relief may apply.

18 See 26.4 (Must the transferor avoid or intend to avoid IT?).

19 No-one expects the depositor to claim the motive defence in their tax return.

### 25.8.1 *Purchase of secondhand company by individual*

Suppose T (UK resident) buys the shares of an already existing non-resident company ("**a secondhand company**"). Assume the company owns assets. That purchase involves a transfer of assets by T – payment of the purchase price[20] – 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 secondhand company (eg 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 T will in principle be within s.720 and taxed on the secondhand company's income.[21] If T is not the transferor, T may be subject to tax under s.731 if T receives benefits (unless the company funds transfer qualifies for the motive defence).

The secondhand company may later make a relevant transfer.[22] If T procures that transfer, T is its transferor.

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20 The sale in fact involves two transfers of assets: payment of the purchase price to the vendor and transfer of the shares to T.

21 As to whether T is the transferor, see 26.3 (Who is the transferor?).

22 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 25.7.1 (Purchase of asset from person abroad).

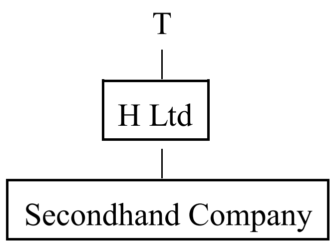
### 25.8.2 *Purchase of secondhand company by holding company*

Now suppose:

(1) T transfers assets to H Ltd, an offshore company ("**the H transfer**").

(2) H uses its funds to purchase a secondhand company ("**the purchase price transfer**").

Thus the position is:




A similar analysis applies:

(1) The H transfer is in principle a relevant transfer. However, no income arises to a person abroad as a result of that transfer.[23]

(2) The purchase price transfer is not a relevant transfer. No income accrues to a person abroad as a result of that transfer. Income does arise to the secondhand company, but not as a result of the H transfer or the purchase price transfer.

Suppose H Ltd then provides additional funds for the secondhand company, directly or indirectly. It appears then that the secondhand company will receive income as a result of the H transfer[24] and T will be subject to tax under s.720 on the income accruing to the secondhand company from the additional funds, if that income can be identified.

## 25.9 Associated operation: definition

Section 719(1) ITA provides just about the widest definition the drafter could devise:

> In this Chapter "associated operation", in relation to a transfer of assets, means an operation of any kind effected by any person in relation to—
> (a) any of the assets transferred,

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23 Assume no income accrues to H (the secondhand company does not pay a dividend).

24 Together with an associated operation (the provision of funds by H).

(b) any assets directly or indirectly representing[25] any of the assets transferred,
(c) the income arising from any assets within para (a) or (b), or
(d) any assets directly or indirectly representing the accumulations of income arising from any assets within para (a) or (b).

An associated operation does not exist in isolation, it exists in relation to a transfer. There are two requirements:
(1) It must be an "operation".
(2) It must be "effected in relation to" items (a) to (d); I describe this as 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.

### 25.9.1 *"Operation"*

"Operation" is (rightly) not defined but is clearly a word of wide import. It includes a company becoming non-resident.[26] It does not include death, but that does not matter because it does include the act of making a will.[27]

In *Herdman v IRC* 45 TC 394 there was a sale (ie 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

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25 "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.

26 *Congreve v IRC* 30 TC 163.

27 *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".

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".

### 25.9.2 *"Associated"*

In *Fynn v IRC* 37 TC 627:

(1) in 1948 T transferred assets to an Irish company ("the original transfer");
(2) in 1952 T lent money to the company ("the 1952 loan").

The 1952 loan was not an associated operation in relation to the original transfer, because it was not effected "in relation to" the assets transferred by the original transfer.
In *Carvill v IRC*:[28]

(1) T transferred assets to a Bermudian company (B Ltd) in exchange for shares, and so became a majority shareholder in B Ltd ("the original transfer").
(2) T became a 100% shareholder in B Ltd by (a) purchasing shares and (b) B Ltd purchasing its own shares.
(3) B Ltd entered into arrangements to remunerate T via a personal services company and a brokerage sharing agreement.

Steps (2) and (3) were not operations associated with the original transfer: they did not relate to the assets transferred by the original transfer.

### 25.9.3 *Associated operation preceding the transfer*

Section 719(2) ITA provides:

> It does not matter whether the operation is effected before, after, or at the same time as the transfer.

This provision (introduced in 2006) gives statutory effect to the view

28 [2000] STC (SCD) 143 at [80]-[85], 75 TC 477 (Special Commissioners).

formerly expressed in RI 201.[29] 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.

### 25.9.4 *Is mere historical association enough?*

On a simply reading of the definition, an operation can be "associated" with an earlier transfer even if the two were not part of any plan and many years apart. Suppose:
(1) A transfers an asset to B (who is UK resident) in 1970; and
(2) B transfers the asset in the year 2010 to an offshore trust under which A may benefit.
On a simple reading, B's disposition is an associated operation in relation to A's transfer even though:
(1) they are not part of a single arrangement;
(2) A is unaware of B's disposition;
(3) B's disposition is itself a relevant transfer;
(4) one or both transfers is a sale on arm's length terms.
The same would apply if A's transfer was made in 1870 or 1670. Indeed, anyone who purchases or disposes of an estate in English land is only effecting the most recent "operation" of a series of associated operations (dispositions of the land) which may perhaps be traced back to the Norman Conquest if not before, and only a lack of records prevents one tracing the sequence of associated operations to the dawn of civilisation. In fact this simple reading cannot be right, for reasons given below.

## 25.10 Significance of associated operations

It is never enough to establish that there is an associated operation in relation to a transfer. This is just the first step. One must then go on to ask what (if anything) follows. The term "associated operations" is used in the definition of "relevant transfer"[30] and it is used in the definition of

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29 "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.

30 See 25.2 ("Relevant transfer").

"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.[31]

*(2) Section 721 ITA*: Individual has "power to enjoy" as a result of transfer and/or associated operations.

*(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.[32]

*(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.[33]

*(6) Motive defence*: All relevant transactions must satisfy the conditions of the motive defence.[34]

## 25.11 Person abroad receives income as indirect consequence of transfer

### 25.11.1 *Transfer from A to B followed by transfer from B to person abroad*

Suppose:

(1) In 1970 A transfers an asset to B (who is a UK resident individual) ("A's transfer").

(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

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31 See 25.11 (Person abroad receives income as indirect consequence of transfer).

32 See 27.7 (Benefit causation condition).

33 See 27.30 (Is income of company relevant income?).

34 See 29.39 (Associated operations and motive defence before 5 December 2005) and 29.40 (Transfer and associated operations both after 4 December 2005).

A is unaware of B's transfer.

B's transfer is obviously a relevant transfer. The question is whether A's transfer is a relevant transfer.

It may be helpful to recap the definition. Section 716(1) ITA provides:

> A transfer is a relevant transfer for the purposes of this Chapter if—
> (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.

I refer to (i) to (iii) as "causation conditions (i) to (iii)".

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:[35] 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?

### 25.11.2 *Position before 2007/08*

Before 2007/08 the TAA provisions applied a more limited causation test. They only applied to:

> transfer of assets *by virtue or in consequence* of which, either alone or in conjunction with associated operations, income becomes payable to persons resident or domiciled outside the UK.

35 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 29.39 (Associated operations and motive defence before 5 December 2005).

This applied causation condition (i) and (iii) but not causation condition (ii).

In the 5th edition of this book I said:[36]

> One might reach this result by understanding [restricting] the reference 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?

### 25.11.3 *Position from 2007/08*

Unfortunately the key which allowed the reader to make sense of the provisions was discarded in the tax law rewrite.[37] I infer that HMRC found causation an inconvenience, so they quietly[38] but substantially relaxed it, by adding causation condition (ii). But no consideration was

36 5th edition, para 14.11. Footnotes omitted.

37 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.

38 The EN did not mention this important change.

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 support in *Vestey* 54 TC 503.

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.[39] 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, ie is A a settlor of B's trust, did A provide the property indirectly?[40] If not, the operations are not associated.

### 25.11.4 *Transfer to UK trust followed by migration of trust before 6 April 2006*

Suppose:

(1) In 1970, A transfers assets to a discretionary trust with UK trustees ("A's transfer");
(2) In 2000, the UK trustees appoint foreign trustees in their place and transfer the trust assets to them ("the appointment of foreign trustees").

The appointment of foreign trustees is a relevant transfer. (The appointment of foreign trustees involves a transfer of assets, as a result of which income accrues to the non-resident trustees.) The question is

39 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.

40 See 69.4 (Gift from A to B followed by gift to trust by B).

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 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.[41]

### 25.11.5 *Transfer to trust followed by transfer from trust to offshore company*

This is in principle the same as 25.11.4 (Transfer to UK trust followed by migration of trust before 6 April 2006). This applies whether the transfer by the trustees is gratuitous or in exchange for shares, debentures or an offshore life policy. But if the investment is for wholly commercial reasons, it may be argued that is not the case and so the income of the underlying company is not within the TAA provisions, but this requires

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41 The position in 25.11.1 (Transfer from A to B followed by transfer from B to person abroad) is different. There B's transfer is independent in a way that trustees are not, because trustees are constrained by the fiduciary nature of their powers.

This view is also supported by obiter dicta in *Congreve v IRC* 30 TC. This concerned a gift to a UK company which became non-resident. This was a relevant transfer without the association operations rule. See 25.5 (Income "becomes payable" to person abroad). But the House of Lords also held (at 206) that the company becoming non-resident was an associated operation; and (by inference) income arose to the company abroad as a result of the transfer and associated operation.

HMRC would have further arguments, if necessary, based on *Muir v Muir* [1943] AC 468.

the Courts to read words into the statute, and the case for doing so here is not strong enough.

### 25.11.6 *Transfer to company followed by migration of company*

This is a relevant transfer even without the associated operations rules.[42]

### 25.11.7 *Transfer to UK trust followed by migration of trust from 6 April 2006*

Suppose the facts of 25.11.4 (Transfer to UK trust followed by migration of trust before 6 April 2006), but assume the migration occurred after 6 April 2006. The trust is deemed to be a single person. The analysis is therefore different. The appointment of foreign trustees does not involve any transfer. Instead the analysis is the same as 25.11.6 (Transfer to company followed by migration of company). The end result is the same, though the route to that destination is different.

## 25.12 Income of person abroad

The concept of "income of the person abroad" is relevant for several purposes of the transfer of asset provisions:

(1) There is a relevant transfer only if "income becomes payable" to a person abroad. If *no* such income becomes payable then there is no relevant transfer and the TAA provisions cannot come into effect.

(2) The *identity* of the income payable to the person abroad as a result of the transfer is relevant:
   (a) for s.720 ITA, as one must ask whether the transferor has power to enjoy that income;
   (b) for s.731 ITA, as one must ask whether that income can be used to benefit an individual.

(3) The *amount* of income payable to the person abroad as a result of the transfer is relevant as ascertaining that amount is the first step in computing the amount on which tax is charged under s.720 or relevant income for s.731.

42 See above footnote.

## 25.13 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".[43]

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[44] even though it is a capital receipt for trust law purposes. Likewise income deemed to accrue on a stock dividend under s.410 ITTOIA and a gain deemed to be income under s.688 ITA (transactions in land). On gains from offshore funds: see 32.9 (OIG arising to non-resident trust). On gains from life policies see 30.6.1 (Non-resident trusts) and 30.6.2 (Non-resident company or institution).

## 25.14 The amount of income of person abroad

This section considers the amount of the income arising to the person abroad as a result of the transfer and associated operations.

### 25.14.1 *Dividend income of person abroad: net or grossed up?*

In order to follow the discussion one needs to bear in mind the usual rules for taxing a UK dividend.[45] In short, a UK resident or EEA national receives a tax credit and the dividend is grossed up. For instance:

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43 See 16.2 (Why does "capital *v.* income" matter?)

44 This is assumed to be the case in the drafting of s.482 ITA.

45 See 19.2 (Income from UK resident company). References in this section to dividends also include other company distributions.

Dividend £1,000 **("net amount")**
Tax credit (one ninth) £111.11
Dividend plus tax credit £1,111.11 **("gross amount")**

A person abroad who is not resident in the EU is not normally entitled to a tax credit and the income is not grossed up.

In *Carvill v IRC* the person abroad received dividends and was not entitled to a tax credit. The transferor argued that the measure of income for s.720 ITA was the net amount. The argument was rejected:

> 100. [HMRC] contended that the income which the section [s.720] deems to be income of the taxpayer is the dividends [received by the person abroad]. ...
> It follows [from what is now s.746 ITA] that the position is the same as if the taxpayer had actually received those dividends. They would be grossed-up by the amount of the tax credit and he would be entitled to the benefit of the tax credit. The position is just as if International Holdings [the person abroad] had never existed.
> 101. [The taxpayer] contended that the income which was deemed to be the taxpayer's was the net income of the company from all sources after deduction of any reliefs which would have been available to an individual in a comparable position. The income lost its original characteristics and became charged under Case VI of Sch D. ...The effect of this approach is that because [the person abroad who received the dividend] is not entitled to the tax credit, the income is not grossed up but is not charged to income tax at the lower rate [now the dividend ordinary rate].
> 102. It is not necessary for me to decide this point but I find [HMRC's] approach more attractive particularly as it precisely gives effect to counteracting the advantage of the transfer.[46]

For s.731 purposes:

(1) If the person abroad was not entitled to a tax credit, the amount of a dividend would be the net amount.
(2) If the person abroad was entitled to a tax credit the amount of a dividend would be the gross amount. However, the relevant income is only the amount which can be applied for the benefit of any person so the amount of relevant income is the net amount.

46 *Carvill v IRC* [2000] STC (SCD) 143, 75 TC 477.

### 25.14.2 *Deduction of administration costs against investment income*

In *Chetwode v IRC* 51 TC 647 an offshore company received dividends and interest of about £3,000 per annum. The transferor was taxed on the gross amount of that income, without deduction for (i) investment advisory fees, (ii) management fees, (iii) safekeeping charges, (iv) security handling fees and bank charges, (v) registered office and executive office 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 all expenses will be deducted in computing relevant income.

### 25.14.3 *Trading income and trading losses of person abroad*[47]

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.

Profits are computed on a current year basis.[48]

For losses, RI 201 provides:

> The Revenue's practice is only to allow trading losses to be carried

47 See at p.687 "In the case of a trade, it is necessary to strike a balance, in respect of a period, before any taxable "income" arises."

48 *Vestey v IRC* 54 TC at p.528.

forward and set against future trading profits. They cannot be offset against investment income of the same, previous or future years.[49]

For s.731, losses will be deducted in computing relevant income if paid out of relevant income. There is no group relief.

### 25.14.4 *Property income of person abroad*

The rules for measuring property income are the same as for the settlement provisions; see 24.2.4 (Property Business Income). Transfer pricing may also need consideration here.

### 25.14.5 *Loan relationship and Forex income*

Since income is computed on IT principles, "income" does not include profits computed under loan relationship or Forex rules which apply for the purposes of corporation tax and not for IT purposes. This is so even if the person abroad is a company.

49 This is consistent with the position for property income losses. See 24.2.5 (Property business losses).

CHAPTER TWENTY SIX

# TRANSFER OF ASSETS ABROAD: TRANSFERORS

## 26.1 TAA charges on transferor

This chapter considers the TAA charges on the transferor. There are strictly two charges: s.720 and s.727 ITA, but s.720 is by far the most important.

Section 720 ITA imposes the charge to tax:

> (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 41.6 (Rates of tax on transferor within s.720 ITA). For a comparison with s.624 ITTOIA see 24.13 (Section 624 *v* s.720: comparison and priority).

## 26.2 Who is liable?

Section 720(5) ITA provides:

> The person liable for any tax charged under this section is the individual to whom the income is treated as arising.

ITA EN provides:

> 2141. Subsection (5) provides that the individual to whom income is treated as arising is the person liable. This person is defined in section 721.

So we turn to s.721 ITA but we do not find a clear definition:

> (1) Income is treated as arising to such an individual as is mentioned in section 720(1) in a tax year for income tax purposes if conditions A and B are met.

The charge is imposed on "such an individual as is mentioned in s.720(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 as is mentioned in s.720(1)". The wise words of Garner are worth quoting here:

> *Such* is a deictic (pointing) term that must refer to a clear antecedent.[1]

The failure to observe this point – obvious though it may seem – has given rise to a good deal of case law. The intention of the ITA rewrite was to preserve the case law and (so far as the law was unclear) to preserve the ambiguities. ITA EN provides:

> 2144. Sections 739(2) and (3) of ICTA indicate the person liable by using the expression "such an individual" – but do not make it clear how much of section 739(1) is implied by that expression. [Sections 721] and 728 ITA, which are based on section 739(2) and (3) ICTA, reproduce the expression "such an individual", which has been the subject of case law: see, in particular, *Vestey v IRC* 54 TC 503.

What, then, are the requirements to be "such an individual", as is

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1 Garner, *A Dictionary of Modern Legal Usage* (3rd ed., 2011), entry under "Such". Harold Pinter adroitly exploits the ambiguity in *No Man's Land* (2001):
"... 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*."

mentioned in s.720(1)? There are two:
(1) The individual must be ordinarily resident in the UK; that seems clear.
(2) The individual must be "the transferor"; that was decided in *Vestey*.

## 26.3 Who is the transferor?

The next question is to identify the transferor (if there is one). Clearly, anyone who actually makes a transfer is a transferor, but the expression is a little wider than that.

### 26.3.1 *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 their share. RI 201 states:

> Where the same assets are transferred by several individuals, the Revenue's practice is to assess the transferors in proportion to their share of the assets transferred. Thus, where, for example, shares of a UK company are held by three shareholders in the proportion 40%, 40% and 20% and there is [s.720 ITA] liability in respect of the income of an overseas person to which the shares are transferred, the liability is assessed on each of the three shareholders in proportion to their respective holdings.

That seems obvious.

### 26.3.2 *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. ... 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 (beneficiaries of a discretionary trust) were clearly not transferors. The House of Lords discussed the question in passing, and the answer was expressed in a variety of different ways. Lord Wilberforce said s.720 applies:

> only where the person sought to be charged made or, maybe, was associated with, the transfer.[3]

Lord Keith said the section only applied to an individual:

> who has sought to avoid liability to income tax by means of such transfers of assets as are mentioned in [s.720(1)].[4]

Lord Dilhorne said the section applied to an individual:

> who has sought to avoid income tax[5]

though in the same paragraph he also approved the Court of Appeal's comment in *Congreve* (which one might have thought a somewhat different approach).

Likewise Lord Edmund-Davis:

> individuals whose purpose is the avoidance of liability to tax ...[6]

Thus in *Vestey*, the question who is a transferor had received different answers (though in practice the differences may not often matter).

These doubts were resolved in *IRC v Pratt* which decided that an individual who did not make the transfer may be within s.720 if and only

2 30 TC 163 at p.197.

3 54 TC 503 at p.587A. 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.

if they "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 anyone to whom s.720 applies, that is, both those who make a transfer and those who procure it.

The classic example of procuring a transfer is if T owns all the shares in a company and uses 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]

This is tentatively expressed, but it is considered to be correct. The position may 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 in which case the shareholders would not be transferors.

The facts of *Pratt* were that the taxpayers alleged to be transferors (i) were three directors out of eight; and (ii) held 30% of the company. They had influence but 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.

In *Carvill v IRC*, T transferred the majority shareholding to a person abroad, and the minority shareholders transferred their shares. HMRC argued (implausibly) that T was the "transferor" of the minority shareholding. But this was rightly rejected:

> For an individual to be the transferor in relation to a transfer by another individual would be a considerable extension of this principle. However, there might be cases where, as a matter of fact, one

7 57 TC 1 at p.51 B –D and p.55 E–F.

8 *IRC v Pratt* 57 TC 1 at p.50.

> individual's influence over another was so strong that he was the transferor of the other's share but this would clearly be an exceptional case. ...
>
> 72. [Counsel] contends that the taxpayer was the transferor of the old minority shares. In order to find that this was an exceptional case where the taxpayer did in effect force his will on the other shareholders so as to become the transferor of their shares, one would need strong evidence that this was so. Of course, the taxpayer as majority shareholder and one of the founders of a company bearing his name was in a position of some influence. However, the influence did not go as far as telling other shareholders what to do with their shares. Here the decision by the old minority to transfer their shares was one which they came to after discussion, having started with different points of view as to the merits of the transfer. There is no evidence that the taxpayer leaned on any of them heavily, for example, by threatening to sack them if they did not. ... Accordingly, there is no evidence that the taxpayer did anything in relation to the old minority shares which would make him the transferor of them, and I find that he was not the transferor of the old minority shares.[9]

What about a gratuitous transfer from A to B and from B to the person abroad? The question whether A has procured B's transfer does not arise, for A is a transferor by virtue of the transfer to B. The true question is whether B's transfer is caught under the associated operations rules.

What if A (perhaps a principal beneficiary but not settlor) encourages trustees to make a transfer? It is considered that A (not being in control of the trust) cannot be said to procure the transfer made by the trustees. Likewise a trustee or other person exercising fiduciary powers is not a transferor, eg a person with power of appointing new trustees does not become a transferor if they exercise the power because the power is fiduciary. So the concept of "procuring" a transfer in practice applies to individuals controlling companies; other cases, while theoretically possible, will be rare.

Contrast the position where:

(1) T transfers assets to A, in consideration for which A transfers assets to a person abroad.

(2) T transfers assets to a company, in consideration for which the

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9 *Carvill v IRC* [2000] STC (SCD) 1543 at [71]-[72], 75 TC 477 (Special Commissioners).

company issues shares to a person abroad.

(3) T (an employee entitled to a bonus) waives the right to the bonus, in consideration for which the employer transfers assets to a pension scheme abroad.

In the first two cases, T is not just a quasi transferor, T is an *actual* transferor for T has made a transfer of assets. In the third case, T has procured the transfer so is within the scope of s.720.

A person who is not a transferor (such as the successful appellants in *Pratt*) might instead fall within s.731 if they received benefits.

### 26.3.3 *HMRC practice*

RI 201 provides:

> [1] Section [720 and 727 ITA] can potentially apply not only to an individual who transfers assets but to someone who is "associated with" a transaction (according to the decision of the Courts in *Vestey v IRC*).
> [2] The Revenue regard this as including anyone who procured the transfer of assets.

Point [1] quotes one of the views tentatively expressed in *Vestey*[10] but disingenuously omits the "maybe". If "associated" here has its normal, rather wide sense, point [1] is clearly wrong in the light of *Pratt* and *Carvill*. It is considered that a person is a transferor only if they have 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.

It appears that HMRC would now agree, for Revenue & Customs Brief 18/11 provides:

> 5.1.1 ... For the income charge provisions [s.720] to apply the individual on whom the charge arises must be the person who transfers the assets or procures the transfer.

10 The comment of Lord Wilberforce is set out at 26.3.2 (Transfer procured by individual).

However, in practice HMRC do not take s.720 points when UK companies make transfers abroad, even if there is a 100% shareholder who could be regarded 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.) The CFC legislation is intended to fill the gap.[11] An exception where HMRC say they might raise the point relates to employee benefit trusts. Revenue & Customs Brief 18/11 provides:

> 5.1.1 ... [1] If the offshore Employee Benefit Trust is a normal commercial arrangement by a company to reward its employees, the transferor is the employer company;
> [2] and in such circumstances the income charge is unlikely to be applicable as the transferor and beneficiaries are different people.
> [3] However, it may be that the employee has transferred a right to receive a bonus into the offshore Employee Benefit Trust and is therefore the transferor. If this is the case the ToA legislation may apply and the employee will be liable to tax on any income arising in the trust.
> [4] If the employer company is controlled by its shareholder/directors and the offshore Employee Benefit Trust was formed solely for their benefit, the director/shareholders may have procured the transfer into the offshore Employee Benefit Trust and could be considered transferors for the purposes of the income charge. Whether or not the ToA income charge is then applied will depend on the facts of each case.

There is a good deal of confusion here:

[1] The fact that the trust is a normal commercial arrangement may be a reason for allowing the motive defence, but does not affect the identity of the transferor. It appears that HMRC are not interested in applying s.720 to "normal commercial arrangements" so they do not care who is the transferor (even in the case of non-resident EBTs).

[2] The correct issue is not whether "the transferor and beneficiaries are different people" but whether the transferor has power to enjoy; which is perhaps similar but not the same.

[3] This is approximately correct; though s.624 may also be in point, and the individual's liability is not on "any income arising in the trust" but

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.

income arising from the transferred asset.

[4] This is correct as far as it goes but it is rightly tentative ("may have procured...").

## 26.4 Must the transferor avoid or intend to avoid IT?

### 26.4.1 *The statutory provisions*

Section 720 ITA provides:

> (1) The charge under this section applies for the purpose of preventing the avoiding of liability to income tax by individuals who are ordinarily UK resident by means of relevant transfers.
> (2) Income tax is charged on income treated as arising to *such an individual* under section 721. ...

The Special Commissioners say:

> 185. It is clear that the meaning of the phrase "such an individual" must be found in the preamble [now s.720(1)] and that it is not confined to an individual "ordinarily resident in the United Kingdom". Once you go beyond that restricted meaning in order to ascertain what individuals are comprised in the phrase "such an individual" it seems to us difficult to find any logical stopping place short of importing the whole of [s.720(1)].
> 186. In our view it therefore follows that "such an individual" is an individual ordinarily resident in the United Kingdom who, *by means of a transfer* of assets in consequence of which income becomes payable to a non-resident, *avoids liability to income tax apart from the operation of these provisions*.[12]

This is, with respect, clearly right. The question which arises is whether a person who "by means of transfers of assets avoids liability to income tax" means:

(1) a person who in fact avoids income tax (in the absence of the TAA provisions); or
(2) a person who in fact avoids and intends to avoid IT; or
(3) a person who intends to avoid IT (whether or not they in fact do so).

12 *IRC v Botnar* 72 TC 205.

I am inclined to think that solution (1) is the most natural reading, as the word "avoids" suggests avoidance in fact. However the words "by means of" might be thought of as involving some element of intention, so there is also much to be said for solution (2), ie s.720 only applies to a person who in fact avoids and intends to avoid income tax, (though this does overlap with the motive defence).

### 26.4.2 *Position before 1996*

In order to understand the present law, it is necessary first to consider the position before the law was changed in 1996. Case law and statutory reform have complicated what ought to be a simple question with a simple answer.

The starting point is the decision of the House of Lords in *McGuckian v IRC*.[13] This was (in short) a case where a transaction was made which was intended to avoid income tax but did not actually do so (because another anti-avoidance provision was overlooked).[14] The Revenue raised an assessment under s.720. The taxpayer argued that s.720 did not apply since income tax was not actually avoided. The argument failed. Lord Steyn said:

> I would reject the argument that it is a condition precedent to [s.720] applying that there must be proof of an actual avoidance of tax liability. Such a construction treats [s.720] as a power of last resort and it substantially emasculates the effectiveness of the power under [s.720].

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13 69 TC 1.

14 The actual facts were not so simple. An interest in possession trust owned a company, and a dividend would have been taxable income of the life tenant. Instead the trustees sold the right to the dividend for a lump sum. This sum was trust capital as a matter of trust law (though it was regarded as income for tax purposes under the *Ramsay* principle). This sale was intended to avoid income tax on the dividend.

It was assumed that the transaction did not actually avoid IT, since the sale of a dividend was caught by anti avoidance provisions (s.730 ICTA 1988) now repealed. Is this right? One might have argued that income tax *was* in fact avoided since even though it was assessable under s.730, no assessment was actually made, but the Revenue did not argue that point. The taxpayer was however assessed under (what is now) s.720 ITA rather than s.730. The simple answer to this should have been to raise the assessment under s.730, as the Court of Appeal decided, but HL did not pursue that approach.

> Nothing in the language or purpose of [s.720] compels such a construction. Properly construed the opening words of [s.720] merely provide that *there must be an intention to avoid liability for tax*. The sensible construction is that [s.720] can be applied even if there are other provisions which could be invoked to prevent the avoidance of tax. That the revenue authorities should have overlapping taxation powers is an unremarkable consequence. And such a construction cannot cause any unfairness to the taxpayer since he cannot be taxed twice in respect of the same income.[15]

Lord Browne-Wilkinson said:

> [Counsel for the taxpayer] submitted that since the dividend would in any event have been taxable under s 470, [s.720] does not apply. He based this submission on the words in [s.720(1)],
>
> > "For the purpose of preventing the avoiding by individuals ordinarily resident in the United Kingdom of liability to income tax …".
>
> He submitted that [s.720] does not apply unless tax has *in fact* been avoided. In my judgment, there is no warrant for this submission. ... the words of subs (1) make it clear that the actual avoidance of tax is not a precondition to the application of the section. The income is deemed to be the income of the United Kingdom resident
>
> > "whether it would or would not have been chargeable to income tax apart from the provisions of this section".
>
> It is therefore clear [!] that [s.720] can still apply even though the effect of the transfer of assets abroad would not have been successful in avoiding United Kingdom income tax.[16]

It is an understatement to say that the reasoning is not compelling,[17] but

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15 69 TC 1 at p.82E.

16 69 TC 1 at p.76.

17 The reason given by Lord Steyn is not compelling since s.720 is not a "power". The reason given by Lord Browne-Wilkinson is not compelling, since the words he cites (now s.721(5)(a) ITA) are needed for where a transfer reduces the rate of income tax (without avoiding it completely). It is significant that neither judge cites the reason given by the other.

Unfortunately, it was impossible to have any sympathy with the taxpayer or his advisors, whose actions ("disingenuous in the extreme") were held to be the reason why no assessment was made under the correct section in the first place and whose appeal had "no ethical merit". One suspects that this was a case where the decision the decision is still binding. The position before 1996 was settled. The majority of the House of Lords[18] decided that it was not a requirement of s.720 that income tax had to be avoided, though Lord Steyn said that there did have to be an *intention* to avoid income tax.[19]

Thus the law until 1996 was that:

(1) section 720 only applied to a person who intended to avoid income tax; but
(2) actual avoidance of income tax was not necessary.

### 26.4.3 *Position from 1996*

Section 721(5) ITA provides:

> It does not matter for the purposes of this section ...
> (c) whether the avoiding of liability to income tax is a purpose for which the transfer is effected.

This applies to income arising on or after 26 November 1996 regardless of the date of the transfer. This does not affect the operation of the motive defence but it reverses point (1): s.720 applies even it there is no purpose of avoiding income tax.

The provision does not expressly deal with point (2) - actual avoidance. It is suggested that the consequence of this amendment is that the question of whether there must *in fact* be an avoidance of income tax needs to be revisited. For Parliament retained the statutory words set out in 26.4.1 (The statutory provisions) which refer to avoiding income tax. The words should be taken to mean something. If they no longer refer (as Lord Steyn

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was made first and the reasons were found later. The issue was first raised in the House of Lords (it is not mentioned in the lower judgments) and so the Lords did not have the benefit of the consideration of the lower courts on the issue.

18 Lord Lloyd agreed with the other judgments; the other two judges did not consider the point.

19 This area was considered in a thorough Special Commissioners decision just before *McGuckian*: *Botnar v IRC* [1998] STC 38 at pp.63–67. Here the *Revenue* submitted (and the SCs accepted) that s.720 only applies if there is avoidance of IT *in fact*. See para 180. But this has now been overtaken by *McGuckian*. The Special Commissioners also inclined to the view that s.720 only applied if the transferor intended to avoid Income Tax. Had *McGuckian* been decided first, they would no doubt have cited and followed the comment of Lord Steyn set out above. But this has now been overtaken by the statutory reform.

thought they did) to the intention to avoid income tax, they should be taken to require that income tax is *in fact* avoided.[20] Thus it is tentatively suggested that the effect of s.721(5) is to reverse the decision of *McGuckian* on this issue.

The position for income arising from 1996 is therefore that:

(1) an intention to avoid income tax is not a requirement for s.720 to apply.
(2) income tax must in fact be avoided for the section to apply.

This raises the question of what amounts to the avoidance of income tax in fact. If the taxpayer avoids an assessment (especially by dubious means) then it is suggested that income tax is avoided. Thus the assessment in *McGuckian* would still be upheld under s.720, though for slightly different reasons.

## 26.5 Transferor not ordinarily resident

Section 720 refers to an individual who is ordinarily resident in the UK, but it does not say exactly when the individual must be ordinarily resident for the section to apply.

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20 This is consistent with the view that HMRC take of s.752(1) ITA (transactions in land) which provides: "This Chapter has effect for the purpose of preventing the avoidance of income tax by persons concerned with land or the development of land." BIM provides:

> **60315. Conditions: Avoidance**
> Section 776 ICTA 1988 is anti-avoidance legislation (Section 776(1) ICTA 1988). The test for avoidance is an objective one, i.e. has tax been avoided, and not a subjective one relating to the intentions of the participants.
> The avoidance need not, therefore, be deliberate, it can be accidental or unwitting ...
> **60320. Conditions: Avoidance: Straightforward transactions of purchase and sale**
> Section 776 ICTA 1988 cannot be used to catch straightforward transactions of purchase and sale of land that do not amount to a trade, or adventure in the nature of trade. ...
> Section 776 ICTA 1988 is not applicable because the necessary avoidance of tax is not present.

### 26.5.1 *Transferor not ordinarily resident when income arises*

Section 720 does not apply to income which arises while the transferor is not ordinarily resident in the UK.[21]

A non-resident individual is subject to tax at their personal rates on their UK rental income. That individual can transfer UK land to an offshore company in order to avoid higher rate income tax.[22] (It is not usually necessary for the individual to transfer other assets to a company in order to avoid higher rate tax as income of a non-resident from most other sources is not subject to tax at the higher rate.)[23]

A UK resident but not ordinarily resident individual is subject to tax at their personal rates on all UK source income. That individual can transfer land and other UK sources of income to a company to avoid higher rate income tax. They 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 they do not retrospectively become liable for income accruing while non-resident. This is consistent with the usual IT position.[24]

### 26.5.2 *Transferor not ordinarily resident when transfer made*

The intention of those responsible for the legislation was that s.720 should only apply if the transferor was ordinarily resident in the UK at the time of the transfer.[25] This was eventually upheld in *IRC v Willoughby*[26] reversing *Herdman v IRC* 45 TC 394.

The position now is governed by s.721(5) ITA:

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21 This is clear from the words of the section; if authority is needed, the point was assumed in *Herdman v IRC* 45 TC 394 at p.412: "Some time after making this transfer of shares the Respondent became ordinarily resident in Northern Ireland and " ... [s.720] *then* applied".

22 Of course, CGT, VAT, IHT, and SDLT all need consideration.

23 See 37.1 (Non-residents income tax relief).

24 See 9.20 (RFI/gains arising when non-resident, remitted when resident).

25 "There has to be a transfer of assets abroad by an individual resident in this country." (W.S. Morrison, then Financial Secretary) 313 HL Official Reports 5th series col 685, cited in *IRC v Willoughby* 70 TC 57 at p.113.

26 70 TC 57.

> 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 they become 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.[27]

## 26.6 Power to enjoy: Section 721 Condition A

Section 721(1) ITA provides:

> Income is treated as arising to such an individual as is mentioned in section 720(1) in a tax year for income tax purposes if conditions A and B are met.

I refer below to **"s.721 conditions A and B"**, to avoid confusion with the myriad other conditions in the ITA. Section 721(2) sets out condition A:

> Condition A is that the individual has power in the tax year to enjoy income of a person abroad as a result of—
> (a) a relevant transfer,
> (b) one or more associated operations, or
> (c) a relevant transfer and one or more associated operations.

Once one has identified the transferor one asks whether they have "power to enjoy" income of the person abroad. "Power to enjoy" is elaborately defined and has given rise to a large case law. But in practice there is not often an issue here. In outline, the transferor has "power to enjoy" if they may possibly enjoy any of the income of the person abroad, or if they are able to control the application of the income. A transferor has no power to enjoy if they (and their spouses/civil partners) are excluded from benefit and have no power of control. A widow or widower of the transferor may be included as a beneficiary.

The test is slightly wider than that of a "settlor-interested" trust for the

27 Also see 27.9.1 (Transferor not ordinarily resident when transfer made; pre-1996 income).

purposes of s.624 ITTOIA[28] though for most practical purposes they are the same. It is hard to see the reason for the distinction, but that is the patchwork nature of income tax.

If the transferor has power to enjoy, but is then excluded and ceases to have power to enjoy, condition A continues to be satisfied for the rest of the tax year. This is an accidental change from the pre-ITA position.[29]

Statutory tax indemnities do not confer a power to enjoy, see 27.4.10 (Reimbursement of tax under statutory indemnity).

On a transfer from a UK domiciled person to their foreign domiciled spouse, see 64.14 (Income tax planning for mixed marriage).

Section 722 ITA provides:

> **When an individual has power to enjoy income of person abroad**
> (1) For the purposes of section 721, an individual is treated as having power to enjoy income of a person abroad if any of the enjoyment conditions are met.
> (2) In subsection (1) "the enjoyment conditions" means conditions A to E as specified in section 723.

I adopt the statutory terminology and refer to "**enjoyment conditions A to E**".

Section 722(1) states that an individual is *treated* as having power to enjoy if any of the five conditions is satisfied. It is considered that this is a comprehensive definition of "power to enjoy" but it is impossible to think of any power to enjoy (in the general sense) which does not also fall within one of the enjoyment conditions, so the point is academic.

Section 722(3) ITA provides:

> In determining whether an individual has power to enjoy income for the purposes of section 721, regard must be had to the substantial result and effect of all the relevant transactions.

It is hard to imagine a case where this makes any difference.

Section 722(4) provides:

28 See 24.3 (Meaning(s) of "settlor-interested").

29 Contrast 24.3.4 (Settlement ceasing to be settlor-interested); 42.6 (Settlor-interested condition).

> In making that determination all benefits which may at any time accrue to the individual as a result of the transfer and any associated operations must be taken into account, irrespective of—
> (a) the nature or form of the benefits, or
> (b) whether the individual has legal or equitable rights in respect of the benefits.

Subsection (b) is a response to the Cayman Islands Trust Act 1967 which formerly provided that a beneficiary of a Cayman Islands exempt trust had no "rights" (as may also be the case under a Jersey foundation or a Cayman Island STAR trust).

### 26.6.1 *Enjoyment 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 un-lawyer-like language was discussed by the Special Commissioners in *Botnar v IRC*:

> 222. [Enjoyment condition A] is concerned with how particular income is dealt with when it arises. [Counsel for the taxpayer] however conceded that this is not confined to its immediate handling on receipt or even to what happens in the year of assessment, if for example it is received late in the year, but that we should look at how it is dealt with within a reasonable time of receipt. ...
> 224. It seems to us that, when the word "calculated" is considered in the context that it refers to income which is "in fact so dealt with", the meaning "likely" is to be preferred to "thought out" in the sense of "intended"; however we are not sure that either "likely" or "intended" gives exactly the same flavour as "calculated". "Calculated" here combines an element of objectivity with an element of forethought.
> 225. It may not however make much difference because if any income was intended to enure for the benefit of Mr. Botnar it is obviously more probable that it was likely to so enure and that it would be seen

objectively as likely to so enure.[30]

### 26.6.2 *Enjoyment condition B: income increases value of T's asset*

Section 723(2) ITA provides:

> Condition B is that the receipt or accrual of the income operates to increase the value to the individual—
> (a) of any assets the individual holds, or
> (b) of any assets held for the individual's benefit.

First one must identify an asset held by T or for T's benefit. Having identified the asset, one asks whether the receipt or accrual of the income operates to increase the value of that asset.

The concept of "assets held by T" is straightforward but what about assets held "for T's 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 T's benefit. One could reach the same result by a different route since T's life interest in the note was itself an "asset" held by T. If the asset is held on a discretionary trust under which T is merely a beneficiary, it is probably not held "for T's benefit". What if the asset is held on interest in possession trusts for T subject to an overriding power of appointment?

The second requirement is that the receipt or accrual of income must increase the value of the asset. This was also considered 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).[31] 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.[32] If a debt is sufficiently covered

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30 72 TC 205. The wording is also discussed *obiter* in *Vestey v IRC* 54 TC 503 at p.555.

31 In some but not all cases T also held a few shares in the companies. The Court of Appeal did not rely on 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.

32 *IRC v Brackett* is another example.

by existing assets of a company, the receipt of further income by the company does not increase the value of the debt.

### 26.6.3 *Enjoyment condition C: individual receives benefit*

Section 723 ITA provides:

> (3) Condition C is that the individual receives or is entitled to receive at any time any benefit provided or to be provided out of the income or related money.
> (4) In subsection (3) "related money" means money which is or will be available for the purpose of providing the benefit as a result of the effect or successive effects—
> (a) on the income, and
> (b) on any assets which directly or indirectly represent the income,
> of the associated operations referred to in section 721(2).

For the meaning of "benefit" see 27.4 (Benefit). For completeness, this question also arose in *Howard de Walden*. The Court of Appeal said:

> ... the payments made and to be made in respect of the notes and deposits are "benefits" within the meaning of (c) since "benefit" as defined ... includes a payment of any kind.

There are two issues here. First, is the payment of a debt to T (or payment of the promissory note) a "benefit" in the general sense? The Court of Appeal rightly thought it was not, since they relied on the former definition clause. Secondly, did the former statutory definition of benefit extend the meaning of benefit to include a payment that is not a benefit in the normal sense? The Court of Appeal held that it did. However, the ITA does not contain the definition of benefit on which the court relied, so this argument no longer arises. However the repayment of an interest-free loan is probably a benefit.[33]

### 26.6.4 *Enjoyment condition D: possibility of benefit*

Section 723 ITA provides:

33 See 24.3.2 ("Settlor-interested" for IT purposes).

> (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 the trust income within enjoyment condition D because what the individual could receive was trust capital and so no longer"income".[34]
(2) The trust held a company. Walton J held that the individual had no power to enjoy the company's income within enjoyment condition D because what they could receive was dividends from the company and that was not the same as the income of the company.[35]

This is bizarre and in the House of Lords Viscount Dilhorne rejected it.[36] It is considered that Dilhorne's reasoning is to be preferred.

### 26.6.5 *Enjoyment condition E: control*

Section 723(7) ITA 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:

34 *Vestey v IRC* 54 TC 503 at p.555.
35 *Vestey v IRC* 54 TC 503 at pp.562-3.
36 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.

> 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.[37]

This is discussed by the Special Commissioners in *Botnar v IRC*:

> 260. It seems to us that due importance must be given to the words "able… to control" in [enjoyment condition E] bearing in mind the words "in any manner whatsoever, and whether directly or indirectly". An example of indirect control is to be found in *Lee v IRC* 24 TC 207, where the taxpayer as majority shareholder could appoint and remove the directors of the company in question.
> 261. In our judgment the ability to control must go beyond an assumption that those controlling the companies will comply with the transferor's wishes and the fact that they do comply is immaterial. We accept the question posed by [Counsel], viz whether Mr. Botnar was in a position to ensure that the companies would act in accordance with his wishes.
> 262. There was in fact no material before us to indicate that Mr. Botnar could have done anything if Dr. Lenz had declined to do what he wanted. The position might have been different if Dr. Lenz was for example an employee who might have been dismissed in the event of failing to cooperate. There was however no evidence to suggest this. We are satisfied that the directors of the companies would have carried out his instructions. We have no doubt that Mr. Botnar was justified in assuming that Dr. Lenz would do what he wanted. However we do not consider that the mere fact that Dr. Lenz was in the saddle of the settlement meant that Mr. Botnar was able to ensure that the income would be applied for his benefit. On the authority of *Schroder* even decisive influence is not enough.
> 263. We readily accept [Counsel's] submission that Mr. Botnar wished to ensure that the shares 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.

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37 *IRC v Schroder* 57 TC 94 at p.125, followed in the non-tax case *R v Radio Authority ex p. Guardian Media Group* [1995] 1 WLR 334 at p.345.

> Botnar's wishes. That is not however the same as Mr. Botnar having the ability, even indirectly, to ensure that the income would be applied in accordance with his wishes.

In practice it is very rare that enjoyment condition E is satisfied and none of the other four enjoyment conditions would be satisfied. *Lee v IRC* 24 TC 207 (shareholder's power to appoint and dismiss directors) offers an example: if T transferred assets to a company under which T's only interest was management shares conferring votes but no dividends or capital, T would satisfy enjoyment condition E. But T would also satisfy enjoyment condition B as company income would tend to increase the value of the voting shares (voting shares do have some value).

### 26.6.6 *Minority shareholding in offshore company*

If T holds a majority shareholding in an offshore company, T has power to enjoy all the income of the company since enjoyment condition E is satisfied. The same applies if T and T's 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 T's 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*.[38]

## 26.7 Power to enjoy: causation condition

It is not sufficient that the transferor has power to enjoy the income of the person abroad. A causation condition must also be satisfied. Section 721(2) ITA provides:

> Condition A is that the individual has power in the tax year to enjoy income of a person abroad *as a result of*—
> (a) a relevant transfer,
> (b) one or more associated operations, or
> (c) a relevant transfer and one or more associated operations.

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38 36 TC 313. See Boyd, "Requiem for a Man of Straw" [1980] BTR 442 at p.457.

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 2005 B transfers the company to an offshore trust under which A may benefit ("B's transfer").

A has made a relevant transfer. However, before 2005, A is not within s.720 since A does not have "power to enjoy" the income of the company.

From 2010 onwards, A does have "power to enjoy". A does not have that power as a result of A's transfer alone. However, B's transfer appears at first sight to be an associated operation in relation to A's transfer.[39] It seems at first sight that s.721 condition A is satisfied and A is taxable under s.720 on the income of B's trust! This clearly cannot be right, but why not? This raises questions similar to those discussed in para 25.11.1 (Transfer from A to B followed by transfer from B to person abroad). Before the ITA, the legislation dealt with this by applying a more limited causation test. If B's transfer was an independent act, it "broke the chain of causation" and A's transfer was not the real or effective or operative cause.

From 2007/08, the foundation of that argument has been knocked away. But the courts will have to fill in the hole with a gloss, or the legislation simply does not work. It is suggested that B's transfer is not an associated operation, so A is not within s.720 if there is a "clean break" between A's transfer and B's transfer (the same test as applies elsewhere).

Suppose:

(1) In year 1, T transferred assets to an offshore company ("the original transfer of assets").

(2) In year 2, T lent money to the company interest-free (" the loan").

Suppose in year 1 T has no interest in the shares of the company and so has no power to enjoy its income and is outside s.720.

In year 2, T probably does have power to enjoy the income of the company by virtue of the interest-free loan.[40] However T is not taxed on the income arising from the original transfer of assets in year 1, since that power to enjoy does not arise *as a result* of the transfer or any associated

39 See 25.9 (Associated operation: definition).

40 See 26.6.3 (Enjoyment condition C: individual receives benefit).

operation. The loan is not an associated operation.[41]

On the other hand, T is in principle subject to tax under s.720 on the income arising to the offshore company as a result of the loan in year 2 (if there is any) as the loan is itself a transfer of assets.

## 26.8 Income chargeable: Section 721 Condition B

Section 721(3) ITA provides:

> Condition B is that the income would be chargeable to income tax if it were the individual's and received by the individual in the UK.

It is not easy to think of income which would not be chargeable if received by a UK ordinarily resident individual in the UK. Perhaps the drafter had in mind a transferor who was ordinarily resident but not resident. If such a person can exist[42] they will benefit from condition B as (being non-resident) they are not chargeable on foreign income. In practice condition B will always be satisfied.

## 26.9 Amount of s.720 charge

Section 720 ITA provides:

> (2) Income tax is charged on income treated as arising to such an individual under section 721 (individuals with power to enjoy income as a result of relevant transactions).
> (3) Tax is charged under this section on the amount of income treated as arising in the tax year.

Unfortunately s.720 does not tell us *what* is the amount of income treated as arising. Section 721 does not answer the question either.[43] So

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41 See 25.9.2 ("Associated"). The example is based on the facts of *Fynn v IRC* 37 TC 629 where the s.720 point was not argued, presumably, because the Revenue accepted this view was correct. For the s.727 issues raised by these facts, see 26.12.3 ("Connected with any relevant transaction").

42 Which is doubtful: see 3.20 (Ordinary resident but not resident).

43 Section 721 ITA provides:
"(1) Income is treated as arising to such an individual as is mentioned in section 720(1) in a tax year for income tax purposes if conditions A and B are met.

construction and common sense must fill the gap.[44]

### 26.9.1 *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 their power to enjoy (in the natural sense of that expression) is limited to part[45] or even none[46] of the income. In such a case T is taxed on all the income: *Howard de Walden v IRC* 25 TC 121.

However, if T has power to enjoy (as defined) over only part of the income, T is only taxed on the income which T 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.[47]

### 26.9.2 *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;
    (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.

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(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."

44 See R.S. Boyd "Requiem for a Man of Straw" [1980] BTR 442. See also 25.13 (Capital receipts deemed to be income) and 25.14 (The amount of income of person abroad).

45 eg if T transfers shares to a company in which T holds debentures. If all the income of the company increases the value of the debentures just a little, T has power to enjoy over all the income within enjoyment Condition B.

46 eg if T has control within enjoyment Condition E.

47 *Congreve* 30 TC 163 at p.199.

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".[48] This view is now supported by s.714(2) ITA which provides:

> The charges apply only if a relevant transfer occurs, and they operate by reference to income of a person abroad that is connected with the transfer or another relevant transaction.

This clearly rejects the view that all income of the person abroad is caught. It suggests however that the measure of income caught is not that which arises as a *result* of the relevant transfer or associated operation, it is income which arises that is *connected* with the transfer or associated operation. "Connected" is not defined. However, while the wording was perhaps 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.

### 26.9.3 *Transferor's deductions and reliefs*

Section 746 ITA provides:

> (1) This section applies for the purpose of calculating the liability to

48 Walton J in vehement form in *Vestey v IRC* 54 TC 503 at p.562, followed in *Carvill v IRC* [2000] STC (SCD) 143 at [97] - [98]. The point had been left open in *Howard de Walden v IRC* 25 TC 119.

> 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.

As far as I can see, this is not needed (except perhaps for the avoidance of doubt). The wording is the same as for the provisions for settlor-interested trusts; so see 24.2.7 (Settlor's deductions and reliefs) for further discussion.

## 26.10 Enjoyment condition C – benefits

Section 724 ITA provides:

> **Special rules where benefit provided out of income of person abroad**
> (1) This section applies if an individual has power to enjoy income of a person abroad for the purposes of section 721 because of receiving any such benefit as is referred to in section 723(3) (benefit provided out of income of person abroad).
> (2) Despite anything in section 720, the individual is liable to income tax under that section for the tax year in which the benefit is received on the whole of the amount or value of that benefit.
> (3) But subsection (2) does not apply so far as it is shown that the benefit derives directly or indirectly from income on which the individual has already been charged to income tax for that tax year or a previous tax year.

This was introduced in 1969 and upset the reasoning of *de Walden* where repayment of a loan was held to fall within enjoyment condition C.[49] Since the charge is now on the value of the benefit, and the value of a payment for full consideration (such as the repayment of a loan) is nil, Condition C is not now satisfied.

In *Botnar* the Special Commissioners said:

> 245. ... Where the power to enjoy arises the tax is charged not on the income which the taxpayer has power to enjoy but on the value of the benefit. This may bear no relationship whatsoever to the income of the

49 See 26.6.3 (Enjoyment Condition C: individual receives benefit).

> non-resident as long as it originated from it even indirectly. We do not accept that [s 724 ITA] only operates where the benefit received in a year exceeds the relevant income.

It is considered that the charge is on the lower of the value of the benefit and the amount of income of the person abroad. The value of a benefit in excess of the income does not come into charge, and if the transferor has power to enjoy the income apart from enjoyment condition C, then this provision does not apply.[50]

## 26.11 Transferor receives capital sum

Sections 727 and 728 ITA must be read together:

> **727 Charge to tax on income treated as arising under section 728**
> (1) The charge under this section applies for the purpose of preventing the avoiding of liability to income tax by individuals who are ordinarily UK resident by means of relevant transfers.
> (2) Income tax is charged on income treated as arising to such an individual under section 728 (individuals receiving capital sums as a result of relevant transactions).
> (3) Tax is charged under this section on the amount of income treated as arising in the tax year. ...
> (4) The person liable for any tax charged under this section is the individual to whom the income is treated as arising. ...
> **728 Individuals receiving capital sums as a result of relevant transactions**
> (1) Income is treated as arising to such an individual as is referred to in section 727(1) in a tax year for income tax purposes if—
> (a) income has become the income of a person abroad as a result of—
> (i) a relevant transfer,
> (ii) one or more associated operations, or
> (iii) a relevant transfer and one or more associated operations, and
> (b) the capital receipt conditions are met in respect of the individual in the tax year (see section 729).

Section 727 ITA is an independent charging section. Lord Greene explains its purpose in *Howard de Walden v IRC* 25 TC at p.135:

50 See Venables "Section 739 and benefits in kind", OTPR Vol 11 Issue 3 p.1.

> 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.

An example would be a non-resident trust or company making an (arm's length) loan to a transferor who was excluded from benefit.

Many of the rules applying to s.720 also apply to s.727. In ITA they are set out twice in full, but I do not discuss them again here. In particular, the words "such an individual" in s.727(2) restrict the charge to the transferor (just as s.720).

### 26.11.1 *Nature of s.727 charge*

ITA EN Change 111 provides:

> Section 739(3) ICTA [now s.727] 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.

In *Vestey v IRC* 54 TC 503, 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*,][51] small or large, whenever received. From these words there is no escape.

### 26.11.2 *Relationship of s.720 and s.727*

In *Vestey v IRC*, Walton J said:

> [Sections 720 and 727 ITA] are ... concurrent and not cumulative. A person cannot be taxed in any one year on the same sum under both [s.720 and also s.727]. Like Warren Hastings, the Crown, in making this concession, doubtless stood amazed at its own moderation ... but

51 The words in italics are wrong since s.727 is limited to transferors.

> make it it did.[52]

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. So it is rare to have to look at s.727 at all.

## 26.12 The capital receipt conditions

Section 729(1) ITA provides:

> For the purposes of section 728(1), the capital receipt conditions are met in respect of the individual in a tax year ("the relevant year") if—
> (a) either—
>   (i) in the relevant year the individual receives or is entitled to receive any capital sum, whether before or after the relevant transfer, or
>   (ii) in any earlier tax year the individual has received any capital sum, whether before or after the relevant transfer, and
> (b) the payment of that sum is (or, in the case of an entitlement, would be) in any way connected with any relevant transaction.

### 26.12.1 *"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.

### 26.12.2 *"Capital sum"*

"Capital sum" is defined in s.729(3) ITA:

> In subsection (1) "capital sum" means—

52 54 TC 503 at p.556.

(a) any sum paid or payable by way of loan[53] 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 p.266 the Special Commissioners say:

> In our judgment the entitlement to use the flat is not a capital sum within the definition in [s.729(3)]; in particular we hold that the entitlement to use was not a "sum" within any normal use of English.

26.12.3 *"Connected with any relevant transaction"*

In *Fynn v IRC* 37 TC 629:
(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 Jan 1952, T lent the company £12,000 ("T's loan").
The Revenue assessed T on the income accruing to the company in 1951/2 and 1952/3 under (what is now) s.727.[54]

During those years T was entitled to receive a capital sum (repayment of T's loan). However, this was not "in any way connected" with the transfer of assets or the charge (an operation associated with the transfer). So the condition in s.729(1)(b) was not satisfied, ie, the capital receipt conditions were not satisfied.

This is the only use of the expression "connected with" in the TAA provisions (though the definition of associated operations uses the comparable expression "in relation to" and it is suggested that the meaning is the same). "Connected with" is of course an expression used in other anti-avoidance provisions.[55]

26.12.4 *Relief for repaid loan*

Section 729(2) ITA provides relief for loans which are repaid:

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53 "Loan" is a fairly narrow term and does not include the right to an unpaid purchase price: *Ramsden v IRC* 24 TC 515.

54 These facts also raise interesting s.720 issues which were not discussed in the case; see 26.7 (Power to enjoy: causation condition).

55 For instance the transactions in securities provisions.

> 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.

## 26.13 Time extent of s.727 charge

### 26.13.1 *Historic income*

A transferor who receives a capital sum is not taxed on income of years before the year of receipt. Section 727 is not in that sense retrospective:

> While the income of the non-resident trustees would be deemed to be the income of [the taxpayer] on her receipt of the £100,000 [capital sum] on 2 May 1966, *in that and subsequent financial years*, I see nothing in [s.727] 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.[56]

The view that s.727 could apply retrospectively to income of years before receipt of the capital sum seems unworkable since it would require an unlimited number of past years to be reopened. This section could even apply to income accruing in years when the transferor was not ordinarily UK resident.

This explains why the capital receipt conditions are satisfied if a transferor has an entitlement to receive a capital sum, even though they have not actually received it. The application of s.727 makes sense here because on the subsequent receipt of the capital sum the historic income would not otherwise be caught.

### 26.13.2 *Present and future income*

The s.727 charge applies to income of years in which the capital receipt condition is met. However once that condition is met in one year, it is generally met in all future years, so s.727 in principle applies to the income of the person abroad in the year that the capital receipt condition is first met and all future years.

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56 *Vestey v IRC* 54 TC 503 at p.594.

To this rule there are two narrow exceptions. The first relates to loans which are repaid.[57] The second is this: The capital receipt condition in s.729(1) (so far as relevant) requires that:

> 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

The condition in (a) is satisfied in a year if the individual receives *or is entitled to receive* a capital sum in that year. The condition is satisfied in a year if the individual received a capital sum in an earlier year.

The condition is not satisfied if the individual was entitled to receive a capital sum in an earlier year (if entitlement has ceased and the individual did not actually receive anything). This was deliberate. ITA EN Change 111 provides:

> But the wording of section 739(3) of ICTA [now s.727] 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 [now s.729(2) ITA] provides that income is not deemed to be the individual's under section [727] 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".[58] 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 [the source legislation] makes no provision about whether section [727] 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 [727]. 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.

However it must be rare that a transferor is entitled to receive a capital

57 See 26.12.4 (Relief for repaid loan).
58 See 26.12.4 (Relief for repaid loan).

sum without ever receiving a capital sum.

In general, therefore, the capital receipt conditions are met in an year if the transferor has received a capital payment in an earlier year. This raises the spectre of a transferor being taxed for all time because they have received a small capital payment. Suppose:

(1) A company under which the transferor has power to enjoy, and under which they are taxed under s.720 ITA.
(2) The transferor receives a capital sum. This does not give rise to any (or any additional) charge under s.727 since all the income is taxed as the transferor's anyway.
(3) The transferor is then excluded from benefit and ceases to have power to enjoy.

It has been suggested in these circumstances that all future income arising in the company will be deemed to be that of the unfortunate transferor. The same point would apply to a non-resident trust if a capital payment was made to the settlor, even though the settlor was subsequently excluded from benefit and ceased to be liable under the settlement provisions. That would be absurd. For good measure, the overlap with s.633 ITTOIA would also lead to a double charge. In practice HMRC do not take that point.[59] It is suggested that s.727 does not normally apply in a situation where s.720 applies, so a capital sum received at that time should be disregarded. A court would no doubt look at the matter differently if there were arrangements under which the transferor effectively enjoyed that income.

The same problem arises if:

(1) Trustees hold a company under which the transferor has power to enjoy, and under which they are taxed under s.720 ITA.
(2) The transferor receives a capital sum.
(3) The trustees then sell the company to a third party..

It has been suggested that all future income arising in the company will be deemed to be that of the unfortunate transferor (though they may not have any right to know from the purchaser what that income will be). That would be absurd. In practice HMRC do not take that point. It is suggested

59 But there is no official statement to this effect. The EN set out above does state:

> "In practice, where entitlement to a capital sum has ceased HMRC do not pursue further liability under s.739(3) ICTA [now s.727]"

but it is assumed there that if the individual *actually* receives a capital sum, liability never ceases.

that s.727 does not normally apply in this situation. A court would no doubt look at the matter differently if there were arrangements under which the transferor effectively enjoyed the company income.

Another possible solution to this conundrum would be that that of Walton J who said in *Vestey* that the charge under s.727 was limited to the amount of the capital sum. This view was rejected by two judges in the House of Lords who commented on the point, though obiter;[60] however it remains arguable, at least in the supreme court, as the court's approach to construction is looser than before, and the problems which arise were not fully explored.

## 26.14 Section 720 remittance basis

Section 726 ITA provides a relief which I call "**the s.720 remittance basis**". Section 726(1) provides:

> This section applies in relation to income treated under section 721 as arising to an individual in a tax year ("the deemed income") if—
> (a) section 809B, 809D or 809E (remittance basis) applies to the individual for the year, and
> (b) the individual is not domiciled in the UK in the year.

In short, the relief applies to remittance basis taxpayers. Section 726(2) ITA defines the term "foreign" deemed income:

> For the purposes of this section the deemed income is "foreign" if (and to the extent that) the income mentioned in section 721(2) would be relevant foreign income if it were the individual's.

"The income mentioned in s.721(2)" is the income of the person abroad (or that part over which the individual has power of enjoyment). Section 726(3) ITA provides the relief:

> Treat the foreign deemed income as relevant foreign income of the individual.

In the HMRC view s.720 deemed income is fictional income distinct from

60 See the comment of Lord Wilberforce set out in 26.11.1 (Nature of s.727 charge).

the actual income of the person abroad. Since fictional income cannot be remitted, the remittance basis would not work. So s.726(4) ITA provides:

> For the purposes of chapter A1 of part 14 (remittance basis), treat so much of the income within section 721(2) as would be relevant foreign income if it were the individual's as deriving from the foreign deemed income.

In short, the remittance basis applies as if the income accruing to the person abroad were the income of the transferor. There is a tax charge if the income of the person abroad is received/brought/used in the UK by the transferor or by a relevant person (in relation to the transferor).

It is desirable for trusts and companies within s.720 to segregate (1) foreign income and (2) capital. They can then remit capital (IT-free) rather than income (chargeable at IT rates). If they fail to do so then the mixed fund rules will apply.

### 26.14.1 *Payment of s.720 income to transferor while non-resident*

Suppose:

(1) Year 1: Income accrues to a company within s.720. The transferor ("T") receives s.720 deemed income but that income is (un)taxed under the s.720 remittance basis.

(2) Year 2:
   - (a) T becomes non-resident.
   - (b) The company distributes its income by way of dividend. T receives actual income (a dividend) but because this dividend is received in a non-resident year, it is not taxed either on receipt or when remitted to the UK.

(3) Year 3:
   - (a) T becomes UK resident.
   - (b) T remits that dividend to the UK.

The question is whether the dividend received in the UK in year 3 constitutes a remittance of the s.720 deemed income of year 1. Is the dividend which the individual received derived from the s.720 deemed income. The answer is that the dividend received is derived from the income of the person abroad, and so is taxable on receipt in the UK in year

3.[61]

The position is no better if T remits the dividend in year 2, as this is in principle caught by the temporary non-residence rules.

In short, one cannot "wash" income taxable on the s.720 remittance basis by a distribution to T in a year of T's temporary non-residence. That view fits the object of s.720 which is to put the transferor in the same position as if they had not made the transfer: see *Chetwode v IRC* 51 TC 647.

### 26.14.2 *Pre-2008 s.720 income and transitional rules*

In the following discussion I use the term **"pre-2008 s.720 income"** to mean foreign income arising before 6 April 2008, which fell within (what was then) s.739 ICTA, but which qualified for the s.739 foreign domicile defence of (what was then) s.743(3) ICTA. There was no tax charge when the income arose.

Before 2008/09 it is considered that there was no charge under s.739 or s.743(3) if such income was (after its receipt) remitted to the UK. This was so whether the income was remitted by:

(1) the person abroad who received it; or
(2) the transferor (if they received the income outside the UK from the person abroad).[62]

Para 170 Schedule 7 FA 2008 provides:

> The amendments made by paras 161 to 179 have effect for the tax year 2008-09 and subsequent tax years.

Pre-2008 s.720 income remitted after 2008/09 is not caught by s.726 as the condition in s.726(1)(a) is not met.[63] So there is still no charge on the

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61 See s.726(4). This seems even clearer if one remembers that distribution relief would be available, had the dividend in fact been taxable; see 28.4 (Distribution relief).

62 This was actually sensible. See *Taxation of Foreign Domiciliaries* 6th edn para 15.10 (Critique of s.648 clawback). Needless to say, no reason was given for changing the position.

63 Contrast the usual RFI remittance basis, where para 83 Sch 7 FA 2008 fills that gap: see 9.15.1 (Transitional rule for pre-2008 income/gains). HMRC may not agree. TAH 1224 provides:

> "The provisions described in TAH 1223 have effect for the tax year 2008-09 and subsequent years. There are no specific transitional arrangements for introduction of the new provisions. As the income charge only looks at income arising to the

remittance of pre-2009 s.720 income. This is right and fair, since there was no charge on remittance before 2008. However (given the retrospective operation of many of the 2008 reforms) this may have been an oversight and HMRC may argue that pre 2008/09 s.720 income is taxable under s.726 on remittance on or after 2008/09. TAH para 1224 provides:

> The provisions described in TAH 1223 [including s.726 ITA as amended in 2008] have effect for the tax year 2008-09 and subsequent years. There are no specific transitional arrangements for introduction of the new provisions. As the income charge only looks at income arising to the person abroad in the tax year it should not be necessary to have regard to income of earlier years in determining whether there is an amount that is to be regarded as foreign deemed income. However if there is foreign deemed income then in considering any possible charge under Part 8 ITTOIA it will be appropriate to consider all sums remitted to the United Kingdom in the tax year even if they arise, for example, from income of periods prior to the introduction of these provisions. Those remittances will fall to be tested against the rules in Chapter A1 Part 14 ITA 2007 as to whether they are taxable remittances.

### 26.14.3 *s.720 income of years 2005/06 to 2007/08: HMRC view*

In the following discussion I use the term "**2005-2008 s.720 income**" to mean foreign income arising in the years 2005/6 to 2007/8 (inclusive), which fell within (what was then) s.739 ICTA.

TAH para 1222 records the bizarre view that ITTOIA absent-mindedly abolished the s.720 remittance basis formerly in s.743(3) ICTA, so that between 2005-2008 s.720 income was always charged on an arising basis:

> Following the tax law rewrite [ITTOIA] new and separate charging provisions were introduced for all types of foreign income replacing the

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person abroad in the tax year it should not be necessary to have regard to income of earlier years in determining whether there is an amount that is to be regarded as foreign deemed income. However if there is foreign deemed income then in considering any possible charge under Part 8 ITTOIA it will be appropriate to consider all sums remitted to the United Kingdom in the tax year even if they arise, for example, from income of periods prior to the introduction of these provisions. Those remittances will fall to be tested against the rules in Chapter A1 Part 14 ITA 2007 as to whether they are taxable remittances."

> general charge under what was Case IV/V of Schedule D. The new provisions, included in the Income Tax (Trading and Other Income) Act 2005 (ITTOIA), also provided, on a claim, an alternative basis for calculating certain income categorised as 'relevant foreign income' and the amount on which an individual would be taxed.
>
> From the introduction of ITTOIA non-UK domicile status could impact this relevant foreign income and resulted broadly speaking in the income subject to the claim being taxed only when received in the United Kingdom.
>
> Apart from minor adjustments consequential upon the introduction of ITTOIA the transfer of assets provisions giving exclusion from charge for certain income of non-UK domiciled individuals remained largely unchanged. However the exclusion [s.743(3) ICTA] was only for income that would not be chargeable to tax on the basis of domicile status alone.
>
> It could be argued that following the new charging provisions brought into effect by ITTOIA, which carried no distinction on the basis of domicile, that from 6 April 2005 there was no such income that fell to be excluded on the basis of domicile under the transfer of assets provisions.

I have not come across any reference to this argument before the publication of the TAH in 2009, nor do HMRC say expressly whether or not they regard it as correct. I find it hard to imagine that anyone could take the argument seriously. But in practice the point is academic as HMRC do not usually take any notice of it:

> However the introduction of ITTOIA was not intended to change the law under transfer of assets in this way and as a result HMRC continues to operate the income charge provisions in this interim period in the same way that they were operated prior to April 2005, subject to cases where there appears to be manipulation of the interaction of the new provisions. Where you identify a case that appears to involve manipulation refer it to the Transfer of Assets Technical Adviser in CAR (Residency) Offshore Personal Tax Team.

If the argument were actually right, so 2005-2008 s.720 income was by law taxed on an arising basis, then HMRC could not of course assess the income in a subsequent year when it was remitted. They can only assess it in the year that it arose. One could envisage circumstances when the taxpayer would want to raise the argument. Similar issues would arise in relation to the s.624 remittance basis. However I doubt if these wider ramifications of the argument will ever need to be considered.

## 26.15 No indemnity for transferor

The transferor has no express statutory indemnity against the person abroad for tax paid under s.720. It is considered that no indemnity can be implied.

## 26.16 Tax return disclosure[64]

Helpsheet 262 (Income and benefits from transfers of assets abroad and income from non-resident trusts - 2009/10) provides:

> **How do you report the income?**
> Unless you are completing box 46 – see ‘How do you qualify for an exemption from charge on income or benefits’ on page 5 – report the amount of income as follows:
> • enter in boxes 10 and 11 dividend income of a UK company together with any other income chargeable as dividend income
> • enter in boxes 12 and 13 all other income chargeable by these provisions. You should enter details of the relevant transactions that have given rise to the income, and the offshore structures involved, in the ‘Any other information’ box on page TR 6 of your tax return.
> All income that is chargeable to tax under the transfer of assets provisions should be entered at boxes 10 to 13 of the Foreign pages not in the corresponding boxes elsewhere in the return for the type of income involved.
> For example, if interest income arose to a foreign company and that income is treated as yours under the transfer of assets provisions, then the income should be entered at box 12 not in the relevant boxes for interest. If you are non-UK domiciled then you may not have to enter all of the income if some of the income arising to the person abroad is from a source outside the UK and not remitted to the UK. See ‘How do you report income or benefits if you are non-UK domiciled?’ on page 5.

This reflects the HMRC’s official view that s.720 deemed income is distinct from the income of the person abroad.

64 See too 29.45 (tax return: disclosure of motive defence claim)

CHAPTER TWENTY SEVEN

# TRANSFER OF ASSETS ABROAD: NON-TRANSFERORS

## 27.1 Non-transferors – Introduction and terminology

The provisions can be divided into four parts. In the order in which they appear in ITA they are: the charge, the fundamental s.732 conditions, computation and defences. This is not the most logical way in which the legislation could have been set out but it is convenient to follow the statutory order.

First, s.731 ITA imposes the charge:

> **731 Charge to tax on income treated as arising under section 732**
> (1) Income tax is charged on income treated as arising to an individual under section 732 (non-transferors receiving a benefit as a result of relevant transactions).
> (2) Tax is charged under this section on the amount of income treated as arising for the tax year. ...
> (3) The person liable for any tax charged under this section is the individual to whom the income is treated as arising. ...

The charge applies if income is treated as arising under s.732, to which we must turn as the second stage of our journey. Section 732(1) ITA sets out five sets of conditions. I refer to them as "**the fundamental s.732 conditions**". They are as follows:

> *(a) a relevant transfer occurs.*

I refer to this as "**the relevant transfer condition**".

> *(b) an individual who is ordinarily UK resident receives a benefit.*

This contains two aspects, the receipt of a benefit and residence. So far as the residence aspects are concerned, I refer to this as "**the ordinary residence condition**".

> *(c) the benefit is provided out of assets which are available for the purpose as a result of—*
> *(i) the transfer, or*
> *(ii) one or more associated operations.*

I refer to this as "**the benefit causation condition**".

> *(d) the individual is not liable to income tax under section 720 or 727 by reference to the transfer and would not be so liable if the effect of sections 726 and 730 were ignored.*

I refer to this as "**the transferor's s.731 defence**".

> *(e) the individual is not liable to income tax on the amount or value of the benefit (apart from section 731).*

I refer to this as "**the benefit liable to IT defence**".

Where there is a relevant transfer to a trust or company, and the motive defence and ss.720 and 727 do not apply, I describe this trust or company as being "**within section 731**".

If all five fundamental conditions are satisfied one moves on to s.732(2) ITA:

> Income is treated as arising to the individual for income tax purposes for any tax year for which section 733 provides that income arises.

The third stage is to compute the amount of income treated as arising: this is dealt with in s.733 ITA (and s.734).

Lastly, there are some defences to the charge: in particular the s.731 remittance basis and the motive defence.

The statute refers on many occasions to "income treated as arising under s.732". It is convenient to have a short label for this, and I call it "**s.731 deemed income**". (It might be called "s.732 deemed income" but the charge is under s.731.)

## 27.2 Relevant transfer condition

The first fundamental s.732 condition is the relevant transfer condition. Section 732(1) ITA provides:

> This section applies if—
> (a) a relevant transfer[1] occurs,

Despite the present tense ("occurs") this condition is met in a year if a relevant transfer occurred in an earlier year. Grammarians call this "the historic present".

## 27.3 Ordinary residence condition

The second fundamental s.732 condition requires ordinary residence. Section 732(1) ITA provides:

> This section applies if ...
> (b) an individual who is ordinarily UK resident receives a benefit,

If an individual receives a benefit in a year but is not ordinarily resident in the year there is no charge under s.731 in relation to that benefit in that year.

What if B later becomes UK resident? Suppose:

(1) Year 1: B is not ordinarily resident in the UK, but receives a benefit.
(3) Year 2: B becomes ordinarily resident in the UK but receives no benefit in that year.

It is considered that the fundamental condition in s.732(1)(b) is still not met in year 2: the words "an individual who is ordinarily UK resident receives a benefit" mean that the individual must be ordinarily resident at the time that they receive a benefit.

Residence at the time that relevant income arises is not in principle necessary. Suppose:

(1) Year 1: B is non resident and relevant income arises.
(2) Year 2: B is UK resident and receives a benefit.

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1 See 25.2 ("Relevant transfer").

The ordinary residence condition is satisfied so there is in principle a charge under s.731 by reference to the income of year 1.

Now suppose:

(1) Year 1: B is ordinarily resident in the UK and receives a benefit. However, there is no relevant income (no income arises at all or it has all been distributed) so there is no charge under s.731.

(2) Year 2: B is not UK resident or ordinarily resident but relevant income arises.

It is suggested that the ordinary residence condition is not met: the words "an individual who is ordinarily UK resident receives a benefit" mean that the individual must be ordinarily resident at the time that the section applies, as well as being ordinarily resident at the time they receive a benefit. This view is supported by the implied territorial limitation of UK taxation; see 16.4 (Why does location of source matter?). But if B returns to the UK in year 3 B may be subject to tax.

## 27.4 Benefit

The second fundamental s.732 condition requires (in short) that the individual receives a benefit. Section 732(1) ITA provides:

> This section applies if ...
> (b) an individual who is ordinarily resident in the UK *receives a benefit*.

I here consider the meaning of "benefit". The word benefit is very common in tax statutes and in other areas of law.[2] So there is no shortage of material for discussion, though it is always necessary to consider the word in its context. Most of the discussion here applies equally to the meaning of "benefit" in s.87 TCGA.

There is no statutory definition of benefit for the purposes of the TAA provisions.[3] It is well established that "benefit" is a word of wide import.

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2 For discussion in a trust law context see Kessler & Sartin, *Drafting Trusts and Will Trusts*, Key Haven Publishing (10th ed., 2010), para 13.12 (What does a settlor exclusion clause cover?).

3 The pre-ITA legislation stated that "benefit" included a payment of any kind: s.742(9)(c) ICTA. This had (almost) no practical effect, and was sensibly omitted in the ITA rewrite.

### 27.4.1 *Arm's length transaction*

A transaction for which the individual gives full consideration is not a benefit.[4] It does not matter if the other party is a connected person (eg a sale to or from a family trust or company).

What if the parties act at arm's length and have no gratuitous intent but owing to some mistake the individual gives less than full consideration? This is not a benefit.[5]

### 27.4.2 *Receipt or sale of equitable interest*

RI 201 states:

> For the purposes of [s.731 ITA] a benefit is treated as not including
> [1] either the giving[6] 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).[7] If the interest is not revocable, then its receipt is a benefit, but this is still outside the scope of s.731 because such a benefit is not "provided out" of trust assets,[8] 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

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4 This is self-evident; but if authority is needed, see *IRC v Lactagol* 35 TC 230 and *Wilson v Clayton* 77 TC 1.

5 *Wilson v Clayton* 77 TC 1 decided that this is the case for the purposes of employment-related benefits. Note the reference to arm's length transactions in the passage from *Cooper* cited at 27.4.8 (Benefit to which a beneficiary becomes entitled under terms of trust); the same should apply for s.731. For CGT the position is dealt with by statute, but only for the avoidance of doubt: see 45.6.4 (Arm's length transaction).

6 "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.

7 The Special Commissioners reached a similar conclusion in the context of (what is now) s.201 ITEPA: *Dextra Accessories v Macdonald* 77 TC 146 at [9]-[12]. The point was not appealed.

8 Likewise for s.87 TCGA purposes the benefit is not "from the trustees".

vendor, or because the value of the "benefit" (if there was one) is zero.[9] 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.[10]

### 27.4.3 *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 B 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[11] and so if the trustees appoint the proceeds to B, B receives a benefit taxable under s.731.

### 27.4.4 *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 [s.720 ITA]. It therefore includes for example receipt of a loan at less than a commercial rate of interest, and the use of trust property at less than an open market rental.

Interest-free loans and use of property at less than full rent are benefits within s.87 and s.731: *Cooper v Billingham* 74 TC 139. On valuation of that benefit see 27.5 (Valuation of benefits).

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9 The drafter of FA 1984 Sch 14 para 5(4) reached the same conclusion for the purpose of (what is now) s.87 TCGA.

10 On a sale of an equitable interest, watch:
   (1) CGT on the disposal of the interest; and
   (2) Schedule 4A TCGA.

11 See 27.27 (Relevant income reinvested: tracing).

### 27.4.5 *Loan (not to life tenant): interest paid at commercial rate*

A simple way of avoiding a benefit (and hence avoiding s.731) is:
(1) a trust 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,[12] 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.

### 27.4.6 *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.

### 27.4.7 *Interest-bearing loan to life tenant*

It is impossible to have an interest-bearing loan to a life tenant, under a transparent *Baker*-type[13] 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[14]

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12 See 17.2 (Interest: charge and location of source).

13 It would be different if the trust was a non-transparent *Garland*-type trust. See 23.1 (Taxation of life tenant).

14 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.

or purportedly rolled up.[15] 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.

### 27.4.8 *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 (eg attaining the age of 25).

(2) The contingency is satisfied (the beneficiary reaches 25 and becomes entitled to the trust property).

There is a "capital payment" for the purposes of s.87 TCGA: see s.97(2) TCGA. There is no equivalent provision in the transfer of asset rules. However, it is considered that the beneficiary does receive a "benefit"[16] and the value of the "benefit" is equal to the value of the trust property. The concepts of "value" and "benefit" can (just) be stretched wide enough to support this conclusion[17] and any other view would be inconsistent with the scheme of the provisions. This view is supported by *Cooper v Billingham* 74 TC 139 CA at [39]:

> The whole scheme of the legislation requires the Court to see what benefit a beneficiary actually receives, in cash or in kind, otherwise than as income or under an arm's-length transaction. Any pre-existing beneficial interest belonging to the beneficiary is irrelevant. The Judge

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15 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).

16 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.

17 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.

dealt with this point shortly[18] 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.[19]

### 27.4.9 *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 they merely receive the property to which they ares 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 employment income benefit in kind rules. On the other hand, the liquidation is analogous to becoming entitled under a trust. 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.

### 27.4.10 *Reimbursement of tax under statutory indemnity*

SP 5/92 provides:

> 8 The settlor's right, under Para 6 Sch 5 TCGA, to reimbursement (or any payment in reimbursement) of tax paid under that Schedule is not regarded as creating an interest in a trust for the settlor under the provisions of [Chapter 5 part 5 ITTOIA] where the settlor, the settlor's spouse, and any companies in which they are participators cannot otherwise benefit from the trust, eg where the only beneficiaries are the settlor's children. Similarly, this statutory right to, or payment in,

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18 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 139 at p.155.

19 This was stated (*obiter*) by the judge in *Cooper v Billingham* 74 TC 139 at p.155. It is the converse of the rule that the receipt of a life interest is not a benefit: see 27.4.2 (Receipt or sale of equitable interest).

> reimbursement is not regarded as bringing the settlor within the provisions of [s.633 ITTOIA, and the TAA provisions], nor as a capital payment for the purposes of s.97 TCGA.
> 9 Further, this statutory right is not regarded as a reservation of benefit for inheritance tax purposes; nor is a provision in the trust deed either requiring the trustees to recognise the settlor's right to reimbursement under Para 6 Sch 5 TCGA or to reimburse the settlor. But where a settlor does not pursue the statutory right to reimbursement, the failure to exercise this right may give rise to an inheritance tax claim under s.3(3) IHTA, in which case the usual rules for lifetime transfers would apply.
> 10 A provision written into a settlement deed requiring the trustees to recognise the settlor's right to reimbursement under Para 6 Sch 5 TCGA, or to reimburse the settlor, is not, of itself, regarded as giving the settlor an interest in the settlement for the purposes of Sch 5, nor as bringing into play the provisions of [s.624 ITTOIA, and the TAA Provisions].

HMRC have suggested that this does not apply if reimbursement is made before the settlor has paid the tax for which they need 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.[20]

### 27.4.11 *Benefit from trust/company under court order in divorce proceedings*

A court sometimes orders a trust or company within s.731 to transfer property to the spouse ("W") of the settlor/principal beneficiary ("H"). Assume that the parties are acting at arm's length, which will normally be the case. Is this a benefit?

It is important to understand the family law background, as to which see 10.38.1 (Is a transfer on divorce made for "consideration"?).

If there were a tripartite agreement whereby the trust transfers assets to W in consideration for W giving up a claim against H, then the transfer from a trust to W would not be a benefit to W (who gives consideration)

20 In practice this is an issue for s.87 but not for s.731 (because the settlor will be the transferor and qualify for the transferor's s.731 defence in any event). For other issues relating to reimbursement, see 27.21 (Relevant income used to pay expenses); 69.21 (Failure to exercise right of reimbursement).

but it would be a benefit to H.

If the transfer is under a court order, including a consent order or Tomlin order, HMRC accept there is no consideration for it. Nevertheless it is suggested there is no benefit to W (or the value of the benefit is nil). Even though there is no consideration (a contract law concept) W does not gain anything. She merely receives what the court finds she is entitled to. For similar reasons H does not receive any benefit from the transfer either. The scheme of the legislation does not require "benefit" to be given an extended meaning. If (contrary to my view) there is a benefit, the benefit is not received as a result of the transfer and associated operations. There is a third argument if needed. The court only has power to make an order against H. It has no power to make an order against the trust.[21] 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.

### 27.4.12 *Payment of IHT*

No individual receives a benefit when trustees pay IHT charges on the trust. This is the case for the IHT 10-year charges and the IHT charges on the death of a life tenant with an estate, but it is necessary to consider them separately:

(1) The IHT 10-year charges are payable by the trustees of the settlement concerned: s.201(1)(a)IHTA.
    Beneficiaries[22] who receive capital payments are also liable for the IHT, but:
    (a) They have a right to recover from the trust fund: s.212 IHTA.
    (b) Also they are only liable if the tax remains unpaid after it ought to have been paid: s.204(5) IHTA.
    Accordingly the payment of IHT 10-year charges by the trustees (or by anyone else) is not a benefit to any individual beneficiary.
    This is so even if that beneficiary was (secondarily) liable for the tax

21 There is a power to vary nuptial settlements, but I assume that power is not exercised.
22 For non resident trusts, settlors are also liable.

under s.201(1).

(2) The IHT charge on the termination of an estate (during the life of the life tenant or on the death of a life tenant) is likewise payable by the trustees of the settlement concerned: s.201(1)(a) IHTA.[23] But the same points apply:
   (a) The life tenant has a right to recover from the trust fund: s.212 IHTA.
   (b) The life tenant is only liable if the tax remains unpaid after it ought to have been paid: s.204(5) IHTA.

   Accordingly the payment of IHT by the trustees (or by anyone else) is not a benefit to the life tenant. It cannot be a benefit to be relieved of a secondary liability of this kind, where one has an effective right of indemnity. Further, in the case of a wide common form trust, even if the class of beneficiaries as a whole may be said to receive a benefit, no individual receives a quantifiable benefit.

## 27.5 Valuation of benefits

The amount of s.731 deemed income depends on the "amount or value" of the benefit: see step 1 of s.733 discussed 27.12.2 (Step 1: Total Benefits.)

"Amount" refers to cash benefits and value refers to non-cash benefits.

For s.87 purposes the wording is different but the end result is the same. The amount of deemed s.87 gains depends on the amount of the capital payment and s.97(4) TCGA provides:

> For the purposes of sections 86A to 96 and Schedule 4C the amount of
> [a] a capital payment made by way of loan, and
> [b] of any other capital payment which is not an outright payment of money,
> shall be taken to be equal to the value of the benefit conferred by it.

Arguments that the value of the benefit is nil tend to overlap with arguments that there is no benefit at all, though the points are conceptually distinguishable.

23 In this case the life tenant is also liable for the IHT, under s.201(1)(b).

There are no statutory valuation rules for s.731 or for s.87.[24] Lord Reid rightly says:

> "Value" is an elusive word: it may mean market value, it may mean value in money to the owner, or it may have other meanings like the value of the work necessary to produce it, or even sentimental value.[25]

In *IRC v Botnar* (Supplementary Special Commissioners Decision at p.262) the Special Commissioners discuss the valuation of living accommodation provided by a trust. This is for the purposes of what is now s.724(2) ITA (enjoyment condition C) but the same applies for the purposes of s.731 and s.87. They say:

> 28. It seems to us that the whole of the value of a non-convertible benefit should, in the absence of any other objective means of valuation, be measured by reference to what it would have cost the individual receiving it. ... When measuring what benefit an individual receives it is not in our view relevant to ask whether he would have purchased the benefit himself. If that were the test a penurious individual receiving a non-money benefit under s.742(2)(c) would escape tax however substantial the benefit since he could not have paid for it.
> 29. The measurement of the benefit by reference to what it would have cost the individual will take account of the terms on which it was provided. In this case although nothing was recording in writing, there is a clear inference that the use of the property was provided on the footing that Mr and Mrs Botnar bore the recurrent outgoings.
> 30. It may be that it will not be easy for a valuer to assess what the cost of a benefit such as this would have been since it is wholly hypothetical there being no market for such benefits. However, it seems to us that one approach may be to take the open market rental and to adjust this by reference to the lack of security of tenure, non-assignabilty and outgoings born by Mr and Mrs Botnar and any other special factors.

*Cooper v Billingham* touches on the valuation of interest free loans:

> [Counsel for the taxpayer] argued that the value of the benefit conferred as required for the purposes of s.97(4) would vary according to the

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24 Contrast the elaborate valuation rules for employee benefits; this is another manifestation of the patchwork nature of IT.

25 *Heaton v Bell* 46 TC 211 at p.246.

> circumstances of the borrower, for example how creditworthy he might be and therefore his ability to borrow at better or worse rates on the market, and that those circumstances might differ from time to time. That may be true and could in theory cause difficulties of qualification in a particular case.[26]

However the status of the borrower as life tenant is disregarded in determining the existence or valuation of the benefit. This is not stated expressly but follows from the scheme of the act.[27] There is not much point in having a charge on benefits if interest-free loans are untaxed.

## 27.6 Who is the recipient of a benefit?

It is important to identify the recipient of a benefit because the individual who receives the benefit is the one who is taxable. It is especially important where some beneficiaries are and others are not UK resident or domiciled, because then the identity of the recipient may affect not only who pays the tax but whether any tax is payable at all. In particular, where a married or unmarried couple of mixed domicile are both beneficiaries under a trust, there is in principle scope for tax saving by arranging that the benefit is received by the non-domiciled beneficiary (and so can qualify for the s.731 remittance basis). The documentation in these circumstances is very important.

For the purposes of s.87 TCGA charge, the concept of "receipt" is explained by s.97(5) TCGA.[28] There is no statutory equivalent for s.731 but it is suggested that the same rules apply: s.97(5) merely states the natural meaning of "receipt".

### 27.6.1 *Payment of school fees*

Suppose trustees pay school fees for an individual's children in circumstances where the parent has no obligation to pay the fees. The children receive a benefit from the trust. The parent merely receives an intangible, non-financial advantage (if they regard the education with

26 74 TC at p.155.
27 74 TC at p 154F. The reasoning was upheld by the Court of Appeal.
28 See 45.7 (Receipt from the trustees).

approval). That is clearly not a "benefit" for the purposes of s.731.[29]

Suppose trustees pay school fees in circumstances where the parent has a family law obligation to meet the fees (such as may arise on a divorce or in other family law proceedings). It might be said that the parent receives a benefit (being relieved of legal obligation). However it is considered that the benefit is outside the scope of s.731 because it is merely incidental.[30]

Suppose trustees pay school fees in circumstances where a parent (or both parents) are under a contractual obligation to pay the school fees (ie the parent has entered into the contract with the school). The position here depends on the facts:

(1) It may be that the parent is entitled to reimbursement from the trustees (eg if the parent entered into the contract at the request of the trustees and on terms that the trustees will meet the fees, or as agent for the trustees). In that case the trustees provide the benefit to the children and the parent does not receive a benefit from the reimbursement.[31] It does not matter that the school are not party to the arrangement (eg the parent may be acting as agent for an undisclosed principal).
(2) On the other hand, the position may be that the trustees are voluntarily meeting a liability of the parent; in that case, the parent is providing the benefit to the child, and the trustees are providing a benefit to the parent.

In practice it is recommended that the contract should be between the trustees and the school, or (if that is not desired) there should be an agency agreement between the trustees and the parent, so the position is clear.

If a parent is the settlor, s.629 ITTOIA needs consideration.

### 27.6.2 *Use of house or chattels*

Suppose a house (or chattels) is provided to a life tenant who then allows their spouse (or partner or children) to live there (and to enjoy the

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29 If it were a benefit to one parent, it would similarly be a benefit to the other parent, and indeed grandparents and great grandparents; that can hardly be right.

30 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 Kessler & Sartin, *Drafting Trusts and Will Trusts*, Key Haven Publishing (10th ed., 2010), para 13.12 (What does a settlor exclusion cause cover?).

31 Contrast 27.4.10 (Reimbursement of tax under statutory indemnity).

chattels). The same analysis applies. The indirect benefit which the spouse (or partner or children) receive is not a "benefit" for the purposes of s.731, or, alternatively, the benefit is outside s.731 as it is merely incidental.

## 27.7 Benefit causation condition

The third fundamental s.732 condition is the benefit causation condition. Section 732(1) ITA provides:

> This section applies if ...
> (c) the benefit is provided out of assets which are available for the purpose as a result of—
> (i) the transfer, or
> (ii) one or more associated operations ...

There are two alternative conditions here:
(i) the benefit is provided out of assets which are available for the purpose as a result of the transfer; or
(ii) benefit is provided out of assets which are available for the purpose as a result of associated operations.

I refer to these as benefit causation conditions (i) and (ii). They are comparable to the relevant transfer causation conditions. Thus, not every benefit that an individual receives falls within s.731.

### 27.7.1 *Benefit to B1 used by B1 to benefit B2*

Suppose:
(1) A discretionary trust within s.731 has accumulated relevant income.
(2) In 1970 a beneficiary ("B1"), receives a trust asset ("B1's asset"). Although B1 receives a benefit assume B1 does not pay tax under s.731 because he is non-resident, or qualifies for the s.731 remittance basis.[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)

32 Although strictly the position of B2 is the same even if B1 *is* taxed on B1's benefit, either as a capital benefit under s.731 or as an income benefit under ITTOIA.

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 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 ("S") is a beneficiary and the settlor wishes to make a payment to another beneficiary ("B"). A direct payment from the trustees to B may be within the scope of s.731. In that case the solution may be to make regular payments to S who may subsequently make a gift to B, but this can only succeed if the gift is genuinely independent, which may not be easy to arrange.

### 27.7.2 *Transfer between trusts*

Suppose:

(1) A trust ("trust 1") within s.731 has accumulated relevant income.

(2) Trust 1 transfers funds ("the transferred funds") to a new UK trust on similar terms ("trust 2").

(3) A beneficiary ("B") receives a benefit from trust 2 out of the transferred funds.

The transfer from trust 1 to trust 2 is an operation associated with the

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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).

34 Assume there is sufficient relevant income.

35 The argument would be the same as in 25.11 (Person abroad receives income as indirect consequence of transfer).

36 See 69.4 (Gift from A to B followed by gift to trust by B).

earlier transfer to trust A.[37] B has received a benefit and the benefit is provided out of assets which are available as a result of the transfer and the associated operation. So B is taxed under s.731. The benefit causation condition is satisfied.

Suppose trust 2 was an established trust with a trust fund ("fund 2"). If B receives a benefit from fund 2 B is not taxable under s.731 because that fund is not available as a result of the transfer of assets to trust 1.

It follows that a transfer between settlements will not in principle avoid s.731 charge. There is no reason why it should (except a misconceived analogy with s.90 TCGA).

## 27.8 Benefit causation condition: two transfers of assets

(1) A settlor by a single disposition transfers assets to a trust within s.731.
(2) Part of the trust fund is invested in assets which yield relevant income.
(3) Another part of the trust fund consists of a house occupied rent-free by B.

B pays tax on the benefit by reference to the relevant income. By contrast, suppose:

(1) A settlor by *two* separate transfers creates *two* trusts within s.731:
    (a) a trust which holds income-producing assets and accumulates relevant income; and
    (b) a trust which holds the family home.
(2) B enjoys the benefit of free occupation in the home.

B is not subject to tax under s.731 as there is no relevant income in relation to this benefit. Thus the use of two trusts may avoid a tax charge under s.731 which would have arisen if there were one.

Indeed, it is not necessary to use two trusts. The same applies if there are two separate transfers of assets to one trust.

## 27.9 Transferor's s.731 defence

The fourth fundamental s.732 condition is the transferor's s.731 defence. Section 732(1) ITA provides:

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37 The transfer between trusts is not a clean break. After all, trustees are expected to pay close attention to the wishes of the settlor, and in doing so they are merely filling in the blanks left by the settlor: see *Muir v Muir* [1943] AC 468.

> This section applies if—...
> (d) [i] the individual is not liable to income tax under section 720 or 727 by reference to the transfer
> [ii] and would not be so liable if the effect of sections 726 and 730 were ignored ...

Section 732(1)(d)[ii] makes clear that this defence applies to a transferor who is a remittance basis taxpayer even though the s.720 deemed income is (un)taxed under the s.720 remittance basis.[38] 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. Section 732(1)(d)[ii] is only for avoidance of doubt, and the position would be the same if those words were omitted.

### 27.9.1 *Transferor not ordinarily resident when transfer made; pre-1996 income*

It has never been a requirement of s.731 that the transferor was ordinarily resident at the time of the transfer, but this was a requirement of s.720 until 1996.[39]

RI 201 provides:

> Similarly, a transferor of assets who is outside the charge to tax under Section 739 ICTA [now s.720 ITA] in respect of income arising before 26 November 1996 through being not ordinarily resident in the UK at the time of the transfer, is not assessed under [what is now s.731 ITA].

This is looking at a transferor "T" (wherever domiciled) who:
(1) makes a transfer of assets before 26 November 1996;
(2) is not UK ordinarily resident when T 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[40] T is not taxable under s.731. This is right because the

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38 See 26.14 (Section 720 remittance basis).

39 See 26.5.2 (Transferor not ordinarily resident when transfer made).

40 I need not now consider the position if the benefit was received before 26 November 1996 but the result was probably the same.

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.

### 27.9.2 *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 T is not ordinarily resident for a period. Suppose:
(1) T is ordinarily resident when T makes the transfer;
(2) T is non-resident for a period ("the non-resident period");
(3) T returns to the UK.
The reasoning above shows that on these facts T is also outside s.731; T qualifies for the transferor's s.731 defence in relation to income of the non-resident period as well as the income arising while resident.

### 27.9.3 *Spouse of transferor*

Section 714(4) ITA provides:

> In this Chapter references to individuals include their spouses or civil partners.

Accordingly the spouse/civil partner of the transferor also qualifies for the transferor's s.731 defence. This only applies during the life of the transferor as a former spouse/civil partner is not a "spouse" or a "civil partner".[41]

## 27.10 Benefit liable to IT defence

The fifth fundamental s.732 condition is the benefit liable to IT defence. Section 732(1) ITA provides:

> This section applies if ...

41 See Appendix 1.2 (Meaning of "spouse") and 1.3 (Meaning of "civil partner").

(e) the individual is not liable[42] to income tax on the amount or value of the benefit (apart from section 731).

### 27.10.1 *Benefit (un)taxed under remittance basis*

For this purpose a remittance basis taxpayer is "liable" to income tax on unremitted foreign income.[43] This question arises where an individual receives income from a non-resident trust where the s.731 remittance basis does not apply. For instance, 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 taxable on the unremitted foreign trust income on the remittance basis 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?[44] 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, B 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 remittance basis regime gives HMRC all they should need. So it is considered that unremitted foreign income received by a UK resident

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42 The word in the pre-ITA legislation was "chargeable" not "liable" but the change has not altered (and has perhaps clarified) the position.

43 This might not seem to accord with the natural meaning of "liable"; but it is consistent with the well established rule that pension schemes and charities are "liable" to tax for the purposes of DTAs even though they qualify for pension scheme or charity exemptions; see Kessler & Brown *Taxation of Charities and Non-Profit Organisations*, (8th ed., 2011), para 15.2.2 (Liable to tax). *Stonor v IRC* [2001] STC (SCD) 199 might be cited against this view but a Special Commissioners decision on other provisions, arguably obiter, and not fully argued, does not count for much. This view is also consistent with the rule that unremitted foreign income is "chargeable" to IT; see 45.6.1 (Definition of capital payment).

44 The s.731 remittance basis is not in point if the benefit relates to UK source relevant income: see 27.34 (Section 731 remittance basis).

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).[45] Anti-avoidance provisions, like hypotheses, should not be multiplied unnecessarily.

## 27.11 Is a benefit within s.731 a capital payment?

The definition of "capital payment" for s.87 purposes is discussed in 45.6 (Capital payment). For present purposes the relevant part of the definition is that a capital payment is any payment "which is not chargeable to income tax on the recipient".

In the following discussion "**a non-capital payment**" is a payment which is not a capital payment.

### 27.11.1 *Benefit giving rise to s.731 charge in year of receipt*

The pre-ITA position was straightforward. Section 740 ICTA was, I think, a tax on the benefit.[46] If a person received a benefit which was subject to tax in the year of receipt, under s.740 (ie assume there was relevant income) then the benefit was a non-capital payment for CGT purposes.

It is not immediately obvious that the position is the same from 2007/08. For s.731 is not expressed as a charge on the benefit. It appears at first sight to be a charge on fictional, deemed income: the amount or value of the benefit is merely an element in the computation of the amount of the

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45 See 27.9 (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 is later remitted to the UK.

  Arguably, double counting relief applies: see 28.6 (Double-counting relief). But there is no provision allowing tax paid under s.731 to be reclaimed.

46 Section 740(2) ICTA provided:

  "(2) ... the amount or value of any such benefit as is mentioned in subsection (1) above, if not otherwise chargeable to income tax in the hands of the recipient, shall -
  (a) to the extent to which it falls within the amount of relevant income of years of assessment up to and including the year of assessment in which the benefit is received, be treated for all the purposes of the Income Tax Acts as the income of the individual for that year... "

s.731 deemed income. However it cannot be the case that the same benefit gives rise to CGT on the benefit and deemed income on an amount equal to the benefit. A strained construction is needed to avoid absurdity. There are two possible solutions:

(1) Either (contrary to first appearances) s.731 is in fact a charge on benefits; or
(2) The reference (in the definition of capital payment) to a payment which is "chargeable to IT" should be read as including a benefit giving rise to deemed income.

Section 97(3) TCGA (see below) adopts the first view and so does s.734(1)(c) ITA.[47] Ultimately it makes no difference for present purposes which solution one adopts, but the better view is that s.731 is a tax on the benefit.

## 27.11.2 *Benefit matched to relevant income after year of receipt*

The pre-ITA position was straightforward. In the absence of express provision, a benefit which is not taxable under s.740 ICTA only for lack of relevant income might arguably have been a non-capital payment. But this argument was ruled out by s.97(3) TCGA. For convenience I set out the text of s.97(3) indicating the ITA amendments in track-change format:

> The fact that the whole or part of a benefit is by virtue of ~~section 740(2)(b) of the Taxes Act~~ section 733 of ITA 2007 treated as the recipient's income for a year of assessment after that in which it is received—
> (a) shall not prevent the benefit or that part of it being treated for the purposes of sections 86A to 96 and Schedule 4C as a capital payment in relation to any year of assessment earlier than that in which it is treated as his income; but
> (b) shall preclude its being treated for those purposes as a capital payment in relation to that or any later year of assessment.

Post ITA this wording is not apt because under s.731 (on a first reading) a benefit is not "treated as the recipient's income". Section 731 is a charge on deemed income. But a strained construction is required to give effect to the obvious intention, that a benefit outside s.731 (for lack of relevant

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47 See 27.13 (Section 733 computation when benefit subject to CGT).

income) is a capital payment for CGT and it is considered that s.731 should be regarded as a tax on the benefit.

Thus if:

(1) a benefit is conferred,
(2) the benefit is not subject to s.731 in year of receipt for lack of relevant income

the benefit can be taxed as a capital payment in year of receipt. If:

(3) the benefit is not subject to s.87 in year of receipt (for lack of s.2(2) gains) the s.731 charge in the following year has priority over the s.87 charge in that year; and so on.

### 27.11.3 *Benefit where s.731 remittance basis applies*

A benefit which falls within s.731 but qualifies for the s.731 remittance basis is taxed on the remittance basis, but is nevertheless "chargeable" to tax, so it is a non-capital payment. HMRC agree. Residence and Domicile: FAQ provides:

> **Interrelation between s727 or s731 ITA and s87**
> **Q** Could it be clarified that where a payment has been made - such as one under s731 which has attracted relevant income but has been protected from tax by non remittance - such a payment will not be regarded as a capital payment for s87 purposes?
> **A** Where a payment (benefit) results in an amount becoming taxable by virtue of s731 ITA 2007, but the charge is deferred by a remittance basis claim because no relevant amount has at that time been remitted to the UK, the benefit will not also be taken into account for the purpose of s87 TCGA. Where the 'capital receipt' condition is met for the purpose of a charge under s727 ITA, even though the charge may be deferred by a remittance basis claim, nothing in that section alters the nature of any payment that triggered the charge.[48]

By contrast, s.731 does not apply to a benefit which does not meet any of the five fundamental s.732 conditions (for instance a benefit to a transferor) and such a benefit is a capital payment.

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48 *www.hmrc.gov.uk/cnr/res-dom-faqs.htm* The rubric to the FAQ explains: "Most of the FAQs have now been incorporated into the new guidance. Those that have not are reproduced below."

### 27.11.4 *Benefit where motive defence applies*

The pre-2006 wording was that "Sections 739 and 740 *shall not apply*" where the motive defence applied, so it was clear that a benefit where the motive defence applied could be a capital payment.

Under the current legislation, where the motive defence applies, the individual who receives a benefit "is not *liable to income tax*" under the TAA provisions. It might be argued that the benefit is chargeable (even if the individual is not liable) but is considered that a benefit where the motive defence applies is a capital payment: it is not chargeable to IT within the meaning of the capital payment definition.

### 27.11.5 *Interaction with IHT exit charge income exemption*

Section 65(5) IHTA provides an exemption from the exit charge otherwise payable under s.65:

> (5) Tax shall not be charged under this section in respect of—
> (b) a payment[49] which
>> [i] is (or will be) income of any person for any of the purposes of income tax or
>> [ii] would for any of those purposes be income of a person not resident in the UK if he were so resident ...

I refer to this as **"the exit charge income exemption"**.

If a UK ordinarily resident beneficiary receives a benefit which is taxable in the year of receipt under s.731, it is considered that this exemption applies. The benefit is income of the recipient.

Suppose:
(1) at the time the benefit is received there is no relevant income; but
(2) the person abroad receives relevant income later in the tax year.
It is considered that the exemption still applies: the benefit is still taxable. This explains why s.65(5) refers to a payment which is *or will be* income.

Similarly, if a UK resident beneficiary receives a capital payment which is subject to income tax under OIG s.87, the capital payment is subject to

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49 Section 63 IHTA provides:
> "In this Chapter, unless the context otherwise requires ... "payment" includes a transfer of assets other than money".

income tax and the exit charge income exemption applies.

This is consistent with the object of the relief, which is to prevent a double charge to IT and IHT.

What if the beneficiary is non-resident? If the trust has "OIG amounts" then the relief applies under s.65(5)(b)[ii] because the payment "would for IT purposes be income of a person not resident in the UK if he were so resident." On the other hand if there is relevant income, but no OIG amounts, the relief does not apply. The payment would only be income of the person if they were *ordinarily* resident and it is not the case that the payment would be income if the person were merely "resident".

## 27.12 Computation of charge

### 27.12.1 *Introduction*

In outline, where an individual receives a benefit, s.731 imposes a charge on the lesser of:

(1) the value of the benefit; and

(2) the amount of relevant income in relation to that individual.[50]

However, the details are more complicated than this outline suggests. The rewrite legislation is defectively drafted (it reproduces some defects from the source legislation and adds some new ones). The task here is to find a construction which (if somewhat loose) will yield a workable scheme of taxation.

The computation is governed by s.733 ITA. This is only a computation provision. It does not apply unless the five fundamental conditions of s.732 are met. I refer to the computation made under s.733 as "**the s.733 computation**". There are six steps in the computation. It could serve as a case study as to how much obscurity can be found in step-based drafting, an innovation of the tax law rewrite in their search for clarity.[51]

### 27.12.2 *Step 1: Total Benefits*

In order to follow Step 1, we need to read it in the context of s.732 and the opening words of s.733

50 Contrast s.720, which in general imposes a charge on the whole of the income accruing to the person abroad.

51 See too 45.10.7 (Commentary: step-based drafting).

**732(1)** This section applies if—
(a) a relevant transfer occurs,
(b) an individual who is ordinarily UK resident receives a *benefit*,
(c) the *benefit* is provided out of assets which are available for the purpose as a result of—
(i) the transfer, or
(ii) one or more associated operations,
(d) [in short - the individual is not the transferor]
(e) the individual is not liable to income tax on the amount or value of the *benefit* (apart from section 731).
...

**733(1)** To find the amount (if any) of the income treated as arising under section 732(2) for any tax year in respect of *benefits provided as mentioned in section 732(1)(c)* take the following steps.

*Step 1*
Identify the amount or value of *such benefits* received by the individual
[1] in the tax year and
[2] in any earlier tax years *in which section 732 has applied*.
The sum of those amounts and values is "the total benefits".

I (slightly reluctantly) adopt the statutory terminology and refer to benefits within step 1 as "**Total Benefits".** I refer to benefits within Step 1[1] as **"present year Total Benefits"** and benefits within [2] as **"earlier year Total Benefits".**
There are two obscure references in Step 1:
(1) Which benefits are counted as Total Benefits? One does not identify *all* benefits received by the individual, but only "such benefits". The drafter has overlooked the basic rule that "such" ought only to be used when it refers to a clear antecedent.
(a) On one view, "such benefits" refers back to the words in the first sentence of s.733(1): "benefits provided as mentioned in s.732(1)(c)". So "such benefits" refers to all benefits which meet the benefit causation condition.
(b) On another view,"such benefits" refers back to s.732(1) which uses the word benefit three times. "Such benefits" means benefits in respect of which all five fundamental s.732 conditions are satisfied (not just the benefit causation condition).

The difference between the two views is, for instance, that on the first view an income-taxable benefit can count as "such benefits" and on the second view an income-taxable benefit cannot (because of the benefit liable to IT defence). Likewise, on the first view a benefit received by a non-resident can count as "such benefits" but on the second view it cannot (because of the ordinary residence condition).

The second view is to be preferred as it yields more sensible results.[52]

(2) Which benefits from earlier years are Total Benefits? One does not identify *all such benefits* received by the individual, but only such benefits in tax years "in which s.732 has applied". It is not of course enough that *section 732 applies*, for the section no doubt applies every year to some taxpayer or other. Section 732 must apply having regard to the circumstances of the transfer or the individual in the earlier year.

If this is right, the definition of "Total Benefits" can be expanded to mean the following:

> [1] *Present year total benefits* must meet the following conditions (in order to be "such benefits"):
> (a) a relevant transfer has occurred
> (b) an individual who is ordinarily UK resident ("B") receives a benefit in the present year
> (c) the benefit is provided out of assets which are available for the purpose as a result of—
> (i) the transfer, or
> (ii) one or more associated operations,
> (d) B is not the transferor; and
> (e) B is not liable to income tax on the benefit (apart from section 731).
> [2] *earlier year benefits* must meet the following conditions (in order to be "such benefits" and to meet the requirement that s.732 applies in the year):
> (a) The relevant transfer has occurred
> (b) B was ordinarily UK resident in the earlier year and received a benefit in the earlier year ("the earlier year benefit").
> (c) the earlier year benefit is provided out of assets which are available for the purpose as a result of -

52 If one adopted the first view one could avoid the problems which arise by a generous application of s.743 ITA (no duplication of charges) but it is better to avoid that solution since the relief depends on HMRC discretion.

(i) the same transfer as [1] (a) above, or
(ii) the same associated operations as [1] (c) above
(d) B is not the transferor, and
(e) B is not liable to income tax on the earlier year benefit (apart from section 731).

### 27.12.3 *Step 2: Total Untaxed Benefits*

"Total Untaxed Benefits" has a relatively commonsense definition. Step 2 provides:

> Deduct from the total benefits the total amount of income treated as arising to the individual under section 732(2) for earlier tax years as a result of the relevant transfer or associated operations.
> The result is "the total untaxed benefits".

We need a label to describe the deduction as it is impossible to follow a discussion which refers more than once to "the total amount of income treated as arising to the individual under section 732(2) for earlier tax years as a result of the relevant transfer or associated operations". I refer to the deduction as "**prior year s.731 income**".

A straightforward example is if:
(1) Year 1: B receives benefit £100.
(2) Year 2: B receives benefit £100.
The Totals Benefit is £100 + £100 = £200. But assuming in year 1 B was treated as receiving £100 s.731 income, then the prior year s.731 income is deducted, so Total Untaxed Benefits are computed thus:

| | |
|---|---|
| Total Benefits | £200 |
| Prior year s.731 income | -£100 |
| **Total Untaxed Benefits** | **£100** |

Section 734 ITA provides for another deduction from Total Untaxed Benefit: since this only arises infrequently I deal with it separately below; see 27.13 (Section 733 computation when benefit subject to CGT).

### 27.12.4 *Steps 3 and 4: Relevant Income and Total Relevant Income*

Steps 3 and 4 concern relevant income and total relevant income, and are discussed below.

### 27.12.5 *Step 5: Available Relevant Income*

Step 5 provides:

> Deduct from total relevant income—
> (a) the amount deducted at Step 2 [ie prior year s.731 income], and
> (b) any other amount which may not be taken into account because of section 743(1) and (2) (no duplication of charges).
> The result is "the available relevant income".

The deduction in Step 5(b) is discussed in 28.6 (Double-counting relief).

What is the reason for the deduction in Step 5(a)? ITA EN explains a double taxation problem in the pre-ITA law:

> Section 740 of ICTA [now s.731 ITA] leaves several questions unanswered.
> It provides that
> [a] if the relevant income exceeds the benefit, the amount or value of the benefit is chargeable to income tax in the individual's hands,
> [b] but does not make provision about the treatment of the excess of the relevant income over that amount.
> [c] Taken literally and in isolation, section 740(2)(a) suggests that whenever a benefit is received the amount or value of the benefit must be compared with *all* the relevant income that has arisen on or after 10 March 1981, regardless of whether the receipt of previous benefits has involved charges by reference to that income before.[53]

For instance, if the relevant income is only £100, and T receives benefits of £100 annually, T would appear to be taxed each year on £100, so the relevant income in effect comes into charge again and again. I refer to this as **"the RI multiple counting problem"**. I confess I had not noticed the

53 Section 740(2) ICTA provided so far as relevant:
" ... the amount or value of any such benefit as is mentioned in subsection (1) above, ... shall— (a) to the extent to which it falls within the amount of relevant income of years of assessment up to and including the year of assessment in which the benefit is received, be treated for all the purposes of the Income Tax Acts as the income of the individual for that year".

problem, but point [c] seems correct if one takes the words literally and in isolation (which is of course never the right approach to a statute). The EN then give two independent reasons why no problem arose, that is, it identifies two pre-ITA solutions to the RI multiple counting problem:

> But
> [1] relevant income is defined as income that can directly or indirectly be used to provide a benefit in the tax year [ie in the year that the tax charge arises], and
> [2] section 744(1) and (2)(c)[54] of ICTA [now s.743 ITA] prevent the same relevant income being taken into account more than once.
> It is therefore considered that the *surplus* relevant income *(if it continues to be available)* has not been taken into account and so must be carried forward year by year until extinguished by a benefit or benefits. Section 733 of this Act gives effect to this view by providing [only] for *surplus* relevant income to be carried forward.[55]

Note that it is assumed in solution [1] that in order to identify the amount of relevant income, one asks whether income can be used to provide a benefit at the time the tax charge arises, ("if it continues to be available") not at the time that the relevant income accrues.

*Example 1: one beneficiary*

Suppose a trust with Total Relevant Income of £200 and:
(1) Year 1: B receives a benefit (£100) and £100 s.731 deemed income. Assume the benefit is not paid out of relevant income.
(2) Year 2: B receives another benefit (£200).
The computation in year 2 goes as follows:

*Step 1*: The Total Benefits of B are £300.
*Step 2*: The Total Untaxed Benefits of B are computed thus:

| | |
|---|---|
| Total Benefits | £300 |
| Prior year s.731 income | - £100 |
| *Total Untaxed Benefits*: | **£200** |

*Steps 3 and 4*: The Total Relevant Income is £200.

54 The original erroneously reads: (2)(b).
55 Change 1113, p.472; emphasis added.

*Step 5*: The Available Relevant Income is computed thus:

| | |
|---|---|
| Total Relevant Income | £200 |
| prior year s.731 income | - £100 |
| *Available Relevant Income:* | **£100** |

*Step 6*: the amount of s.731 income in year 2 is the lower of Total Untaxed Benefits and Available Relevant Income = £100.

That is fair and reasonable and tax law rewrite's solution to the RI multiple counting problem has worked.

*Example 2: two beneficiaries*

Now suppose a trust with Total Relevant Income of £200 and:

(1) Year 1: B receives a benefit (£100) and £100 deemed income under s.731.

(2) Year 2: C (not B) receives a benefit (£200).

The computation for C in year 2 goes as follows:

*Step 1*: The Total Benefits of C are £200.
*Step 2*: The Total Untaxed Benefits of C are £200 (nothing is deducted).
*Step 5*: Total Available Income = £200: There is no deduction from the Total Relevant Income under Step 5(a) because nothing is deducted at Step 2.

Here the Step 5(a) deduction does not prevent double taxation. The tax law rewrite team have only partly solved the RI multiple counting problem which (on a literal reading and taken in isolation) they identified. They have solved the problem where the *same* beneficiary receives benefits in different years. They have not solved it where *different* beneficiaries receive benefits in different years. Why is C not taxed on £200?

C must fall back on one of the two pre-ITA solutions identified by the tax law rewrite team:

(1) that distributed income ceases be relevant income (because it ceases to be available); so the amount of relevant income is only £100 (assuming B's benefit is a distribution of relevant income); or (if relevant income is not distributed):

(2) Step 5(b): double counting relief.

Solution (2) applies if the distribution to B did not consist of relevant income. It depends on HMRC discretion, but that was the position before the ITA rewrite, so nothing has changed.

*Example 3: one beneficiary receives a distribution of relevant income*

The second difficulty is that the rewrite team solution – a deduction for prior year s.731 income – does not link in with the first of the pre-ITA solutions to the RI multiple counting problem. Suppose a slight variant to example 1: a trust with Total Relevant Income of £200 and:

(1) Year 1: B receives a benefit (£100) and £100 s.731 deemed income. Assume the benefit *is* paid out of relevant income.[56]

(2) Year 2: B receives another benefit (£200).

The computation in year 2 goes as follows:

*Step 1*: The Total Benefits of B are £300.

*Step 2*: The Total Untaxed Benefits of B is computed thus:

| | |
|---|---|
| Total Benefits | £300 |
| Prior year s.731 income | - £100 |
| *Total Untaxed Benefits*: | **£200** |

*Steps 3 and 4*: The Total Relevant Income is £100 (because £100 has already been distributed and is not available to provide a benefit.)

*Step 5*: The Available Relevant Income appears to be:

| | |
|---|---|
| Total Relevant Income | £100 |
| prior year s.731 income | - £100 |
| *Available Relevant Income:* | **£0??** |

B should have £100 s.731 income in year 2, not £0! I think that the best solution is to say that where relevant income is distributed, no further deduction is allowed at Step 5, so there is no double deduction. Though this is reading a good deal into the provision.

### 27.12.6 *Section 733 computation where s.731 remittance basis applies*

Where the s.731 remittance basis[57] applies, s.731 deemed income is still treated as accruing to the foreign domiciled individual under s.731, even though not remitted. So the s.731 remittance basis does not prevent a deduction under Step 2 (and Step 5(a)) if applicable.

Suppose the facts of example 1 or 3 above, but the benefit which B received in year 1 was an unremitted foreign benefit which qualified for

56 For instance, trust income is accumulated and then paid to the beneficiary as capital.

57 See 27.34 (Section 731 remittance basis).

the s.731 remittance basis. The computations are exactly the same. Thus benefits to B within the s.731 remittance basis reduce available relevant income in relation to B (whether or not made out of relevant income) just as where the arising basis applies.

Suppose the facts are as in example 2 above, but the benefit which B received in year 1 was a foreign benefit which qualified for the s.731 remittance basis. There is as before no deduction under Step 2 or Step 5, but C must fall back on the two pre-ITA solutions to the RI multiple counting problem:

(1) that distributed income ceases be relevant income (because it ceases to be available); or (if relevant income is not distributed):
(2) Step 5(b): double counting relief.

Solution (2) depends on HMRC discretion, but it is considered that the relief ought to apply to relieve C. Of course, B may not agree. Suppose a variant of example 2:

*Example 4: two beneficiaries (one taxed on remittance basis)*
Suppose a trust with Total Relevant Income of £200 and:

(1) Year 1: B receives a benefit (£100) and £100 deemed income under s.731. B is a remittance basis taxpayer and does not remit the benefit so no tax is due.
(2) Year 2: C receives a benefit (£200).
(3) Year 3: B receives the benefit in the UK.

The computation for C in year 2 is the same as example 2:

*Step 1*: The Total Benefits of C are £200.
*Step 2*: The Total Untaxed Benefits of C are £200 (nothing is deducted).
*Step 5*: Total Available Income = £200: There is no deduction from the Total Relevant Income under Step 5(a) because nothing is deducted at Step 2.

Is C taxed on £200? C must fall back on one of the two pre-ITA solutions identified by the tax law rewrite team:

(1) that distributed income ceases be relevant income (because it ceases to be available); so the amount of relevant income is only £100 (assuming B's benefit is a distribution of relevant income); or (if relevant income is not distributed):
(2) Step 5(b): double counting relief.

If the distribution to B did not consist of relevant income solution (2) is the only one available. It depends on HMRC discretion but it is considered that it ought to be allowed. It follows that C will be taxed in year 3. C may argue that B ought to be taxed and B's may be subject to tax remittance should be tax free, but that seems less "just and reasonable".

### 27.12.7 *Step 6: computation of charge*

We have at last reached the final step of the s.733 computation. Step 6 is as follows:

> Compare the total untaxed benefits and the available relevant income.
> The amount of the income treated as arising under section 732(2) for any tax year is the total untaxed benefits unless the available relevant income is lower.
> If the available relevant income is lower, it is the amount of income treated as so arising.

That is, the s.731 deemed income is the lesser of:
(1) Total Untaxed Benefits; and
(2) Available Relevant Income.

### 27.12.8 *Section 733 computation: commentary*

The reader who has laboriously followed the text to this point will agree that s.733 needs to be rethought and rewritten.

## 27.13 Section 733 computation when benefit subject to CGT

Section 734 ITA provides:

> **Reduction in amount charged: previous capital gains tax charge**
> (1) This section applies if—
> (a) benefits provided as mentioned in section 732(1)(c) are received in a tax year,

That is, the benefit is in principle taxable under s.731.

> (b) for that tax year the whole or part of any benefits so provided is a capital payment to which section 87 or 89(2) of, or para 8 of Schedule 4C to, TCGA 1992 applies (chargeable gains: gains

attributed to beneficiaries),

That is, the benefit is in principle taxable under s.87.

(c) it is such a payment because the total untaxed benefits[58] 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 para (b).

The CGT charge applies under the rules set out in 27.11 (Is a benefit within s.731 a capital payment?).

> (2) For any tax year after one in which such chargeable gains are so treated, the amount of income treated as arising to the individual under section 732(2) in respect of benefits provided as mentioned in section 732(1)(c) as a result of the transfer or operations in question is calculated as follows.
> (3) The amount is calculated under section 733(1) as if the total untaxed benefits were reduced by the amount of those gains.

This ensures that a benefit charged under s.87 is not later also charged to IT.

## 27.14 "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:

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58 Section 743(4) provides:
"In this section 'the total untaxed benefits' and 'the available relevant income' have the same meaning as in section 733(1) (see Steps 2 and 5)."

*Step 3*
Identify the amount of any income which—
(a) arises in the tax year to a person abroad, and
(b) as a result of the relevant transfer or associated operations can be used directly or indirectly for providing a benefit for the individual.
That amount is "the relevant income of the tax year" in relation to the individual and the tax year.

The condition in Step 3(a), income arising to a person abroad, is the same as in the transfer of asset conditions.[59]

Strictly one should not use the term"relevant income" in the abstract. Relevant income can exist only *in relation to an individual*. There may be relevant income in relation to A which is not relevant income in relation to B (eg 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 (eg income of a discretionary trust with a power to benefit anyone in the world). But where the context is clear, one may refer to "relevant income" in isolation (leaving the words "in relation to the individual" and the identity of that individual to be inferred from the context).

The s.731 concept "relevant income" must not be confused with "relevant foreign income."

## 27.15 Deemed income of person abroad

### 27.15.1 *Capital deemed to be income*

Although the statute refers to "income" capital receipts of the person abroad are sometimes treated for tax purposes as income of the person abroad, and such receipts can therefore be relevant income.[60]

### 27.15.2 *Stock dividends and accrued income profits*

Suppose non-resident trustees receive a stock dividend from a UK

59 See 25.5 (Income "becomes payable" to person abroad).

60 See:

(1) 25.13 (Capital receipts deemed to be income).

(2) 30.6.2 (Non-resident company or institution).

(3) 32.9 (OIG arising to non-resident trust).

company. In that case "income is *treated* as arising to the trustees": see s.410(3) ITTOIA. The amount is deemed "income" for TAA purposes, but it is considered 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 DTA context;[61] here the distinction between the actual stock dividend and the fictional income is similar but clearer.

The same point arises if a person abroad is treated as receiving AIP income. The amount is treated as income becoming payable to the person abroad for TAA purposes[62] but it is considered 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 proceeds of the AIP securities can be used for that purpose, but that is not the same income.

HMRC may argue that one should carry through the deeming:[63] if the person abroad is treated as receiving income, the (deemed) income must be treated as if it can be used to benefit beneficiaries (even though it does not exist). If that were right, however, two difficulties would arise:

(1) How would the rule that distributed income is not relevant income[64] operate in this context? In order to distribute the AIP income would it be necessary to distribute the entire proceeds of the transfer (sale) of the security? Perhaps the matter would be analogous to the DDS scheme.[65] Then the only way to avoid relevant income by distribution would be to distribute the entire proceeds of the securities. Perhaps a division would be possible as it is under the mixed fund rules.[66]

(2) How does one deal with AIP loss relief? This tends to support the view that deemed AIP income is not relevant income.

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61 See 50.9 (The characterisation issue).

62 See 33.15 (Transfer of assets abroad).

63 For the general approach to deeming provisions, see 54.11.1 (Construction of deeming provisions).

64 See 27.22 (Relevant income of trust distributed as income in year it arises) to 27.26 (Distributed income: HMRC view).

65 See 34.12.1 (Section 731 ITA).

66 See 33.9.2 (Mixed funds and separating income/capital: sale with accrued interest).

## 27.16 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.[67]

There is nothing surprising in this conclusion: there is no need for s.731 in these circumstances, and one would not expect it to apply. If it did apply there could be double taxation – L being taxed on the income L receives, and on other benefits (if L receives any) to the value of the relevant income.

## 27.17 Is trust income within s.624 relevant income?

One must consider UK resident and domiciled settlors separately from those who are non-resident or domiciled.

### 27.17.1 *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 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

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67 See 27.22 (Relevant income of trust distributed as income in year it arises). Even if that were wrong:

(1) The trust income is not relevant income in relation to L. One would not say in ordinary language that the trust income *can* be used for providing a benefit for L. The income *is* the property of L.

(2) The trust income is not relevant income in relation to any other person. Since the income belongs to L, one cannot say that the income "can" be used to benefit anyone else. See 27.19 (Income which "can" be used to benefit another person).

purposes as the income of the settlor *and of the settlor alone* ...
(Emphasis added)

The trust income is not relevant income as it does not meet the condition in Step 3(a): the income is treated by s.624 as accruing to S, so it cannot be regarded as arising to a person abroad. This is so even if S (wrongly) fails to pay the tax due on the income.

27.17.2 *UK resident foreign domiciled settlor*

Now suppose:
(1) a non-resident discretionary trust within s.731;
(2) a UK resident but not UK domiciled settlor ("S") has an interest in the trust; and
(3) the trust income is actually subject to tax under s.624 ITTOIA (the s.624 remittance basis does not apply).[68]

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 income is within the s.624 remittance basis. Section 624 does not apply to income which qualifies for the s.624 remittance basis.[69] 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, eg where:
(1) Year 1
 (a) a beneficiary ("B") receives a benefit;
 (b) foreign source income arises on which the settlor ("S") is not subject to tax as the s.624 remittance basis applies. This is relevant income in relation to B, so B pays tax under s.731.

68 This may be because there is UK source income, or foreign income is received in the UK, or S does not claim the remittance basis. See 24.5 (Section 624 remittance basis).
69 See 24.5 (Section 624 remittance basis).

(2) Year 2: that income is remitted to the UK, so S pays tax under s.624. Where s.720 applies (as well as s.624) see 27.18 (Is income within s.720 relevant income?).

### 27.17.3 *Non-resident settlor*

Suppose now:
(1) a non-resident discretionary trust within s.731; and
(2) a non-resident settlor ("S") has an interest in the trust.
Section 624 does not apply to foreign source trust income.[70] 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 UK source income is not relevant income.

## 27.18 Is income within s.720 relevant income?

The analysis is different if income falls within s.720 and not s.624 because the wording of the provisions is different.

### 27.18.1 *HMRC view*

ITA EN provides:

> Where a non-UK domiciled individual transfers assets but is not chargeable to tax under section 739 ICTA [now s.720 ITA] owing to section 743(3) ICTA [the s.720 remittance basis, now replaced by the somewhat different s.735 ITA], there is no bar in HMRC's view on the application of section 740 ICTA [now s.731] to others who did not themselves make the transfer but were beneficiaries of it. HMRC interpret section 732 ITA in the same way.[71]

In HMRC's view the position (as in the s.624 case) depends on whether

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70 See 24.7 (Non-resident settlor).

71 See Change 105 in ITA EN Vol III, annex 1. The same point was made in the same words in RI 201.

the s.720 remittance basis applies:

(1) where the s.720 remittance basis applies, so the transferor is not taxed, the income of the person abroad is relevant income; but
(2) where the s.720 remittance basis does not apply (so the transferor is taxed under s.720 on an arising basis) the income of the person abroad is not relevant income.

### 27.18.2 *Where the s.720 remittance basis applies*

At first sight, the application of the s.720 remittance basis does not disapply s.720: the transferor receives s.720 deemed income even though not taxed on it, so it cannot be relevant income.

HMRC might respond that the s.720 income is different income from the income of the person abroad, but that view is to be rejected; see 50.12 (DT reliefs: section 720 ITA). It is suggested however that even though the income of the person abroad is deemed to accrue to the transferor, it also accrues to the person abroad. See *R v Dimsey & Allen* 74 TC 263.

What happens where the s.720 remittance applies and there is a subsequent remittance is an interesting question.

### 27.18.3 *Where the s.720 remittance basis does not apply*

If that is right, the only defence is s.743 ITA (double counting relief).[72] 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.

## 27.19 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:

72 See 28.6 (Double-counting relief).

Expressing a possible contingency; = May possibly.[73]

### 27.19.1 *Income of individual*

Of course, any income "can" be used for the benefit of any individual in the world if it is received by a beneficial owner who so directs. That contingency must plainly be ignored or the definition does not work.[74]

### 27.19.2 *Income received by company owned by individual*

Suppose an individual, T, transfers assets to a non-resident company all the shares of which T owns absolutely. Assume the transfer does not qualify for the motive defence. So long as T remains owner of the company, the income of the company is not relevant income in relation to any person (other than T[75]).

For the position if T later gives the company to a trust, see 27.30 (Is

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73 *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 fine discussion of *can* in Williams *Tradition & Change in Legal English* (2005), at 2.8.

74 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 sense of "may possibly") 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).

75 Strictly the income of the company may be relevant income in relation to T, but T is not concerned with s.731 as T will qualify for the transferor's s.731 defence.

income of company held by a trust relevant income?).

### 27.19.3 *Income of trust only payable to B on remote contingency*

Now consider this type of trust,[76] divided into two sub-funds:

(1) A's sub-fund: income to be applied for the benefit of A or accumulated; capital to be paid to A at the age of 25; if A dies under 25, the share accrues to B's share.

(2) B's sub-fund is held on similar terms: income to be applied for the benefit of B or accumulated; capital to B at 25 with accrual to A if B dies under 25.

Suppose income is accumulated on A's sub-fund. It is relevant income in relation to A. Is it relevant income in relation to B? It is payable to B only on the contingency that A dies under 25. It is suggested that this income is not relevant income in relation to B. One would not, in normal language, say that the income "can" be used to benefit B just because A may die under 25. The contingency is too remote.

If A dies under 25:

(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*.[77] 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 themselves completely in a straightforward manner, and is taxed if they fail to do so. A beneficiary (not the settlor/transferor) does not have the same opportunity. To tax B on income of A's fund (on the facts of the above

76 This was quite a common form before the abolition of relief for Accumulation and Maintenance trusts in 2006.

77 See Williams, *op. cit.* p.139; *may* (compared with *can*) "tends to convey a more hypothetical degree of possibility". It is reasonable to assume that the drafter of the transfer of assets provisions did not copy the language of the settlement provisions because a different result was intended.

example) would not be just or fair.[78]

### 27.19.4 *Income of discretionary trust*

Conversely, consider a common form discretionary trust. In principle, all trust income "can" (in the sense of "may possibly") 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. If there is 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 (theoretically) potential beneficiaries.

## 27.20 When does one ask? – the timing issue

One must ask whether income "can" be applied for the benefit of an individual. *At what moment in time does one ask this question?*

(1) It often happens that, at the moment it arises, income can be used to provide a benefit for a person, B, but at a later point in time it cannot be so used; for instance if income of a discretionary trust is:
    (a) distributed to another individual (not B);
    (b) transferred to another trust (under which B cannot benefit); or
    (c) retained by the trustees, but on terms under which B cannot benefit; or
    (d) used to pay trust expenses.
(2) The converse also sometimes happens: at the moment it arises income cannot be used to provide a benefit for B, but at a later time it can be

78 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 p.565. A similar unfairness does arise for CGT under s.87 TCGA. However, it is possible to avoid that by transfers to another settlement.

so used; for instance:

(a) if B is born after the income arises;

(b) if one share of a trust fund later accrues to another share (eg on the death of a beneficiary);[79] or

(c) (arguably) where a company within s.731, wholly owned by A, which has accumulated income during A's ownership, is later given to B or to a trust under which B can benefit.[80]

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 a discretionary trust or company within s.731 would usually have some period of time after income has accrued, during which they may:

(1) distribute income; or
(2) apply the income in the payment of expenses.

Then the income will not be relevant income in relation to the beneficiaries because *at the moment when one asks the question* it is no longer income which "can" be applied for the benefit of the beneficiaries.

To answer the timing question we must return to the legislation. Section 733 ITA Steps (3) and (4) provide:

> *Step 3*
> Identify the amount of any income which—
> (a) arises in the tax year to a person abroad, and
> (b) as a result of the relevant transfer or associated operations can be used directly or indirectly for providing a benefit for the individual.
> That amount is "the relevant income of the tax year" in relation to the individual and the tax year.
> *Step 4*
> Add together the relevant income of the tax year and the relevant income of earlier tax years in relation to the individual (identified as mentioned

79 See 27.19.3 (Income of trust only payable to B on remote contingency).
80 See 27.30 (Is income of company held by a trust relevant income?).

in Step 3).
The sum of those amounts is "total relevant income".

Steps 3 (taken with step 4) 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 normal font are the words of Step 4; the words in italics are the words of Step 3; the words underlined are added; note that some words must be added in any event.)

In clause [2][b] readings [i] [ii] [iii] are alternatives.

It is considered that one looks to the position at the later of:

(1) the end of the tax year in which the relevant income has accrued, or
(2) the end of the tax year in which the benefit accrues.

One asks whether *at that time* the income:

> can ... be used for providing a benefit for the individual.

Another way to put it is that one asks the question with the benefit of hindsight, taking into account facts known at the time that the question matters.

The main reason for this view is that it is more sensible to ask the question at the time it matters.

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.[81] In other cases it is only possible to ascertain a moment at which income arises by rules of a somewhat arbitrary kind.[82] Similarly, the moment that the benefit arises is not a suitable moment. Some benefits (such as interest free loans) also arise over a period. Moreover it is not practical to have to constantly compute relevant income every time that a benefit is provided during the year.

The legislation does not provide an express answer, but it does offer at least a hint in support of this view. Step 3 does not refer to "relevant income" in isolation. It refers to relevant income *of the tax year in relation to ... the tax year*. It is obviously necessary to attribute relevant income to a tax year, eg to deal with the situation where:

(1) an individual receives a benefit in year 1;
(2) the benefit is not taxed because there is no relevant income in year 1;
(3) relevant income arises in year 2.

There is only relevant income *of year 2* and so the s.731 charge arises in year 2 and not in year 1. However, the reference in Step 3 is to income of the tax year *in relation to the tax year*. These extra words suggest that the relevant income of tax year 2 in tax year 2 may be different from the relevant income of tax year 2 in tax year 3. In year 3 one must ask again what is the relevant income of year 2.[83]

The Tax Law Rewrite agree. ITA EN provides:

> 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.[84]

## 27.21 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

81 eg trading or property income.

82 eg the rules in ss.18–19 ITEPA (When general earnings are received).

83 I have considered whether any guidance is to be found in the principle that income tax is an annual tax. However, that does not shed much light on the problem.

84 The EN passage is discussed in 27.12.5 (Step 5: Available Relevant Income).

taken above. This applies even to income used for capital (rather than income) expenditure.

This is confirmed by (or at least consistent with) two HMRC statements. First, income used to meet a statutory indemnity ceases to be relevant income (even a CGT indemnity, ie a capital liability):

> **CIOT Letter (extract)**
> It would also be helpful if the Revenue could confirm that if the trustees do in fact make a payment to the settlor in response to a request for reimbursement, either under [s.646 ITTOIA] or under para 6 of Schedule 5 to TCGA, such a payment would not be regarded as: ...
> (b) Taken into account for [s.731 ITA] purposes...
>
> **The Revenue's reply**
> ...
> Using your lettering ...
> (b) *it will reduce the relevant income if paid out of income* but will not be a payment [ie not a benefit.][85]

Secondly, income used to pay a sum in lieu of interest ceased to be relevant income (even though the payment is of a capital nature). Tax Bulletin 8 provides:

> ESC D41 allowed, inter alia, demand loans made to offshore trustees on better than commercial terms before 19 March 1991 to be put on commercial terms after that date. This enabled a trust to remain outside the condition in para 9(3), Schedule 5, TCGA 1992. In order to meet the terms of this concession, it may have been necessary to pay a sum in lieu of interest in respect of periods ended 5 April 1992. Where this was the case, such a payment would ... qualify as a deduction both in determining the income of the life tenant *and for the purposes of [s.731 ITA] provided it was paid out of trust income.*
> Where the amount in lieu of interest was paid to a person who is not a beneficiary under the terms of the trust, it would nevertheless be treated as a capital payment to that individual under TCGA 1992, Section 97. If the amount in lieu of interest was paid by a company underlying the

85 *Taxation Practitioner*, April 1996 p.25 accessible *www.kessler.co.uk*, emphasis added. For other issues relating to reimbursement see 69.21 (Failure to exercise right of reimbursement). See too 27.4.10 (Reimbursement of tax under statutory indemnity).

trust, that payment would not qualify for a deduction from the profits of that company [because it is capital and not income].

Thus income used to pay interest ceases to be relevant income. Income used to repay borrowed capital also ceases to be relevant income; though if this principle was pushed to extremes in a tax avoidance scheme, the sum borrowed might be regarded as representing the relevant income: see 27.27 (Relevant income reinvested: tracing).

## 27.22 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.

### 27.22.1 *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 my 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 trust income and another beneficiary taxed under s.731).[86]

### 27.22.2 *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 B1's benefit; it is income which *is* used for B1's benefit.[87] This is significant for B1 if:

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86 Arguably s.743 ITA would provide relief: see 28.6 (Double-counting relief). But this is not a satisfactorily solution as it is not clear who pays the tax.

87 The same argument as 27.16 (Is income of life tenant relevant income?) but not so strong.

(1) B1 is a remittance basis taxpayer, 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 RFI remittance basis on the income B1 receives from the trust. B1 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.)

## 27.23 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 a past year, and
(2) had not paid tax under s.731 in the past year, 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 my 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.

## 27.24 Relevant income of trust accumulated

### 27.24.1 *Income accumulated and retained on wide discretionary trusts*

If trustees of a common form discretionary trust accumulate income, it remains relevant income in relation to all beneficiaries as long as it is retained by the trustees, because the trust capital (which represents the accumulated income) can be used to benefit any beneficiaries.

### 27.24.2 *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, eg a formerly common form of accumulation and maintenance trust provided:

(1) Income as it arises 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.

### 27.24.3 *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,[88] and these cannot be "accumulated" in the normal trust sense. It would be odd if they were treated differently from ordinary income for s.731 purposes.
(2) Income of a company within s.731 cannot be "accumulated" in the trust sense. It would be odd if companies were treated differently from trusts.

For my part I do not see why the process of accumulation should by itself make any difference to the s.731 position. If income of a common form

88 See 25.13 (Capital receipts deemed to be income).

discretionary trust is accumulated, and later distributed as income to B1, it ceases to be relevant income in relation to other beneficiaries. This only applies if the sum distributed is (or represents) the accumulated relevant income. This raises tracing issues discussed below.

### 27.24.4 *Income accumulated and distributed as capital*

Suppose income of a common form discretionary trust is accumulated and distributed as capital to a beneficiary, B. It is considered that the income ceases to be relevant income in relation to any beneficiary except B. (It is relevant income in relation to B so that B is in principle subject to tax under s.731 if B 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 is not a capital payment and so does not reduce s.2(2) amounts. However the same payment to a charity or a non-resident individual will reduce s.2(2) amounts and relevant income.

## 27.25 Corporate income distributed to trust

Suppose a company within s.731 is held by a common form discretionary trust within s.731:

(1) the company receives income ("**corporate income**");
(2) the corporate income is distributed by way of dividend and retained by the trustees.

Thus:

| | |
|---|---|
| Trust | *Dividend* |
| \| | ↑ |
| $\boxed{\text{Company}}$ | *Corporate income* |
| \| | ↑ |
| Assets | |

The corporate income ceases to be relevant income so it is not counted twice. For one cannot say that the corporate income and the dividend income are *both* available to provide a benefit.[89]

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.)

## 27.26 Distributed income: HMRC view

RI 201 states:

> For the purposes of Section 740(3) ICTA [now s.733 ITA] the measure of "relevant income" is treated as not including such part of the income as has already been genuinely paid away to a beneficiary or to a bona fide charity.
> Once relevant income has arisen *and continues to be available to provide a benefit*, it must in the Revenue's view be carried forward year by year until extinguished by such a benefit, even if it is capitalised in the accounts of the overseas person.
>
> (Emphasis added)

This does not address all the permutations discussed above, but it seems to be more consistent with the above than with any other interpretation.

## 27.27 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

89 Even if that were wrong, it is suggested that double counting relief prevents the corporate income and the dividend income from counting as relevant income; see 28.10 (Section 731 trust/company structure).

abroad.[90] Thus it makes no difference if the relevant income is invested in another asset.

Suppose:

(1) A non-resident company held by a trust has received relevant income ("**the corporate income**").

(2) The trustees sell the company to a purchaser.

It has been suggested that the corporate income ceases to be relevant income in relation to the beneficiaries, because (after the sale) that income can no longer be used to benefit them. That would be absurd, but there is no difficulty in construing the legislation to avoid that absurdity. The proceeds of sale represent the corporate 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.

## 27.28 Tracing: are distributions out of relevant income?

The principle that distributed income ceases to be relevant income applies only if the asset distributed constitutes the relevant income. Whether or not this is the case raises questions of tracing. The safest approach is for a trust or company within s.731 to keep trust income in a separate account so funds distributed can easily be identified as relevant income. But if we must enter this unchartered territory, it is suggested that the case law on pre-2008 remittance basis tracing principles provides helpful guidance.

### 27.28.1 *Cash distribution from trust within s.731*

Suppose:

(1) Trustees of a discretionary trust within s.731 receive relevant income and pay it to a mixed account (ie holding income and trust capital together).

(2) They pay a sum out of that account in exercise of a power over trust income.

---

90 Similar principles apply for the RFI remittance basis; see 9.3.5 (Capital/income terminology in remittance basis context) example 4. A similar principle applies in ascertaining what is income for the definition of power to enjoy; see 26.6.4 (Enjoyment Condition D: possibility of benefit).

It is considered that the sum distributed would be (or represent) the relevant income.

Suppose:

(1) The trustees receive relevant income, accumulate it and pay it into a mixed account (ie holding accumulated income and trust capital together).

(2) They pay a sum out of that account in exercise of a power to apply accumulated income as income.

It is suggested that the sum distributed would be (or represent) the relevant income.

Suppose:

(1) The trustees receive relevant income, accumulate it and pay it into a mixed account (ie 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.[91] Otherwise there must be an apportionment.

### 27.28.2 *Cash distribution from company within s.731*

Suppose:

(1) A company within s.731 receives relevant income and pays it to a mixed account (ie holding relevant income, capital profits and other company funds together).

(2) The company declares a dividend.

In the absence of documentation, it is arguable that income comes first out of a mixed fund: the alternative view is that the dividend represents the company's distributable profits *pro rata*. If the company has only received income (ie has not realised capital gains), the dividend represents that income.

Suppose:

91 See 11.14.1 (Remittance from mixture of taxed and untaxed income).

(1) A company within s.731 receives relevant income and pays it to a mixed account (ie 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 could 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.

### 27.28.3 *Distribution of company*

Suppose a non-resident company held by a trust has received relevant income ("**the corporate income**"). If the trust transfers the company to an individual, the corporate income ceases to be relevant to beneficiaries (except the individual). If the trust transfers the company to a new trust, the corporate income is relevant income in relation to the beneficiaries of the new trust but not in relation to beneficiaries of the old trust who cannot benefit under the new trust. This is a sensible rule as it allows different branches of a family to separate their interests fairly.

## 27.29 Distributing income: tax planning

A common strategy is:
(1) distribute all income (from a discretionary trust or underlying company within s.731) to a foreign domiciled settlor;
(2) the settlor may re-settle the income on the same trusts.

This avoids relevant income in the trust or company.[92] It would be better to have an interest in possession trust so income at the trust level will be distributed automatically. Watch *Furniss v Dawson*: it is best to avoid provocative circularity.

A variant of this idea is to distribute income to a beneficiary who is not the settlor/transferor, but who is non-resident (or domiciled) and so outside s.731. Watch *Furniss v Dawson* here.

92 Also this ensures that the settlor receives the benefit of distribution relief (if applicable); see 28.4 (Distribution relief).

## 27.30 Is income of company held by a trust relevant income?

### 27.30.1 *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.[93] 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.

### 27.30.2 *Income accruing before company is acquired by trust*

Suppose:
(1) An individual ("T") owns all the shares of a company within s.731.
(2) T gives the shares to a trust with a common form power of appointment.
Income of the company arising after the gift of T is in principle relevant income in relation to the beneficiaries of the trust.

What is the status of income arising before the gift ("old income")? HMRC say that old income is also relevant income in relation to all the beneficiaries. HMRC's argument is simple: at the relevant time (when benefits are received) the old income "can" be used for the benefit of beneficiaries. The tax consequences of this are so severe that one feels it cannot be right, but what is the flaw in the argument?

At the time when the old income accrued to the company, that income "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 my 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.[94]

93 In practice the motive defence may apply to the transfer to the company; see 29.31 (Transfer of UK assets from non-resident trustees to non-resident trust subsidiary).
94 The reference here is to the reference to associated operations in s.732(1)(c).

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 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 25.11.1 (Transfer from A to B followed by transfer from B to person abroad).

## 27.31 Individual not a beneficiary when income arises

### 27.31.1 *Beneficiary unborn when income arises*

Suppose:

(1) In Year 1 a discretionary trust within s.731 receives and accumulates relevant income.
(2) In Year 2 a beneficiary is born.

Is the income accumulated in year 1 before the birth relevant income in relation to that beneficiary? The answer depends on the timing issue. If my 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.

### 27.31.2 *Individual in existence but not a beneficiary when income arises*

Suppose:

(1) In Year 1 a discretionary trust within s.731 receives and accumulates relevant income. The class of beneficiaries consists of the issue of the settlor and their spouses.
(2) In Year 2 an individual ("W") marries a beneficiary and so joins the

class of beneficiaries.[95]

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 my view is right, undistributed income accumulated before the marriage can be relevant income in relation to W. Those who take the view that pre-birth income is not relevant income might consistently take the view that this pre-marriage income is not relevant income. This is not quite a *reductio ad absurdum*, but it is surely a bold view. If necessary, a court would hold that W "can" benefit in year 1 because of the possibility that W may marry a beneficiary in year 2. See *IRC v Tennant* 24 TC 215. But this contingency may be very remote, so my preferred analysis is less artificial.

### 27.31.3 *Beneficiary dead when income arises*

Now suppose the opposite situation:

(1) Year 1: a beneficiary receives a benefit from a trust (which is not taxable for lack of relevant income).
(2) Year 2: the beneficiary dies.
(3) Year 3: relevant income accrues.

Here it is plain that there is no tax charge on the beneficiary. Income cannot be deemed to have accrued to them once they are 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 their benefit.

### 27.31.4 *Individual excluded from benefit*

Income arising after a former beneficiary is excluded from benefit cannot (on any view) be relevant income in relation to that beneficiary. It is not necessary that the beneficiary should be excluded from benefit altogether: just that they are excluded from benefit from the income.

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95 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.

## 27.32 Transfer between trusts

Section 90 TCGA provides a code dealing with transfers between settlements for the purposes of s.87 TCGA.[96] This is needed because a s.2(2) amount is computed in relation to settlements. Each settlement has a s.2(2) amount attributed to it.

Section 731 by contrast has no such need. Relevant income is *not* computed in relation to settlements. It is computed in relation to individuals. Thus a transfer of relevant income from trust 1 to trust 2 does not reduce the relevant income if the beneficiaries of trust 1 and trust 2 are the same.

## 27.33 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. In order to understand the law one must carefully distinguish three concepts:

(1) The actual income of the person abroad.
(2) Relevant income for s.731.
(3) The income which is deemed under s.731 to accrue to the UK resident individual who receives a benefit ("s.731 deemed income").

These must not be confused!

The *actual income* of the person abroad is taxed (if at all) under general principles.

*Relevant income* is not taxed as such: it is merely something computed as a part of the process of ascertaining the amount of s.731 deemed income.

*Section 731 deemed income* is taxed at the beneficiaries marginal rate. 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? What (if anything) is there to prevent double taxation: (1) tax on the person abroad and (2) tax on the beneficiary.

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.

96 See 45.19 (Transfers between trusts).

(3) A company owned by an individual.
(4) A company owned by a non-resident trust.

### 27.33.1 *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 50%, the relevant income is reduced to £50. However, s.731 makes no further allowance for a beneficiary. So if a beneficiary receives a benefit of £50, taxable under s.731, they pay tax at their marginal rate on the £50. The effective rate of tax on the actual income of the person abroad can therefore reach 75%. Section 743 ITA probably does not help. It would be much better if the beneficiary received an income receipt from the trust.[97] Then s.731 would not apply[98] and instead the beneficiary will effectively obtain some credit for the UK tax paid by the offshore trust under the regime of Chapter 7 Part 9 ITA.[99]

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.

### 27.33.2 *Purchase of own shares*

The receipt on a purchase of own shares by a UK company is income.

Any trust, discretionary or IP, is subject to additional rate tax on a purchase of own shares. This raises the same tax problems as income of 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.

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97 As to how to achieve this, see 22.8 (Payment from discretionary trust: income or capital?).

98 See 27.10 (Benefit liable to IT defence).

99 Unfortunately the credit is less than full credit in the case of dividend income. The regime is too complex to set out here.

### 27.33.3 *Tax and tax credits of non-resident company within s.731*

A non-resident company will normally pay tax on its actual UK source income at the basic rate. The amount of tax paid reduces the relevant income so that if the gross UK source income is £100 and tax is 20%, the relevant income is reduced to £80. Once again, s.731 makes no further allowance. So if an individual receives a benefit of £80, on which they are taxed under s.731, they pay tax at the appropriate rate on the £80. The effective rate of tax on the actual income of the person abroad is therefore nearly 52% for a higher rate taxpayer and 60% for an additional rate taxpayer.

A similar point arises in relation to dividend income, which is not taxable in the hands of the company.

It would be slightly more efficient if the beneficiary received a dividend from the company. Then s.731 would not apply. The individual may still not receive any credit for the tax paid by the offshore company but their dividend income would at least be taxed at the slightly lower dividend rates.

### 27.33.4 *Tax planning by means of UK resident company*

Further tax planning is to make the company UK resident (or to acquire a UK resident company). Then the actual income of the company is paid out by way of dividend (assuming this is possible as a matter of company law) and taxed at the dividend upper rate with the benefit of the UK tax credit. Watch s.1071 CTA 2010. The benefit of this kind of planning varies with the applicable rates of tax which depend on the circumstances of the beneficiaries and whether it is s.731 or s.87 which would apply on a capital payment.

### 27.33.5 *Commentary*

In the 6th edition of this book I said:

> These are harsh rules, but the unfairness of s.731 is generally avoidable in practice and any other rule would certainly be extremely complicated to draft and to administer.

The complexity arises in matching s.731 deemed income with the taxable income of the person abroad. But now the FA 2008 has introduced matching rules. (Complexity was not a serious concern to the architects of the 2008 reforms.) What is sauce for the goose is sauce for the gander. If the matching rules must be retained, fairness requires that there should also be a system of credit for tax on the relevant income.

The better solution would be the rough and ready but simpler rules which took effect from 1981 to 2008, but at present we have the worst of both worlds: complexity and unfairness.

## 27.34 Section 731 remittance basis

Section 735 ITA[100] provides a relief which I call "**the s.731 remittance basis**". Section 735(1) provides:

> This section applies if—
> (a) income is treated under section 732 as arising to an individual in a tax year ("the deemed income"),
> (b) section 809B, 809D or 809E (remittance basis) applies to the individual for the year, and
> (c) the individual is not domiciled in the UK in the year.

In short, the relief applies to remittance basis taxpayers.

### 27.34.1 *"Foreign" income*

In order to understand the law one must carefully distinguish:
(1) relevant income (in short, income arising to the person abroad); and
(2) income treated under section 732 as arising to an individual. Statute calls this "the deemed income" but I use the term "**s.731 deemed income**" to distinguish it from the myriad types of deemed income in the taxes acts.

Further, the legislation distinguishes between two types of relevant income and two types of s.731 deemed income.

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100 Flagged (somewhat unnecessarily) by s.731(2A) ITA:
"(2A) But see section 735 (non-UK domiciled individuals to whom remittance basis applies)."

(1) Relevant income may be:
  (a) foreign relevant income or
  (b) not foreign (which one might call UK relevant income).
(2) S.731 deemed income may similarly be:
  (a) foreign: the statutory term is "foreign deemed income" but I will use the term "**foreign s.731 deemed income**".
  (b) not foreign.

The crucial term is "foreign s.731 deemed income". Section 735(2) ITA provides:

> For the purposes of this section the deemed income is "foreign" if (and to the extent that) the relevant income to which it relates would be relevant foreign income if it were the individual's.

I deal with the concept of "relates" in the next section.

27.34.2 *Operation of the s.731 remittance basis*

Assuming we have identified foreign s.731 deemed income, we can turn to s.735(3) ITA which provides the relief:

> Treat the foreign deemed income as relevant foreign income of the individual.

This incorporates the RFI remittance basis. It would not work by itself as the s.731 deemed income (being fictional) does not exist and cannot be remitted. So s.735(4) ITA provides:

> For the purposes of chapter A1 of Part 14 (remittance basis) treat relevant income, or a benefit, that relates to any part of the foreign deemed income as deriving from that part of the foreign deemed income.

This means:

> For the purposes of the remittance basis provisions treat *both*
> [a] relevant income *that relates to any part of the foreign deemed*

*income*[101] *and*
[b] a benefit that relates to any part of the foreign deemed income as deriving from that part of the foreign deemed income.[102]

Thus we have three fictions. First we pretend that the individual receives s.731 deemed income. Secondly, we pretend that that s.731 deemed income is RFI. Thirdly, we pretend that certain relevant income *and* certain benefits derive from that RFI.[103] The third fiction feeds into remittance condition B. If anything derived from that benefit (or from that relevant income) is received in the UK by the individual or by a relevant person (in relation to the individual), there is a charge under the remittance basis.

### 27.34.3 *Transitional rules*

Para 170 Sch 7 FA 2008 provides:

> The amendments made by paras 161 to 179 have effect for the tax year 2008-09 and subsequent tax years.

Section 735 does not apply to benefits accruing to a person abroad before 2008/09 because the condition in s.735(1)(b) is not met.

## 27.35 Section 731 matching rules

In order to decide whether the remittance basis applies, we need to identify the foreign s.731 deemed income, so we need to identify the relevant income to which the s.731 deemed income "relates" to see if it is foreign relevant income.

In order to operate the remitttance basis if it applies, we need to identify

101 If relevant income relates to s.731 deemed income then the s.731 deemed income relates to the relevant income: that is, "relates" is a transitive concept and if A relates to B then B relates to A.

102 That is, the phrase "that relates to any part of the foreign deemed income" qualifies "relevant income" as well as "benefit".

103 Contrast the solution adopted for the s.87 remittance basis, where the capital payment (corresponding to the remittable benefit) is deemed to derive from the deemed s.87 gains, but the s.2(2) amount (corresponding to remittable relevant income) is not.

the benefits that relate to s.731 deemed income in order to see if it has been remitted.

Although statute uses the word "relate" the rules are more clearly described as matching rules.

These rules are set out in s.735A ITA. This works in four stages.

### 27.35.1 *Place benefits in date order*

Section 735A(1) ITA provides:

> For the purposes of section 735—
> (a) place the benefits mentioned in Step 1 [benefits within s.731][104] in the order in which they were received by the individual (starting with the earliest benefit received)

Some benefits are not received at any particular moment in time, eg the benefit of rent-free accommodation, and it is not possible to place them in the order in which they are received. Perhaps there should be a time apportionment.

One then makes certain deductions from the benefits:

> (b) deduct from those benefits so much of any benefit within section 734(1)(b) as gives rise as mentioned in section 734(1)(d) to chargeable gains or offshore income gains.

See 27.13 (Section 733 computation when benefit subject to CGT).

### 27.35.2 *Place UK/foreign relevant income in due order*

Section 735A(1) ITA continues:

> (c) place the income mentioned in Step 3 for the tax years mentioned in Step 4 ("the relevant income") in the order determined under subsection (3)

Note that Steps 3 and 4 here refer to the steps in s.733; confusingly the

104 Section 735A(2) ITA provides:
"In subsection (1) references to a step are to a step in section 733(1)."

reference is not to the steps in s.735A(3) which immediately follow.

This takes us to s.735A(3) ITA:

> The order referred to in subsection (1)(c) is arrived at by taking the following steps.
> *Step 1*
> Find the relevant income for the earliest tax year (of the tax years referred to in subsection (1)(c)) [ie the tax years where s.731 applies]
> *Step 2*
> Place so much of that income [relevant income] as is not foreign[105] in the order in which it arose (starting with the earliest income to arise).
> *Step 3*
> After that, place so much of that income as is foreign in the order in which it arose (starting with the earliest income to arise).

In order to carry out Steps 2 and 3 it is necessary to distinguish between:

(1) foreign relevant income; and
(2) other relevant income ("**UK relevant income**").

It is then necessary to ascertain the date that the relevant income arises. Some income is not received at any particular moment in time, eg trading and property income, where the income is computed as a net figure after allowing deductions. Section 735A(5) ITA deals with this:

> For those purposes [for purpose of putting relevant income into date order] treat income for a period as arising immediately before the end of the period.

TAH para 1234 provides:

> ... For example, business profits accrue over an accounting period to say 31 December so for the purpose of this provision the income would be treated as arising on 31 December. Therefore if in a tax year there was say interest income arising on 30 September and business profits accruing over an accounting period to 31 December, for the purpose of this provision they would be placed in the order interest first and profits

105 Section 735A(4) ITA gives a commonsense definition to "foreign" relevant income: "For the purposes of subsection (3) relevant income is 'foreign' where it would be relevant foreign income if it were the individual's."

second.

The author probably assumed that interest is not "income for a period" and so the interest is not affected by s.735A(5). In fact, interest is income for a period to which it relates, even though it is only charged when it arises. But normally interest is paid in arrears, ie interest arising on (say) 30 September is for a period ending 30 September, so the end result is the same.

Then one carries out Steps 1–3 for subsequent years, year by year::

> *Step 4*
> Repeat Steps 1 to 3.
> For this purpose, read references to the relevant income for the earliest tax year as references to the relevant income for the first tax year after the last tax year in relation to which those Steps have been undertaken.

Amended as step 4 requires, steps 1-3 provide:

> *Step 1*
> Find ~~the relevant income for the earliest tax year~~ *the relevant income for the first tax year after the last tax year in relation to which those Steps [Steps 1-3] have been undertaken* (of the tax years referred to in subsection (1)(c)) [ie the tax years where s.731 applies]
> *Step 2*
> Place so much of that income [relevant income] as is not foreign in the order in which it arose (starting with the earliest income to arise).
> *Step 3*
> After that, place so much of that income as is foreign in the order in which it arose (starting with the earliest income to arise).

### 27.35.3 *Deduction from relevant income*

Section 735A(1)(d) ITA provides:

> (d) deduct from that income any income that may not be taken into account because of section 743(1) or (2) (no duplication of charges),

Section 735A(6) ITA provides:

> Subsection (1)(d) does not apply if the income may not be taken into

account because the individual has been charged to income tax under section 731 by reason of the income.

### 27.35.4 *Place s.731 deemed income in date order*

Section 735A(1)(e) provides:

> place the income treated under section 732(2) as arising to the individual in respect of the benefits in the order in which it is treated as arising (starting with the earliest income treated as having arisen),

### 27.35.5 *The matching rule*

Having identified all these matters, and placed them in date order, we can at last turn to the matching rule itself. Section 735A(1)(f) ITA provides:

> treat the income mentioned in para (e) [s.731 deemed income] as related to—
> (i) the benefits, and
> (ii) the relevant income,
> by matching that income with the benefits and the relevant income (in the orders mentioned in paras (a), (c) and (e)).

### 27.35.6 *Summary*

In short, the matching rules are:

(1) Match to relevant income of earlier years before later years.
(2) Within the years, match to UK relevant income before foreign relevant income.

Why does the legislation not simply say that? For a discussion of the drafting issues see 45.10.7 (Commentary: step-based drafting).

The rule is arbitrary (but any matching rule is arbitrary).

### 27.35.7 *HMRC examples*

TAH gives a number of examples, most of which are self-evident, but two are worth setting out here. Para 1234 Example 10 involves UK and foreign relevant income (7 items of income altogether) and non-UK benefits (2 benefits altogether):

| | | | Relevant income | | Benefits |
|---|---|---|---|---|---|
| **Item** | **Date** | | *UK* | *Foreign* | **(non-UK)** |
| *1* | *Year 1* | 30 Sept | 500 | | |
| *2* | | 31 Dec | | 500 | |
| *3* | *Year 2* | 31 Dec | | 1,000 | 750 |
| *4* | *Year 3* | 30 Sept | | 500 | |
| 5 | | 31 Dec | 500 | | |
| *6* | *Year 4* | 30 Sept | | 500 | |
| 7 | | 31 Dec | 500 | | 750 *[or 1,500]* |

The HMRC analysis is:

> There are potential transfer of assets benefits charges in Yr 2 of 750 and Yr 4 of 750.

More analytically, the individual receives s.731 deemed income of £750 in years 2 and 4.

> In Yr 2, 250 will be foreign deemed income and ring fenced to be charged under Part 8 ITTOIA as and when there is an amount remitted to the UK. 500 is charged under transfer of assets.

More analytically, the £750 s.731 deemed income of year 2 is matched as follows:
£500 is matched to income item 1: that £500 is not deemed RFI and so is charged on an arising basis.
£250 is matched to income item 2: that £250 is deemed RFI and taxed on the s.731 remittance basis, ie on a future remittance of the benefit or the foreign relevant income. I would not use the term "ring-fenced" to describe this, but it might serve as a loose metaphor.

> In Yr 4 the whole 750 will be deemed foreign income [*recte* foreign deemed income].

More analytically, the £750 s.731 deemed income of year 4 is matched to the remaining unmatched £250 of item 2 and to the first £500 of item 3. The £750 is deemed RFI and taxed on the s.731 remittance basis.

> If however the benefit in Yr 4 was 1500, then only 1250 would be ring fenced as foreign deemed income and 250 would be charged under transfer of assets.

More analytically if the benefit in Yr 4 was 1500, the individual receives s.731 deemed income of £1,500 in year 4. That is matched as follows:
£250 is matched to the remaining unmatched part of income item 2.
£1,000 is matched to income item 3.
The total of £1,250 is deemed RFI and taxed on the s.731 remittance basis.
£250 is matched to income item 4 and is taxed on the arising basis.

TAH para 1236 Example 11 is a slightly more complex example with:
(1) UK and foreign relevant income - 12 items altogether.
(2) UK and foreign benefits - 4 benefits altogether.

An individual who is ordinarily resident, but not domiciled, in the UK has received cash benefits from an offshore structure in circumstances where the conditions for the transfer of assets provisions to apply are met. The 'remittance basis' of taxation applies for each year.

| | | | **Relevant income** | | **Benefits** | |
|---|---|---|---|---|---|---|
| **Item** | **Date** | | *UK* | *Foreign* | *UK* | *Foreign* |
| *1* | *Year 1* | 30 Sept | 500 | | | |
| *2* | | 31 Mar | | 800 | | 1,000 |
| *3* | *Year 2* | 31 Mar | 100 | | | 1,400 |
| *4* | | 31 Mar | | 1,000 | | |
| *5* | *Year 3* | 31 Mar | | 500 | | |
| *6* | | 31 Mar | 500 | | | |
| *7* | | 31 Mar | 500 | | | |
| *8* | *Year 4* | 30 Sept | 200 | | 1,000 | |
| *9* | | 31 Mar | | 500 | | |
| *10* | *Year 5* | 30 Sept | 500 | | | 600 |
| *11* | | 30 Sept | | 100 | | |
| *12* | | 31 Mar | | 400 | | |

The HMRC analysis is (to say the least) informal in its use of terminology and it should be recast along the lines of example 10. this is done here by adding only brief comments in italics as the text is long and the reader will have the idea.

**Year 1**
The potential benefits charge [*s.731 deemed income*] is 1000 (being the lesser of 1300 relevant income and 1000 benefits received).
As all of the conditions for Section 735 to apply are met, consider whether any

of the potential charge [*s.731 deemed income*] is foreign deemed income. The principles in Section 735A are used for this purpose.
- First match the 1000 with the UK [*relevant*] income of 500. As this income cannot be relevant foreign income then 500 cannot be foreign deemed income and thus is charged under the transfer of assets benefits charge [*on an arising basis*].
- The remaining benefit [*£500 s.731 relevant income*] is then matched with the foreign [*relevant*] income of 800. This [*relevant*] income would be relevant foreign income if it was the individuals and thus 500 of the deemed amount [*s.731 deemed income*] is foreign deemed income. This is treated as relevant foreign income and becomes potentially chargeable under Part 8 ITTIOA 2005 [*ie is taxed on the s.731 remittance basis*].
- There is a balance of 300 relevant income that remains unmatched.

Where any amount is remitted to the UK during that or any subsequent year which is a remittance for Chapter A1 Part 14 ITA 2007 (the Remittance Basis) then part or all of the ring fenced amount may be charged under Part 8 ITTOIA in the year of remittance, subject as appropriate to the rules on remittances from mixed funds.

The total taxable amount for the year under transfer of assets benefits charge is therefore 500.

**Year 2**

The potential benefits charge [*s.731 deemed income*] is 1400 (being the lesser of the total relevant income 2400 and the total benefits 2400 less 1000 already charged).

Calculate how much of the total potential charge [*s.731 deemed income*] can be regarded as foreign deemed income applying Section 735A-

The potential chargeable amount [*s.731 deemed income*] is in effect matched with-

(a) 300 of foreign [*relevant*] income from year 1. This gives foreign deemed income of 300 chargeable [*on the s.731 remittance basis*] under Part 8.

(b) 100 UK income of year 2. As this income cannot be relevant foreign income this amount of 100 remains chargeable [*on an arising basis*] under the transfer of assets benefits charge.

(c) The foreign [*relevant*] income of year 2 of 1000. As this would be relevant foreign income if it were the individual's this amount can [*must*] be regarded as foreign deemed income and so chargeable [*on the s.731 remittance basis*] under Part 8.

The result is that of the potential charge [*s.731 deemed income*] of 1400, 100 is charged under transfer of assets benefits charge [*on the arising basis*] and 1300 is ring fenced and treated as relevant foreign income chargeable [*on the s.731 remittance basis*] under Part 8 ITTOIA.

The total charge under the transfer of assets benefits charge is therefore 100. Where any amount is remitted to the UK during that or any subsequent year which is a remittance for Chapter A1 Part 14 ITA 2007 (the Remittance Basis) then part or all of the ring fenced amount may be charged [*on the s.731 remittance basis*] under Part 8 ITTOIA in the year of remittance, subject as appropriate to the rules on remittances from mixed funds.

**Year 3**
Although there is further relevant income in this year there are no unmatched benefits so there can be no potential charge [*s.731 deemed income*] under transfer of assets benefits charge so a consideration of S735 is not applicable.

**Year 4**
The potential charge [*s.731 deemed income*] is 1000 (being the lesser of the total relevant income 4100 and the total benefits 3400 less 2400 already charged).
Work out the deemed foreign income [*foreign s.731 deemed income*] applying Section 735A-
The potential chargeable amount [*s.731 deemed income*] is in effect matched with
(a) The UK relevant income 500 from year 3.
(b) The foreign [*relevant*] income of 500 from year 3.
The total amount charged under the transfer of assets benefits charge is therefore 500.
500 is ring fenced as foreign deemed income and treated as relevant foreign income *charged on the s.731 remittance basis*].
Where any amount is remitted to the UK during that or any subsequent year which is a remittance for Chapter A1 Part 14 ITA 2007 (the Remittance Basis) then part or all of the ring fenced amount may be charged [*on the s.731 remittance basis*] under Part 8 ITTOIA in the year of remittance, subject as appropriate to the rules on remittances from mixed funds.
There is 700 of unmatched relevant income to take forward.

**Year 5**
The potential charge [*s.731 deemed income*] is 600 (being the lesser of the total relevant income 5100 and the total benefits 4000 less 3400 already charged).
Work out the deemed foreign income [*foreign s.731 deemed income*] applying Section 735A-
The potential chargeable amount [*s.731 deemed income*] is in effect matched with
(a) The UK relevant income 200 from year 4.
(b) 400 of the foreign relevant income from year 4.
The total amount charged under the transfer of assets benefits charge is therefore

200.
400 is ring fenced as foreign deemed income and treated as relevant foreign income.
Where any amount is remitted to the UK during that or any subsequent year which is a remittance for Chapter A1 Part 14 ITA 2007 (the Remittance Basis) then part or all of the ring fenced amount may be charged [*on the s.731 remittance basis*] under Part 8 ITTOIA in the year of remittance, subject as appropriate to the rules on remittances from mixed funds.
As the benefit was received in the UK a minimum of the ring fenced amount of this year will be charged under Part 8 ITTOIA and consideration would need to be given to whether there are further untaxed amounts of ring fenced income that would be charged for this year applying the relevant remittance basis rules.
There is 1100 of unmatched relevant income to take forward.

### 27.35.8 *Planning implications*

Where the s.731 remittance basis applies the best planning by far is to arrange that the person abroad (the foreign trust or company):
(1) does not have any UK source income and
(2) does not remit its foreign income.
Then there is no need to worry about the complex s.735A matching rules. The relatively simple position is that there is a remittance if the benefit is received in the UK.
This also avoids the double charge to UK tax which arises when benefits are matched to UK source relevant income.
The next best planning is to arrange that:
(1) UK source income arises in years where no s.731 benefit is provided; and
(2) In a year where a s.731 benefit is provided, the person abroad has no UK source relevant income *and* has foreign source relevant income of an amount sufficient to match the value of the benefit (ie the foreign source relevant income will frank the benefit). If the trust property is held through a trust subsidiary, a dividend from the subsidiary may conveniently achieve that.

### 27.35.9 *Commentary*

The reader who has closely followed the text to this point will agree that the s.731 remittance basis is unworkably complicated. The rule should simply be that there is a tax charge if the benefit is remitted, and the matching rules completely abandoned. That would be fairer, consistent with the principle of the remittance basis, consistent with the s.87 remittance basis, and a simplification.

## 27.36 Where is a benefit received?

The s.731 remittance basis requires one to identify:

(1) where a benefit is received (or at least, whether it is received in the UK); and

(2) where anything derived from that benefit is received.

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 location of a source of income, problems to which wholly satisfactory answers do not exist.

It may be that some benefits are not received in any particular identifiable place but it is suggested that just as every asset has a situs (and only one situs), the better view is that every benefit should have one (and only one) place of receipt. However to identify that place will sometimes require an arbitrary selection of connecting factors.

The benefit of the transfer of money paid to a beneficiary's bank account is received where the account is kept.

The benefit of the transfer of a debt or shares might be received where the debt or shares are situated under private international law principles. Or it might be received in the jurisdiction whose law governs the transfer of the asset.

### 27.36.1 *Interest-free (or low-interest) loan*

Where is the benefit of an interest-free (or low-interest) loan received? The possible solutions are:

(1) where the money lent is received;

(2) where the debt is situate under private international law principles.[106]

The objection to solution (1) is that the benefit is not the money lent, it is the interest forgone. It is suggested that the best solution is that the benefit is received where the debt is situate.[107] It is arguable that the money lent

106 See 70.12 (Simple contract debt) and 70.13 (Specialty obligation).

107 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

is derived from the benefit.[108]

The same solution would apply if the benefit was leaving outstanding a debt which was not a debt for money lent, for instance, if the offshore person sold an asset for full value to the individual and left the purchase price outstanding.

27.36.2 *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.

27.36.3 *Release of debt*

Suppose:
(1) money is lent to a beneficiary;[109]
(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. The money lent is not, strictly, derived from the benefit.

27.36.4 *Receipt of benefit outside UK and subsequent remittance*

Suppose:
(1) a UK resident foreign domiciled individual receives a benefit in the

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(2) when interest is not payable this would be a difficult hypothetical question to answer.

108 See 10.14.5 (T lends to R).

109 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 benefit becomes taxable under the s.731 foreign domicile remittance basis. Before 2008 the contrary was arguable.

For this reason, the tax consequence of a benefit received by one beneficiary may depend on whether *other* beneficiaries have remitted their benefits (and so used up relevant income). One might expect one beneficiary (with access to trust documents) to be able to find out what benefits other beneficiaries have received and where. But a beneficiary is not entitled to find out and often will be unable to find out what benefits received by other beneficiaries have been remitted. The legislation is in many cases unworkable. But in 2008 workability was not regarded as a requirement of anti-avoidance legislation.

If the beneficiary is not ordinarily resident when they receive the benefit but ordinarily resident when it is received in the UK, there is no tax charge.

### 27.36.5 *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 foreign relevant income. However, if OC distributes the income to the trust, OC's income ceases to be relevant income. Instead the income of the trust is relevant income (unless distributed), but this income is foreign source income and so in principle excluded relevant income. So where UK source income is received by a trust subsidiary company, the s.731 remittance basis 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.

## 27.37 Section 720 and 731 remittance basis compared

Sections 720 and 731 both offer a form of remittance basis. The s.720 remittance basis is more generous. So a transferor (chargeable under s.720 but not s.731) will often be in a better position than other beneficiaries (chargeable under s.731)! For example:

(1) Suppose T (UK resident, foreign domiciled) creates a trust within s.720. T occupies a property owned by the trust. The trust also receives and accumulates foreign income. There is no tax charge. T is not subject to tax under s.720.

(2) Now suppose T dies and B occupies the same property. B is taxed on the benefit of the rent-free accommodation under s.731. The s.731 remittance basis does not help B because the benefit is received in the UK.

## 27.38 Summary of responses to s.731

(1) Avoid relevant income by
 (a) distributing income:
  (i) as it arises; or
  (ii) in a year before a beneficiary receives a benefit; or
 (b) using interest in possession settlements in preference to discretionary; or
 (c) not using trusts and companies where inappropriate.

(2) Motive defence.

(3) Remittance basis.

(4) Arrange that foreign domiciled beneficiaries receive benefits of an income nature (outside s.731).

## 27.39 Tax return – disclosure[110]

Box 42 in the Foreign pages (form SA 106) 2009/10 reads:

> If you have received a benefit from a person abroad, enter the value or payment received.

110 See too 29.45 (Tax return: disclosure of motive defence claim).

This rewording tacitly acknowledges the criticism of former wording, set out in the 8th edition of this work at 17.15.

The reference to a benefit is a reference to an income taxable benefit, so if a foreign domiciled individual received a benefit which is not subject to IT (because of the remittance basis or for lack of relevant income) then the figure here should be nil. HMRC agree. Helpsheet 262 (Income and benefits from transfers of assets abroad and income from non-resident trusts - 2009/10) provides:

> **How do you report benefits?**
> Unless you are completing box 46 – see 'How do you qualify for an exemption from charge on income or benefits?' on page 5 – you should enter the amount computed at Step 6, in box 42.
> Enter in the 'Any other information' box of your tax return the full name and address of the person abroad receiving the available relevant income, details of the relevant transactions that have given rise to the income and how you have calculated the benefits included on the return. Where the benefit has come from a UK resident trust in the circumstances described in the previous section, also give details of those circumstances including the full name of any other trust involved.

CHAPTER TWENTY EIGHT

# TRANSFER OF ASSETS ABROAD: DOUBLE TAXATION ISSUES

## 28.1 TAA reliefs – Terminology

The transfer of asset rules could often give rise to double taxation, and there are four reliefs to prevent this. Statute does not provide names for the reliefs, so I coin the following terminology:

| Name of Relief | 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 worded DT relief |

For the separate issue of DTAs and foreign tax credit reliefs, see 50.12 (DT reliefs: Section 720 ITA) and 50.13 (DT reliefs: s.731 ITA).

## 28.2 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:

(1) OC pays income tax at the basic rate under ordinary principles.

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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.

(2) The transferor ("T") pays income tax on the same income under s.720. What is there to prevent double taxation?

### 28.2.1 *Transferor's credit*

Section 745(1) ITA provides relief for T:

> Income tax at the basic rate, the starting rate for savings or the dividend ordinary rate shall not be charged by virtue of section 720 or 727 in respect of any income to the extent that it has borne tax at that rate by deduction or otherwise.[2]

I refer to this as "**transferor's credit**".

The credit is available where OC is a UK resident foreign incorporated company even though such a company is subject to corporation tax at CT rates (not income tax at the basic/savings/dividend ordinary rates). HMRC say:

> If tax has been paid on the income of the person abroad on which you are also liable to tax under these provisions and which you have entered in Column B before box 13 then you may be able to claim a deduction against your liability for that tax. You will only be entitled to relief for the tax paid by the person abroad if it is in effect tax on 'the same' income, and only to the extent that the tax has actually been paid by, and not refunded to, the person abroad. This could include in some circumstances, for example, UK Corporation Tax. Relief for the tax paid, including any UK Corporation Tax, should be included at Column C and you should note Column E of your claim. Full details of how you have calculated the amount of credit claimed, and details (name, address and, where appropriate, tax reference number) of the person or company which paid the tax should be given in the 'Any other information' box of your Tax Return. If you do not yet know the final amount of tax paid by the person abroad, you should estimate the amount of credit available and amend your Tax Return when the final details are known. You must draw attention to the estimate and explain the circumstances in the 'Any

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2 This was considered in *R v Dimsey & Allen* 74 TC 263 at [53]:
"This provision would have dealt with the case where the transferee's income included income sourced in the UK and from which tax had already been deducted at source. But the words 'or otherwise' show that the provision would have covered also any case in which the transferee had paid tax on its income."

> other information' box of your Tax Return. If any additional tax becomes payable as a result of using an estimate the usual provisions for charging interest on tax paid late will apply.[3]

The guidance note for 2006/07 added:

> We will consider providing details of Corporation Tax paid upon receipt of written authority from the company concerned[!].[4]

### 28.2.2 *Transferee's concessionary credit*

The limitation of the transferor's credit was explained in *R v Dimsey & Allen* 74 TC 263 at [56]:

> Section [745(1)] ... is looking at the double taxation problem from the point of view of the transferor on whom the liability to pay tax on deemed income is being imposed. There is no comparable provision protecting the transferee in a case where, under s [720], the transferor has paid tax on his deemed income.

In the course of argument in *R v Dimsey & Allen*, HMRC announced a concession to solve this problem:

> **The Inland Revenue's Practice on section [720]**
> [1] If in any case tax is paid by the transferee, the Inland Revenue will give credit for that tax against any charge to tax on the transferor under section [720 ITA] on the same income;
> [2] and conversely, if in any case tax is paid on any income by the transferor under section [720], the Inland Revenue will not tax the transferee on that income.
> So that in every case, the Treasury received in all the full amount of tax chargeable on the transferor as if he were the only person liable.

Point [1] is the transferor's credit. I refer to point [2] as "**the transferee's**

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3 Help sheet 262 (income and benefits from transfers of assets abroad) 2009/10. In *R v Dimsey & Allen* 74 TC 263 at [55] Lord Scott suggested (without deciding) that transferor's credit would apply in this case. But see 25.4.1 (UK resident foreign incorporated company) for an argument that s.720 does not apply here.

4 "Notes on Foreign" (the Notes on the Foreign pages of the tax return for the year ended 5 April 2007, under the heading "box 6.4A", page FN11).

**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 T usually pays higher rate tax only).

This concession does not say whether (1) or (2) is to be the case. As far as HMRC are concerned it does not matter because the amount of tax collected will generally be the same. If T is the beneficial owner of OC, it may likewise not make much economic difference to T whether T or OC pay the tax. But T may have "power to enjoy" the income of OC while only having a remote and not particularly valuable interest in it.[5] One can imagine a situation where T and OC each ask HMRC to assess the other! There is no mechanism for tax paid by T to be recovered from OC or vice versa. HMRC have a broad discretion, subject to judicial review if they act unreasonably. How in practice should HMRC collect tax? It is suggested that HMRC's starting point should be that tax is to be borne by OC where tax is reasonably collectible from OC, ie 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, ie if OC complies with its duties under those regulations; or
(3) OC is prepared to complete UK tax returns and pay the tax on its income.

It is fair that OC, which receives the income, should pay the tax on it. Then only higher rate tax is normally collected from T. Only in cases where OC refuses to pay should all the tax be collected from T. This seems consistent with the extract from "Notes on Foreign" cited above.

It is arguable that double-counting relief also provides a defence to double taxation.[6] If this is correct, the transferee's concessionary credit is the law and not a concession.

## 28.3 Distribution to T of income of company within s.720

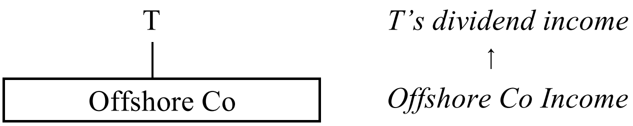
So far we have been considering undistributed income of OC. I now turn to consider the position where the income is distributed to T by way of

5 For instance, if OC owes T a small debt.

6 See 28.6 (Double-counting relief).

dividend. Suppose:

(1) An offshore company ("OC") within s.720 receives income ("OC's income").
(2) T owns all the shares in OC.[7]
(3) The income of OC is distributed by way of dividend to T ("T's dividend income"):




Possible charges to tax here are:

(1) IT on OC's income paid by T under s.720.[8]
(2) IT on the dividend (paid by T) on normal principles.

Is there any relief from economic double taxation?

## 28.4 Distribution relief

Section 743(4) ITA provides:

> If
> [a] income treated as arising to an individual is charged to income tax under section 720 or 727 and
> [b] the individual subsequently receives *that income*,
> it is treated as not being the individual's income again for income tax purposes.
> (Emphasis added)

I refer to this as "**distribution relief**". There are three conditions for this relief to apply:

(1) Income treated as arising to the individual is charged to income tax under s.720.
(2) The individual receives the income.

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7 The position is not materially different if the shares in OC are held in a trust under which T has an interest in possession.

8 Or IT on OC's income paid by OC and T, but with credit to avoid double taxation: see above. That makes no difference for the purpose of this example. It is assumed here that T does not qualify for the remittance basis.

(3) The dividend income which the individual receives is "that income", ie the same as the income treated as arising to the individual.

Condition (1) would normally be satisfied.[9] Condition (2) is *ex hypothesi* satisfied.

### 28.4.1 *When is income "the same" for purposes of distribution relief?*

At first sight condition (3) is more doubtful. The income which the individual actually receives is the dividend income. The income which the individual is treated as receiving under s.720 is the income of OC.[10] The two are not the same. But if that is correct, then s.743(4) can never apply at all, which cannot be correct.

OC's income and the dividend income are in substance or economic reality the same income. It is true that they are usually regarded for tax as separate sources of income, not the same income. "The income of the company and the income derived from the company by the shareholders are two quite different incomes."[11] Nevertheless for this purpose one looks to the substance and does not apply a 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*.[12] The facts were

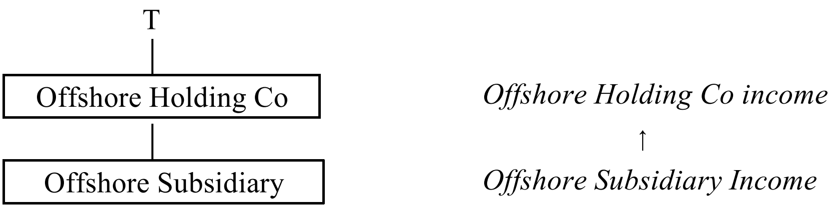
9 See 28.2 (Undistributed UK taxable income of offshore company); 28.7.2 (When is an individual "charged to tax" under s.720?).

10 Or on an alternative view, the income which the individual is treated as receiving is fictional, notional income, but for the purposes of distribution relief it does not matter if that view is correct.

11 *Vestey v IRC* 54 TC 503 at p.562. This is obvious but if further authority is needed, see *Canadian Eagle Oil Co v The King* 27 TC 205 at p.257: "for the purposes of Income Tax, the income of a foreign company and the income received from it in dividends by its British shareholders are not to any extent or effect one and the same income, but are two distinct incomes".

12 24 TC 515. The substance (as opposed to a formalistic) view of income identity is also applied in other contexts in the transfer of assets code. In *Vestey v IRC* Walton J held that a shareholder had no "power to enjoy" the income of the company in which he held shares because (applying the formalistic view of income identity) the shareholders had power to enjoy *different* income! However, this view was rejected in the House of Lords. See 26.6.4 (Enjoyment condition D: possibility of benefit). Similarly the court looked at the economic substance in order to determine whether two assets were "the same" (for the purposes of stamp duty subsale relief) see *Fitch*

relatively simple. T (UK domiciled) held an offshore holding company (within s.720) which held an offshore subsidiary (within s.720):[13]




(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. T was not assessed on the offshore subsidiary income in 1936/7.

This was not an individual/company structure but a company/subsidiary structure, but in the context of distribution relief the issue is the same.

T argued that T could be assessed at stage (1) and so could not be assessed at stage (2). T 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.

### 28.4.2 *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;

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*Lovell v IRC* [1962] 1 WLR 1325.

13 More accurately, there were several holding and subsidiary companies, but nothing turns on that.

(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 (eg 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, this is not an anomaly. The object of s.720 is to put the transferor in the same position as if they had not made the transfer: see *Chetwode v IRC* 51 TC 647.

### 28.4.3 *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 (eg because of capital allowances). Distribution relief applies only so far as the income of the company has been charged 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 (ie 100–10).

In these circumstances, the use of an offshore company does give rise to tax on the distribution which would not have arisen if there were no company.

Suppose OC receives £100 and spends £20 on expenses, but, the company having spare assets available for distribution, £100 is nevertheless distributed. It is suggested that the dividend of £100 should be identified with OC's income of £100 and so qualifies for distribution relief in its entirety. The £20 spent on expenses is attributed to other assets, even though as a matter of tracing it was paid for out of the s.720 income. The position is analogous to the *Duke of Roxburghe* case.[14]

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14 20 TC 711. See 11.14.1 (Remittance from mixture of taxed and untaxed income).

### 28.4.4 *Planning: distribution and re-settlement*

Where distribution relief can apply it is generally worthwhile distributing income to T; T may re-settle the income if T wishes. If this is not done during T's life, the benefit of the relief is lost later; see below.[15]

## 28.5 Distribution (*not* to T) of income of company within section 720

Suppose:
(1) An offshore company ("OC") within s.720 receives income ("OC's income");
(2) T is not a shareholder in OC but has "power to enjoy" the income;[16]
(3) P (a UK resident third party) owns all the shares;[17]
(4) The income of OC is distributed by way of dividend to P.
In these circumstances it appears that there is economic double taxation:
(1) OC's income is subject to tax in the hands of T (or T and OC) under s.720.
(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.

## 28.6 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

15 This may also be done to avoid relevant income accumulating in a company held by a trust; see 27.30 (Is income of company held by a trust relevant income?).

16 T may have power to enjoy by reason, perhaps, of a debenture or through being a beneficiary of the trust which holds OC.

17 The position is not materially different if the shares in OC are held in a trust under which P is life tenant, and to which s.624 ITTOIA does not apply.

of income may be taken into account in charging income tax[18] under this Chapter, it is to be taken into account—

(a) in relation to such one or more of them as appears to an officer of Revenue and Customs to be just and reasonable, and

(b) if more than one, in such respective proportions as appears to the officer to be just and reasonable.

I refer to this as "**double-counting relief**". This provision is vaguely worded, but I suggest it prevents double taxation:

(1) Where T1 is charged under s.720 and T2 is charged under s.720; ie there are two transferors (but *Vestey* decided that there can only be one transferor).

(2) Where T1 is charged under s.731 and T2 is charged under s.731; eg where two different individuals receive benefits, the s.733 computation often prevents a double charge (but not always).[19]

(3) Where T1 is charged under s.720 and T2 is charged under s.731.[20]

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18 Section 744 ITA provides:

"**744 Meaning of taking income into account in charging income tax for section 743**

(1) References in section 743(1) and (2) (no duplication of charges) to an amount of income taken into account in charging income tax are to be read as follows.

(2) In the case of tax charged on income under section 720 (charge where income enjoyed as a result of relevant transactions)—

(a) if section 724(1) (benefit provided out of income of person abroad) applies, they are references to an amount of the income out of which the benefit is provided equal to the amount or value of the benefit charged, and

(b) otherwise they are references to the amount of income charged.

(3) In the case of tax charged on income under section 727 (charge where capital sums received as a result of relevant transactions), they are references to the amount of that income.

(4) In the case of tax charged under section 731 (charge to tax on income treated as arising to non-transferors where benefit received as a result of relevant transfers), they are references to the amount of relevant income taken into account under section 733 (income charged under section 731) in calculating the amount to be charged in respect of the benefit for the tax year in question."

19 See 27.12.5 (Step 5: Available Relevant income).

20 Although the words in s.743(1) could be construed to apply to situation (3) only, that would be absurd. Indeed, it is unusual that income could be taxed under s.720 and s.731. An example might be if income accrues which is not within s.720 because it is not remitted to the UK, then there is a charge under s.731, and then there is a remittance. Another example might possibly be if s.720 does not apply (because the transferor has no "power to enjoy") but subsequently there is a capital payment within

(4) Where T1 is charged under general principles and T2 is charged under s.720 or s.731.

This therefore applies in the circumstances of the example of 28.5 (Distribution (*not* to T) of income of company within s.720). Before the enactment of double-counting relief in 1981, there was economic double taxation in these circumstances. Lord Greene did not regard this as double taxation. In an obiter comment in *Howard de Walden v IRC* 25 TC at 131, decided in 1940, he said:

> [Counsel] pointed out that in so far as the right to enjoy income of the four companies is vested in the Appellant's son, who holds the majority of the shares, income received by the son will be taxed in his hands in the ordinary way and at the same time the Appellant will be liable to tax on the whole income of the companies which is deemed to be his. This, said [Counsel], involves double taxation since no relief is afforded by [what is now s.726 ITA]. There is a short answer to this argument. There is no double taxation since the subject-matter of tax is different, the income of the son being one thing and the income of the companies being another.

Several passages of *Howard de Walden* exhibit an anti-taxpayer ethos which may be attributed to the war-time background; "as we are at war", as Darling J said in another context, "the ordinary mode of construing legislation has been suspended".[21]

Formalistically Lord Greene is right, the situation is one of economic rather than formalistic double taxation. However, since the purpose of distribution relief is to avoid economic double taxation, both fairness and the scheme of the Act suggest that double-counting relief should do the same work in this context. It is considered that Lord Greene's comment does not support the contrary view.

In practice this situation is rare as T either has no "power to enjoy" and so is outside s.720, or else T is life tenant/shareholder and receives the dividends personally and distribution relief applies.

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s.727. Another possible case is in 27.18 (Is income within s.720 relevant income?).

21 Cited in David Foxton, "*R v Halliday* in Retrospect" [2003] LQR 455.

## 28.7 Section 720 trust/company and company/subsidiary structure

So far we have been considering the (relatively) simple situation of an offshore company (OC) 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:

*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?

### 28.7.1 *Distribution relief*

It will be recalled that distribution relief applies if:[22]

(1) OC's income is within s.720;

(2) the trustees' dividend income is received by T;

(3) the trustees' dividend income is "that income" (ie the same income as OC's income);

(4) the individual is charged to income tax on OC's income under s.720.

Condition (1) is satisfied. Condition (2) is satisfied because income is treated as received by T. Condition (3) is also satisfied: see 28.4.1 (When

22 See 28.4 (Distribution relief).

is income "the same" for purposes of distribution relief?).

### 28.7.2 *When is an individual "charged to tax" under section 720?*

The next requirement of distribution relief is that the income treated as arising to the individual must be "charged to income tax under section 720". In *Aykroyd*[23] T failed because T 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.[24]

It may or may not include unremitted income (un)taxed on the remittance basis, depending on the context.

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 eg 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

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23 See 28.4.1 (When is income "the same" for purposes of distribution relief?).

24 These correspond to the three stages in the imposition of a tax:

> "there is the declaration of liability, that is the part of the statute which determines what persons in respect of what property are liable. Next, there is the assessment. ... assessment particularises the exact sum which a person liable has to pay. Lastly, come the methods of recovery, if the person taxed does not voluntarily pay."

*Whitney v IRC* 10 TC 87 at p.109.

that a s.720 liability arises or may be unable to make an assessment. So the *Aykroyd* interpretation that "charged" means "assessed" is probably correct. But in the case of unremitted foreign income where the remittance basis applies, it is suggested that the income should be regarded as "charged"

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 T's income and should in principle return the income of the offshore subsidiary as T's 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, eg if the underlying company receives interest or rental income it may makes a difference of 7.5% (the difference between the higher or additional rates and the dividend upper or dividend additional rates).
    (b) availability of transferor's credit for UK tax paid by the company and double tax relief.
    (c) source of income.
(2) It may also affect the year in which the income is subject to tax.

### 28.7.3 *Double-counting relief*

This provision is discussed in 28.6 (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.

### 28.7.4 *Trust/company structure: HMRC practice*

RI 201 provides:

> where income arises in an offshore company underlying a settlement

> and the income is not paid up immediately to that settlement the provisions of section [720 ITA] will be invoked where necessary to assess the income of the underlying company.

The position therefore depends on whether income is paid up "immediately".

(1) *If the income is not paid up immediately.* The provisions of s.720 will be invoked. This is clearly correct. RI 201 does not address the question (discussed above) of relief for a subsequent dividend by the underlying company.
(2) *If the income is paid up immediately.* RI 201 implies that:
    (a) s.720 will not be applied so OC's income (if non-UK source) will not be taxed; and
    (b) the settlor will be taxed on the trust income under s.624 ITTOIA in the normal way.

An important question is exactly the moment when one moves from (1) to (2). What is the meaning of "immediately"? Does it mean within a day? Or a week? Or at any time within the same tax year? Or at any time before the relevant returns are due or submitted? Do HMRC have a discretion? Does the answer depend on the type of income? One must bear in mind that some forms of income cannot be quantified until the end of an accounting period (eg 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.

### 28.7.5 *Trust/company structure: further example*

Suppose in the trust/company structure illustrated at 28.7 (Section 720 trust/company and company/subsidiary structure) the company:

(1) receives £100 income;
(2) spends £20 of the £100 it received on expenses (not deductible for the purposes of s.720); and
(3) distributes £80.

It is suggested that £100 is taxable at stage (1) and the £80 is tax free at stages (2) and (3). Close examination of RI 201 (see above) suggests HMRC might assess £20 at stage (1) and £80 at stage (2). It is doubtful whether the statement is meant to bear close examination, but it makes little difference in practice.

## 28.8 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 have been double taxation:

(1) T would pay income tax on income arising to the life insurance company (to the extent that it arose as a result of T's premium); and
(2) T would pay income tax on the gain arising from the policy under the chargeable event provisions.

HMRC argued that relief was available under two provisions, s.547(2) ICTA and distribution relief.

The Special Commissioner rightly rejected the argument that distribution relief applied:

> ... s.743(4)[25] only relieves from tax income which is subsequently received by an individual whose income it has been deemed to be in earlier years under s.739(2).

The deemed s.720 income is not the same as the chargeable event income.

Section 547(2) ICTA then provided:

> Nothing in subsection (1) above [deeming chargeable event gains to be taxable income] shall apply to any amount which is chargeable to tax apart from that subsection.

The Commissioner rightly dismissed the argument that this conferred relief:

25 The reference is to ICTA but remarkably, perhaps uniquely, the reference is still the same: s.743(4) ITA.

> So far as double taxation is concerned, in my view s.547(2) [ICTA] and s.743(4) [ICTA] do not provide relief. The former gives relief if the amount of the gain arising in connection with a policy on the happening of a chargeable event, which is deemed to form part of the individual's total income for the year in which the event happens, is chargeable to tax apart from subs (1) of s 547. This does not provide relief for the taxation of income under s.739 [ICTA] in the years before the chargeable event occurs.

That is not the end of the story, as the tax law rewrite have expanded the scope of the relief: s.527 ITTOIA provides:

> (1) This section applies if the whole or part of any receipt or other credit item is taken into account in calculating both—
> (a) the amount of a gain treated as arising under this Chapter, and
> (b) an amount on which income tax is charged otherwise than under this Chapter or on which corporation tax is charged.
> (2) The amount of the gain on which tax is charged under this Chapter is reduced by so much of the amount of that receipt or other credit item as is taken into account in both those calculations.

It appears from EN ITTOIA change 95 that this change was intended to benefit traders in policies[26] but it could arguably apply here. There is a

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26 "**Change 95: Gains from contracts for life insurance etc: reductions for sums chargeable to tax apart from section 547(1) of ICTA: section 527**
This clarifies the meaning of the exception from the charge to tax under section 547(1) of ICTA given by section 547(2) of ICTA for any amount chargeable to tax apart from section 547(1) of ICTA.
Section 547 of ICTA deals with the method of charging chargeable event gains to tax. This differs according to the person who is interested in the policy. For example, under section 547(1) of ICTA where the rights in a policy or contract are held by an individual as beneficial owner the gain forms part of the individual's total income. However, section 547(2) of ICTA states "Nothing in subsection (1) shall apply to any amount which is chargeable to tax apart from that subsection.".
In practice, the words "amount which is chargeable to tax" in section 547(2) of ICTA are taken to mean the amount of the receipts and credits taken into account for the purposes of ascertaining the overall taxable profit under another provision, rather than the actual amount that is charged to tax under another provision, which in the case of a trader, for instance, will be the net profits of the trade.
Section 527 which rewrites section 547(2) of ICTA makes it clear that the amount chargeable to tax under Chapter 9 of Part 4 of this Act is reduced by the amount of the receipt or other credit item that is taken into account in calculating the amount on

also hint in *Willoughby* at p.84 that relief may be available by concession, but that would obviously not bind HMRC. In practice, fortunately, it will be rare for the TAA rules apply to income arising as a result of payments of policy premiums or other payments to life companies.[27]

## 28.9 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.

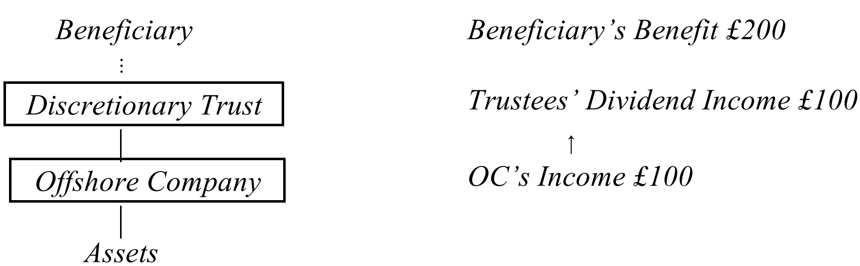
Suppose:

(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.

## 28.10 Section 731 trust/company structure[28]

The problem is best illustrated by example:




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)").

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which income tax is charged otherwise than under Chapter 9 of Part 4 or the amount on which corporation tax is charged."

27 See 30.6.5 (Income accruing to life company).

28 Contrast 28.7 (Section 720 trust/company and company/subsidiary structure).

(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 28.6 (Double-counting relief).[29]

29 If that is wrong, then a second argument is that after the company's income is distributed it ceases to be relevant income. See 27.25 (Corporate income distributed to trust). This argument will not avail if the facts are a variant of the above example:
(1) £100 income is received by the company;
(2) a beneficiary receives a benefit of £200;
(3) the £100 is subsequently paid to the trustees as dividend income.
For then even if the company's income ceases to be relevant income after being distributed, it does so too late.

CHAPTER TWENTY NINE

# TRANSFER OF ASSETS ABROAD: MOTIVE DEFENCE

## 29.1 Motive defence – Introduction

Sections 736 to 742 ITA provide a defence to the TAA provisions which I call "**the motive defence**".[1] This topic was never easy, but the FA 2006 made it twice as complicated: it introduced stricter and obscurer rules which apply to transactions from 2005, while retaining the old rules for earlier transactions.[2]

Section 736(3) ITA provides two self-explanatory terms:

> In this section and sections 737 to 742—
>
> "**post-4 December 2005 transaction**" means a relevant transaction effected on or after 5 December 2005, and
>
> "**pre-5 December 2005 transaction**" means a relevant transaction effected before 5 December 2005.

In this chapter:

(1) "**Old Conditions A and B**" are conditions A and B in s.739 ITA (applying to pre-5 December 2005 transactions).

(2) "**New Conditions A and B**" are conditions A and B in s.737 ITA (applying to post-4 December 2005 transactions).

References to Condition A or B (without more) means either the old or the

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1 The word "motive" is not used in the legislation, but the label is convenient and reasonably accurate. It originates from the Inland Revenue's Notes on clause 18 Finance Bill 1936.

2 EN FB 2006 stated:

> "The new provisions recast the test for exemption in cases not involving a tax avoidance purpose to make its meaning clearer."

But no-one was intended to take that seriously.

new version of the Conditions.

There have been two explanations of the 2006 clauses: Explanatory Notes on the Draft Clauses, published 5 December 2005, and Explanatory Notes on the Finance Bill 2006. I refer to these as "**EN Draft Clauses (2005)**" and "**EN FB 2006**".

I distinguish between:

(1) An "**innocent**" transaction, one which satisfies Condition A or B (in short, no tax avoidance purpose); and

(2) a "**tainted**" transaction, one which does not satisfy Condition A or B.

For the definition of "**relevant transactions**" see 25.10 (Significance of associated operations).

## 29.2 Motive defence condition A

Section 737 ITA sets out New Condition A:

> (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:

> (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.

## 29.3 Motive defence condition B

Section 737(4) ITA sets out New Condition B:

> Condition B is that—
> (a) all the relevant transactions were genuine commercial transactions (see section 738), and
> (b) it would not be reasonable to draw the conclusion, from all the circumstances of the case, that any one or more of those transactions was more than incidentally designed for the purpose of avoiding liability to taxation.

Section 739(4) ITA sets out Old Condition B:

> Condition B is that the transfer and any associated operations—
> (a) were genuine commercial transactions, and
> (b) were not designed for the purpose of avoiding liability to taxation.

## 29.4 Enactment history

The original wording was much simpler. It provided exemption if:

> the transfer and any associated operations were effected mainly for some purpose other than the purpose of avoiding liability to taxation.[3]

The Solicitor-General explained why the text was changed to (what is now) Old Conditions A & B:

> A taxpayer[4] transferred a large amount – he was not one of the small people for whom my hon. and learned Friend was pleading – of foreign securities to a trust company abroad on certain trusts under which the income was to be accumulated until the death of the taxpayer. There

3 Section 18 FA 1936. Section 28 FA 1938 substituted the text which is now Old Conditions A and B.

4 Presumably a UK resident and domiciled transferor. (HMRC did not contend at that time that (what is now) s.720 applied to a transferor unless UK resident at the time of the transfer, and a foreign domiciled transferor would have qualified for the remittance basis.) So one can see why HMRC found the case troubling

> was a discretion to the trustees to pay certain portions of the income to the taxpayer or to his son. The deed gives to the taxpayer and his son power, with the consent of the trustees, to revoke the trust, or, alternatively, they can withdraw all or any part of the trust property for their own benefit. The trust income has been accumulated, and none of it has been distributed. The vigilant Revenue authorities pursued this taxpayer, and he contended, successfully, as it transpired, on appeal, that the foreign trust was born because of his fears as to the financial position of this country and the dangers of the situation on the Continent ... in 1936. He stated that he wanted to find a stable country where he could make safe provision for his family. The Special Commissioners decided that the main purpose of the transaction was occasioned by A's pessimistic view of the European situation at the time; that, arising out of that, his main intention was to make provision for his family in a safer country; and that, if there was any intention of avoidance of taxation, it was incidental to the main purpose. They therefore decided that there was no liability under Section 18 FA 1936. That instance has only to be cited to the Committee for the Committee to realise that on this particular matter the hon. Member for Chesterfield (Mr. Benson) was a true prophet in 1936, when he said that the word "mainly" would be too wide.[5]

A case on similar facts might still succeed today, but the test is stiffer. The taxpayer would need (in short) to show that tax avoidance was not even one of the purposes of the transfer.

## 29.5 "Commercial" in Old Condition B

Commercial is a requirement for Condition B but not Condition A. In Old Condition B the term is not defined. "Commercial" is an imprecise word.[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.

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5 Hansard 27 June 1938, col 1610. It is impressive that an income tax dispute relating to 1936/7 was resolved by a Special Commissioners' decision early in 1938.

6 *IRC v Plummer* 54 TC 1 at p.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 p.598.

### 29.5.1 *Transfer with element of bounty*

A transaction made with bounty (gratuitous intent) is not commercial.[7] The concept of bounty (unlike "commercial") is relatively clear. For instance, a gift to a trust for the benefit of the settlor's family is not commercial. The same applies even 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.[8]

### 29.5.2 *Non-business transaction*

In *Carvill v IRC* the Special Commissioner ventured this explanation:

> There was not much difference between the parties about what constituted a bona fide commercial transaction. [Counsel for the taxpayer] contended that this was any genuine transaction which implements or facilitates a business end; [Counsel for HMRC] contended that the transaction must be in furtherance of commerce, ie

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7 *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:

> **12140. Subscriptions for shares: Commerciality**
> For the EIS and CVS, an investor in a company is not eligible for relief unless the subscription is made for bona fide commercial purposes. This rules out any subscription which is motivated by considerations of benevolence. This could be the case if, for example, the company were the proprietor of an unsuccessful professional football club and a supporter of the club paid a large premium for shares in the company; that may well [interestingly, the text formerly said *would clearly*] not be a commercial subscription. Similarly, if the company is owned by a person whom the investor wishes to benefit, and the investor pays a large premium for the shares with the object of increasing the value of the other person's shares, that too would not be a commercial subscription."

Ambrose Bierce makes the same point in *The Devil's Dictionary* (1911) defining "Merchant": "A commercial pursuit is one in which the thing pursued is the dollar."

8 This is supported by *Wannell v Rothwell* 68 TC 719 at p.733B, a case on loss relief which uses the word "commercial". See too *IRC v Levy* 56 TC 68 at p.87. The issue arose in a case on the meaning of settlement-arrangement. The definition of settlement-arrangement does not include the word "commercial" but the case law "bounty" requirement overlaps with the concept of "commercial".

> a trade or business. I shall follow these two meanings.[9]

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 29.4 (Enactment history). Another example is a transfer to avoid claims by non-business creditors, eg a claim on divorce or forced heirship. These transfers may involve an element of bounty (and may be classified as non-commercial for that reason) but in any event they should be classified as non-commercial transactions because they are not in furtherance of a business purpose.

### 29.5.3 *Making or managing investments*

In HMRC's view:

> The expression "bona fide commercial" in [Old Condition B] is taken to apply [1] only to the furtherance of trade or business, and [2] not to the making or managing of investments.[10]

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

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9 [2000] STC (SCD) 143 at p.166.

10 RI 201. This was perhaps the view of the drafter of s.724 CTA 2010 which refers to transactions:

> "(a) for genuine commercial reasons *or* (b) in the ordinary course of making or managing investments."

(Emphasis added). But para (b) might have been added for the avoidance of doubt, or for some exceptional case, and it is not clear that the drafter really thought that making or managing investments would not usually be commercial.

managing investments.[11] I guess that the intended meaning is, that investment transactions in the course of a business are commercial, but investment transactions which are not in the course of a business are not commercial. This (difficult) concept of business is entirely distinct from the concept of what is commercial.

(2) More fundamentally, making or managing investments *is* generally regarded as "commercial" even if it does not constitute a business. What can be more "commercial" than the management to maximise investment return? This point is recognised in *Lewis v IRC* [1999] STC (SCD) 349 at p.362:

> It is trite law that in exercising their duties trustees must use as much diligence as a prudent man of business ... Faced with the self-investment problem their duty was to act in a business-like manner: this they did. Put another way, they acted commercially as was their duty. In our view it would be construing the statute too narrowly to hold that they did not carry out the transactions for bona fide commercial reasons, unless an investment decision cannot be for commercial reasons.

(3) Section 738(4) ITA assumes that making/managing investments may be "commercial" (in the ordinary sense of the word).

Proposition [1] (that the expression "commercial" applies *only* to the furtherance of trade or business) was put to the Commissioners in *Carvill*, where it obtained some support, see above. Nevertheless, it is too narrow. In practice, commercial transactions will normally further trades or businesses so the issue will not often arise. But there are counter examples, as discussed above: making or managing investments is in 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.

11 Making or managing investments often constitutes a business. For instance, s.105(3) IHTA refers to the business of making or holding investments; s.1218 CTA 2009 refers to "a company whose business consists wholly or partly of making investments".

### 29.5.4 *Commercial from whose viewpoint?*

From whose viewpoint does one assess commerciality? The answer is that it should be looked at from the viewpoint of the transferor, but it would be a rare arrangement under which one party is and the other party is not acting commercially. In *IRC v Willoughby* HMRC accepted that bonds were commercial transactions for Royal Life who issued them but argued that they were not for Professor Willoughby who acquired them. The Special Commissioner did not agree:

> If a contract is entered into by two people and it is a bona fide commercial transaction for one of them, it cannot be not a bona fide commercial transaction for the other party to the contract in the absence of any reason for impeaching the latter's good faith.[12]

The point was not discussed on appeal.

## 29.6 "Commercial" in New Condition B

Section 738 ITA contains a definition of "commercial" for the purposes of New Condition B. The definition is artificial in that it excludes some transactions that are "commercial" in the normal sense of the word. New Condition B is therefore rather narrower than Old Condition B.

Section 738(1) ITA provides:

> For the purposes of section 737, a relevant transaction is a commercial transaction only if it meets the conditions in subsections (2) and (3).

Is s.738 an *exhaustive* definition of "commercial" or is it merely a partial, exclusory definition? That is, if a transaction meets the requirements set out in 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

12 70 TC at p.86H.

which is not commercial in the ordinary sense of the word, so the issue may not arise.

### 29.6.1 *Course of business*

Section 738(2) ITA sets out the first requirement of "commercial":

> It [the relevant transaction] 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, eg a purchase of a company. This is commercial in the general sense of the word, but it is not "commercial" within the new definition. Section 738(2) thus gives effect to HMRC's proposition [1] of the meaning of "commercial" in Old Condition B.[14]

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).

### 29.6.2 *Arm's length requirement*

Section 738(3) ITA sets out the second requirement of "commercial":

> It [the relevant transaction] 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

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13 For HMRC views on what constitutes a business, see CG Manual para 65715 and Shares and Assets Valuation Manual para 111110.

14 See 29.5.3 (Making or managing investments).

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.

### 29.6.3 *Investments restriction*

Section 738(4) ITA restricts the definition of commercial by providing an artificial definition of "trade or business":

> For the purposes of subsection (2), making investments, managing them or making and managing them is a trade or business only so far as—
> (a) the person by whom it is done, and
> (b) the person for whom it is done,
> are persons not connected with each other and are dealing at arm's length.

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". This is gibberish. 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. Normally an activity is or is not a business: it cannot be a business to a limited extent? If it is, what follows: what if most but not all of the customers are unconnected?

While one might, charitably, rewrite the subsection so that it meant that the business must be substantially carried on between unconnected persons, the proper course would be for a court to dismiss it as meaningless.

The subsection does not apply to a company trading in financial assets since these are not "investments".

Suppose T subscribes for shares or debentures in (or makes a loan to) an investment company. The transaction satisfies s.738(2) since the company is carrying on a trade or business. The transaction satisfies s.738(3) if it is on arm's length terms. 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.

### 29.6.4 *Commentary*

When one contemplates the difficulties raised by the statutory definition, one appreciates the wisdom of the 1936 drafter in leaving "commercial" undefined. The word "commercial" is often used motive defence tests[15] and nowhere else is it defined. It is suggested that the statutory definition of commercial in s.738 ITA should be repealed.

## 29.7 "Avoidance", "mitigation", "tax reduction", "evasion": introduction[16]

I turn to discuss the complicated, emotionally charged, and in practice constantly abused term "tax avoidance." It is helpful to begin with a fourfold categorisation:

(1) *Tax evasion*: Conduct which constitutes a criminal offence (fraud on HMRC or similar offences). This normally involves dishonest submission of an incorrect tax return. Dishonesty is essential to the offence.
(2) *Honest misdeclaration*: The submission of an incorrect tax return without dishonesty. Those involved may be culpable (guilty of neglect or wilful default) but not dishonest.
(3) *Tax avoidance*: Arrangements that reduce tax liability in a manner contrary to the intention of Parliament (I come later to consider this

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15 There are too many to give a full list but among the most important are s.138 TCGA; s.734 CTA 2010.

16 For further reading, see Nabil Orow, *General Anti-Avoidance Rules* (Jordans, 2000). This has an extensive bibliography.

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, these concepts and their associated terminology have only emerged after a gradual process of development and even now the terminology is not always adopted. It is essential to bear this in mind on reading sources on this subject.[17]

For an assessment of subjectivity, morality and judicial criticism of the avoidance/evasion distinction see Kessler "Tax Avoidance Purpose and s.741 ICTA" [2004] BTR 375 at p.407.

### 29.7.1 *Avoidance/evasion distinction*

An avoidance/evasion distinction very similar to the present was recognised very early (and was surely self-evident at any time) but at first there was no terminology to express it. In 1860 Turner LJ suggested evasion/contravention (where evasion stood for the lawful side of the divide).[18] In 1900 the distinction was noted as two meanings of the word "evade".[19] The technical use of the words avoidance/evasion in the

17 eg the 1920 Royal Commission on the Income Tax Cmd. 615 discussed evasion, honest mis-declaration and avoidance in one chapter headed "The Prevention of Evasion". In this discussion the words "avoidance" and "evasion" were used quite indiscriminately, see para 625. It is an interesting question whether the absence of terminology hampered discussion of the issues or whether the 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.

18 *Fisher v Brierly* (1860) 1 de G F&J 643 at p.663. It is a pity this terminology did not catch on because it is more transparent than avoidance/evasion.

19 *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

modern sense originated in the USA where it was well established by the 1920s.[20] 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".[21] 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.[22] Now that the

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consequences of the Act of Parliament, although I am brought within it'. That is an act of quite a different character."

20 It is found in the scholarly Sears, *Minimising Taxes*, 1922, Vernon Law Book Co and can be traced to Oliver Wendell Holmes in *Bullen v Wisconsin* (1916) 240 US 625 at p.630. It is regarded as basic in Dennis Hartman, *Tax Avoidance*, 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 Moore, *The Saving of Income Tax Surtax and Death Duties*, (1935) (the publication of which lead to the enactment of the TAA provisions).

21 The 1955 Royal Commission Cmd. 9474 para 1016:

> "It is usual to draw a distinction between tax avoidance and tax evasion. The latter denotes all those activities which are responsible for a person not paying the tax that the existing law charges upon his income. *Ex hypothesi* he is in the wrong, though his wrongdoing may range from the making of a deliberately fraudulent return to a mere failure to make his return or to pay his tax at the proper time. By tax avoidance, on the other hand, is understood some act by which a person so arranges his affairs that he is liable to pay less tax than he would have paid but for the arrangement. Thus the situation which he brings about is one in which he is legally in the right, except so far as some special rule may be introduced that puts him in the wrong."

Note that "evasion" is used here (unlike present usage) to describe dishonest criminal evasion and honest mis-declaration. Lord Templeman used this (by then old-fashioned) terminology in *IRC v Challenge Corporation* [1986] STC 548: "Tax evasion occurs when the commissioner is not informed of all the facts relevant to an assessment of tax. Innocent evasion may lead to a re-assessment. Fraudulent evasion may lead to a criminal prosecution as well as re-assessment." It does aid clarity if the term "evasion" is restricted to what Lord Templeman terms "fraudulent evasion".

22 Examples include: *Coutts & Co v IRC* [1964] 1 AC 1393 at p.1420; *Jamieson v IRC* (1963) 41 TC 43 at p.70; *Cory v IRC* [1965] AC 1088 at p.1107; *Greenberg v IRC* (1971) 47 TC 240 at p.271: "Parliament attempted to prevent this and other methods of tax evasion by provisions in the Finance Act 1960". This usage seems to have stopped in the 1970s; at this time UK economists were giving increasing attention to the subject of tax avoidance and evasion (*Tax Avoision*, p.1, IEA 1979) and perhaps

terminology has received official approval in the UK[23] this usage can be condemned as erroneous (but it still happens).[24] But it is sometimes helpful to use the expressions "legal avoidance"[25] and "illegal evasion", to make the meaning clearer.

The distinction is now accepted internationally:

> 72. The terms "tax evasion" and "tax avoidance" have not always been used precisely or with a uniform meaning.[26] Strictly speaking, tax evasion is considered to consist of wilful and conscious non-compliance with the laws of a taxing jurisdiction. Tax evasion is an action by which a taxpayer tries to escape legal obligations by fraudulent or other illegal means. The illegal conduct might involve simply failing to report income or fabricating deductions, or it may involve highly sophisticated tax planning that is premised on false or intentionally deceptive representations to the tax authorities. Tax evasion may arise as a result

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their work had an effect on legal usage. Note that this is purely a semantic and not a substantive point that is being made here. The old usage certainly does not reflect the view that the evasion/avoidance distinction is unreal or unclear or that one can shade into the other. The legal distinction between the two is tolerably clear since evasion involves dishonesty, a tolerably well defined and understood concept. The term "avoision" used in the IEA publication referred to was coined as a convenient term to mean avoidance/evasion. The book noted the lack of *economic* distinction between the two concepts; the economic similarity was the justification for the new coinage. (The book also noted the blurring of a moral distinction between the two concepts either because avoidance was seen by some as immoral or because evasion was seen by some as not immoral; the book did not suggest a lack of a legal distinction which was unquestioned then and still should be now.)

23 *Craven v White* 62 TC 1 at p.197; OED 2nd edition (1989) entry under "Taxation."

24 For example, see *R v Charlton* [1996] STC 1418 at p.1421.
This is particularly a problem in the context of EU law, as ECJ cases regularly use "evasion" where avoidance is meant; eg *Cadbury Schweppes v IRC* [2006] STC 1908 at [50]; *Thin Cap Claimants v HMRC* [2007] STC at [37] discussed 51.5.3 (Need to prevent tax avoidance). Either EU translators do not know the UK distinction or they do not know the UK terminology, being perhaps mislead by the French word *evasion* which means (in UK terminology) avoidance.
Similarly, s.482 United States Internal Revenue Service Code refers to allocation of income that "is necessary to prevent evasion of taxes" but the intended concept is one of avoidance.

25 "Legal avoidance" is a standard term in recent double tax conventions.

26 [Footnote original] Part of the problem is a linguistic one. In English, "tax evasion" is synonymous with tax fraud, and means criminal activity. In French, "evasion" means avoidance. Tax evasion should therefore be translated into French as "fraude fiscal". ...

of a failure to properly report income that is legally earned. It may also result from the evasion of tax on income that arises from illegal activities, such as smuggling, drug trafficking, and money-laundering. In a broader sense, tax evasion may encompass a reckless or negligent failure to pay taxes legally due, even if there is no deliberate concealment of income or relevant information.

73. Tax avoidance, in contrast, involves the attempt to reduce the amount of taxes otherwise owed by employing legal means.[27] However, the borderline between evasion and avoidance in specific cases may be difficult to define. For one thing, the criminal laws of countries differ, so that behaviour that is criminal under the laws of one country may not be criminal under the laws of another.[28] In addition, the definitions of civil and criminal tax fraud may overlap, so that it is within administrative discretion whether or not to pursue a criminal fraud case in a specific instance. In reality, there is a continuum of behaviour, ranging from criminal fraud on one extreme, to civil fraud, to tax avoidance that is not fraudulent but which runs afoul of judicial or statutory anti-avoidance rules and therefore does not succeed in minimizing tax according to law, and finally to tax-planning behaviour which is successful in legal tax reduction. ...[29]

### 29.7.2 *Avoidance/mitigation distinction*

The clear[30] articulation of the *concept* of an avoidance/mitigation distinction goes back only to the 1970s[31] and the concept originated from

27 [Footnote original] Black's Law Dictionary (Fifth Edition) has defined "tax avoidance" as: "The minimization of one's tax liability by taking advantage of legally available tax planning opportunities. Tax avoidance may be contrasted with tax evasion, which entails the reduction of tax liability by using illegal means".

28 [Footnote original] While most countries define criminal tax fraud fairly broadly, there are some exceptions. For example, Switzerland has a narrow concept of "tax fraud", which is an offence subject to imprisonment, defining it as the use of "forged, falsified or substantially incorrect documents". See Direct Federal Tax Law, art. 186.

29 United Nations Manual for the Negotiation of Bilateral Tax Treaties between developed and Developing Countries) 2003.

30 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.

31 In 1946, Wrottesley J was unaware of it. Discussing the motive defence, he said: "There cannot, I think, be two opinions as to what 'avoiding' means. Where what is to be avoided is a liability, it must mean to evade, or to keep out of the way of,

economists, not lawyers. In 1973 C.T. Sandford wrote:

> A government may have one of three attitudes to a particular 'avoidance' measure – using the wide definition of avoidance. It may welcome it; the government may have deliberately offered a tax concession to promote some objective, e.g. tax concessions on mortgage interest, combined with the abolition of Schedule A income tax, in order to encourage owner-occupation; or investment and initial allowances to stimulate new investment in development areas. Second, without having sought positively to encourage a particular 'avoiding' action the government may find it entirely acceptable as when an income tax payer reduces his tax liability by taking a wife or having children; or when a person on retirement transfers savings from a building society to some 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'.*[32]

The use of the terminology avoidance/mitigation to *express* this distinction is an innovation of Lord Templeman in 1986.[33] The expression "tax

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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).

32 *Hidden Costs of Taxation*, IFS, 1973, p.113 (emphasis added). Sandford proposed a second requirement of "avoidance" which he related to the taxpayer rather than to the legislature:

> "It is reasonable to confine 'avoidance' to action which results in the would-be avoiders substantially achieving the objective to which the tax had become an obstacle. Let us give some examples. If a man ceases to buy cigarettes because of tobacco tax he has not achieved his pre-tax objective, i.e. to smoke. Buying sweets instead of cigarettes therefore, is not avoidance. Again, if a taxpayer decides to use most of his wealth for a consumption spree because estate duty makes it not worth while saving for heirs, he is not 'avoiding' for he has abandoned his objective of passing property to heirs. On the other hand, if he reacts to estate duty by making *inter vivos* gifts (assuming he survives for seven years), this is avoidance; it has achieved, though by a more circuitous route, the objective of passing to heirs an intact property."

This is problematic, because there is no obvious way to identify the "objective to which the tax has become an obstacle", and it has not been adopted into the law.

33 *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

avoidance" has very often been used in the loose sense, meaning or including mitigation.[34] The reason may be either that the author does not have any avoidance/mitigation distinction in their mind or (if they do) that they are not using the modern terminology to express it. Even now, the term "tax avoidance" is sometimes still used in a loose or etymological sense to include mitigation but nowadays this usage is sometimes jocular, which suggests that the technical meaning is seeping into public consciousness.[35] Likewise "mitigation" was and sometimes still is used in the sense of "avoidance".[36]

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",[37] "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.

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altogether new to describe it.

34 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).

35 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* : "Evidently those who do not smoke or drink are ... avoiding taxation."

36 eg C.T. Sandford wrote in 1973 that tax avoidance (in the strict sense) "is often referred to by expressions such as tax planning or tax mitigation": *Hidden Costs of Taxation*, IFS, 1973, p.104. *Craven v White* 62 TC at p.203 (a requirement of *Furniss v Dawson* is that a transaction "had no other purpose than tax mitigation").

37 See para 15E(4) Sch.25 ICTA (Controlled Foreign Companies). INT Manual provides Introduction to the CFC motive test:

**208010 Introduction to the motive test** [April 2009]

> ... 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' ...

## 29.8 Meaning of "avoidance" in motive defence

The House of Lords in *IRC Willoughby* decided that "avoidance" in motive defence meant tax avoidance in the strict sense and not mitigation:

> ... it was essential to understand what was meant by "tax avoidance" for the purposes of s 741 ICTA [now Conditions A and B]. Tax avoidance was to be distinguished from tax mitigation. ... My Lords, I am content for my part to adopt these propositions.[38]

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. One way[39] to reach that result is to give a narrow meaning to tax avoidance and so to widen the motive defence.

### 29.8.1 *Purpose of tax evasion*

Suppose an individual transfers assets abroad with the dishonest purpose of *evading* UK taxation. Can one apply the avoidance/evasion distinction and say that the individual did not intend to *avoid* taxation, so that – while they 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. This was assumed without argument in *R v Dimsey & Allen* 74 TC 263.

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38 [1997] STC 995 at p.1003.

39 An alternative, 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 29.14.1 (A choice principle?). Another solution is to say there is no relevant transfer.

## 29.9 Meaning of "taxation" in the motive defence

"Taxation" in Old Conditions A and B means any form of UK taxation, and not only income tax: *Sassoon* v *IRC* 25 TC 154. HMRC agree. The International Manual provides:

> **600040 - Transfer of assets abroad** [October 2010]
> **Overview of ITA 2007/S736 - 742 - exemption from liability**
> ..In the context of this test "taxation" includes any UK tax liability, for example, Inheritance Tax, Capital Gains Tax, Corporation Tax as well as Income Tax.

*Sassoon*, though criticised,[40] 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:

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40 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: eg s.682 ITA (transactions in securities), 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 989 ITA provides:
"'tax', if 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 29.21 (Practical examples: introduction).
While of course "context is king", *Sassoon* is supported by consideration of s.22 F(No 2)A 1931 where "taxation" plainly means any tax.

> In this section—
> "revenue" includes taxes, duties and national insurance contributions,
> "taxation" includes[41] any revenue for whose collection and management the Commissioners for HMRC are responsible.

Foreign tax is not "taxation" for this purpose. The House of Lords assumed that this was so without argument in *Herdman v IRC* 45 TC 394. This must be right since (1) it is illogical that the purpose of avoiding foreign taxes should have UK tax consequences and (2) it would be almost impossible to apply an avoidance/mitigation distinction to foreign taxes (where the distinction would depend on the foreign tax culture and attitudes).

## 29.10 Identifying and classifying purpose: the old conditions

It is considered that the identification of a tax avoidance purpose requires a two-stage approach: identifying and classifying purpose.

### 29.10.1 *Identify purpose: stage 1*

One must look into the mind of the transferor to ascertain whether their purpose was (to use the neutral term) to reduce tax. The issue is subjective in that it depends on what is in the mind of the transferor. If they 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 their 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

41 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 (eg a new tax was introduced which was managed by a different Government department).

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".[42] Secondly, the transferor may have been aware of (or even have wanted) the advantage but it may nevertheless not properly be classified as their "purpose".[43]

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.

### 29.10.2 *Classifying purpose: stage 2*

If the transferor did have the purpose of reducing tax, one must (applying *Willoughby*) categorise that purpose as "avoidance" or "mitigation". This is determined objectively (in the sense that the issue is independent of the mind of the transferor).

It would be wrong at stage (2) to ask whether the transferor subjectively thought their purpose was "tax avoidance" (as opposed to mitigation) because avoidance/mitigation is a question of law, a decision for the Court and not for them. Indeed, it would generally be pointless, since (unless the individual is a tax lawyer) they will not know the correct meaning of the terms.

The motive defence therefore involves a mixture of objective and subjective elements, as often happens.

Stage (1) – the mind of the transferor – is a question of fact, decided by the Tax Tribunal on evidence and the appellate courts have had little to say about it. Anything said on the subject of tax avoidance in motive defence cases before *Willoughby* needs to be reviewed because it will not have considered stage (2).

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42 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.

43 See 29.13 (Foresight and purpose) and 29.14 (Consequence and purpose).

### 29.10.3 *HMRC view(s): objective purpose*

RI 201 states:

> [1] If a transaction involves tax avoidance, that is considered by the Revenue to be at least one of its purposes
> [2] even if the transferor did not form the subjective intention[44] of avoiding tax.[45]

This is a rejection of the stage (1) test set out above. In the HMRC view a transfer may have been effected for a tax avoidance purpose even though the transferor did not have the subjective purpose of obtaining a tax reduction. That must be wrong for several reasons. First, the natural meaning of "purpose" is to connote a subjective concept. This meaning is supported by high authority.[46] Of course context may show the word is used in an unusual sense, but that is not the case here. Secondly, this is

44 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."

45 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."

46 "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 p.804. *Dicta* apparently to the contrary in *Newton v Commissioner of Taxation* [1958] AC 450 at pp.465–466 are rightly criticised and distinguished in John Avery Jones [1983] BTR 22–24. Twenty years later, Avery Jones had the opportunity to make the same point judicially in *Carvill v IRC* [2000] STC (SCD) 143, 75 TC 477. A subjective test also applies for the escape clause in the transactions in securities rules; see *Addy v IRC* 51 TC 71 at p.81E.

the way that the motive defence has always been applied and understood.[47]

While the HMRC statement clearly rejects a subjective purpose test, it is not clear what test HMRC wish to apply instead. What is meant by a transaction "involving" tax avoidance? Sometimes HMRC have argued that the statute requires one to identify the "objective purpose" of the transfer. The attraction of putting the matter this way is that it is close to the wording of the statute. The difficulty is that the expression "objective purpose" is an oxymoron. If that means anything, it means, I think, the purpose which an ordinary reasonable person would have if they 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.[48] Their subjective purpose was not tax avoidance. Was their objective purpose tax avoidance? I do not know how to begin to answer the question.

The test that HMRC ultimately wanted to apply is that a transfer has a tax avoidance purpose if it has a tax saving *result*, if its *effect* has been to save tax, or at least if it was reasonably foreseeable that it would do so. This test does make sense (unlike "objective purpose") and it is practical to apply. The difficulty 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*,[49] *Carvill v IRC*.[50] Until

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47 The drafter of s.33(3) FA 1944 and s.32(3) FA 1951 plainly agreed. This provided (in short) 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.

48 See 29.4 (Enactment history).

49 "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].

50 [2000] STC (SCD) 143 at [9]–[13], 75 TC 477 (Special Commissioners). The dictum of Lord Nolan in *IRC v Willoughby* mentioned above which appears to favour an objective approach is, as *Carvill* demonstrates, inconsistent with a long line of

2008 HMRC contended that these cases were wrongly decided. However, HMRC sensibly abandoned that position before the Tribunal in *Burns v HMRC*,[51] where the Commissioner said:

> It seems to me to be settled law that what I must address is "purpose", rather than objectively ascertained effect, or presumed effect.

In practice the "objective purpose" argument is now (I think) resolved.

## 29.11 Identifying and classifying purpose: the New Conditions

Old Conditions A and B refer simply (?) to the purpose for which the transactions were effected or designed. New Condition A is that:

> *it would not be reasonable to draw the conclusion, from all the circumstances of the case*, that the purpose of avoiding liability to taxation was the purpose, or one of the purposes, for which the relevant transactions or any of them were effected.

New Condition B is that:

> *it would not be reasonable to draw the conclusion, from all the circumstances of the case*, that any one or more of those transactions was more than incidentally designed for the purpose of avoiding liability to taxation.

The new words are italicised. What difference do they make? Perhaps we should look first to see what HMRC said they intended to achieve:

> 59. The new section 741A ICTA [New Conditions A and B] aims to ensure that all relevant factors are taken into account in deciding whether exemption is due. That is the normal way of applying any purpose test, but in relation to section 741 [Old Conditions A and B] the view is sometimes expressed by tax practitioners that the present test should be interpreted more narrowly. They contend that
> [1] it is only necessary to look at the subjective intentions of the individual, and

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authority and has to be ignored (as in *Carvill*) or explained (as in *Beneficiary*).

51 [2009] STC (SCD) 165.

> [2] 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.

There are two distinct "contentions" here. The first is correct. The second cannot be taken seriously: see 29.10.1 (Identify purpose: stage 1).

> 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.[52]

These paragraphs are somewhat muddled. I think it is making the point made at 29.10.1 (Identify purpose: stage 1). All relevant circumstances must be taken into account in order to identify an individual's purpose. A particularly significant fact is whether the transaction resulted in a significant tax reduction, that is, the actual objective outcome of the transactions.

I have wondered whether the drafter's aim here is something different: to replace the subjective purpose test (which clearly applies to the Old Conditions) with an objective results test. However this is inconsistent with what the EN actually said. First, 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

52 EN Draft Clauses (2005). The point is made more briefly in EN FB 2006 para 66.

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 wrong 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.

Had the drafter sought to replace a purpose test with an objective results test, then they would have used quite different wording, and, indeed, a precedent existed in s.33(3) FA 1944 and s.32(3) FA 1951.

## 29.12 Transfer made for tax and non-tax purposes

### 29.12.1 *Condition A*

Condition A depends on whether the purpose of avoiding liability to taxation was the purpose *or one of the purposes* for which the transfer or associated operations were effected.

If one of these purposes is tax avoidance, the transfer fails condition A. It does not matter what the other purposes are.[53]

### 29.12.2 *Old Condition B*

Old Condition B contains two requirements; both must be satisfied. The first is that the transfer and any associated operations were commercial transactions. Secondly that the transfer and associated operations were not designed for the purpose of avoiding liability to taxation.

What happens if a commercial transaction has two or more purposes? HMRC say in RI 201:

53 This is plain from the terms of the statute but if authority is needed, see *Philippi v IRC* 47 TC 75 at p.110.

> 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[54] too generous to HMRC. The Special Commissioner stated:

> One must ask in para (b) whether the transfer was designed for the purpose of avoiding tax or not. This seems to me to require that the main purpose was not tax avoidance because if one has to categorise a transaction as being either designed for the purpose of tax avoidance or not, when it is clearly accepted that a transaction may be designed for more than one purpose, the only way to categorise the design into one purpose is to look at the main purpose of the design. I think, therefore, that the taxpayer's contention of sole purpose is too loose a test and the Revenue's contention of significant purpose is too stringent a test although it will in practice be difficult to determine the difference between a significant and a main purpose.[55]

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.

### 29.12.3 *New Condition B*

The wording has changed in New Condition B. The test is now whether:

> any one or more of those transactions was *more than incidentally* designed for the purpose of avoiding liability to taxation.

This brings the law into line with RI 201.[56] At first I thought (like the Special Commissioner) the difference is relatively slight. But (depending

54 Depending to an extent what nuance one gives to the malleable word "significant".
55 *Carvill v IRC* [2000] STC (SCD) 143 at [89], 75 TC 477. The same Special Commissioner cited and followed this passage in *4Cast v Mitchell* [2005] STC (SCD) 280 at [12].
56 I take "more than incidental" in New Condition B to have the same meaning as "significant" in RI 201.

what nuance is given to the malleable word "incidentally") the change does make a difference. Since a merely incidental motive is not likely to amount to a "purpose" at all, a claim which fails Condition A will rarely (if ever) qualify under Condition B. For this reason (and because the "commercial" requirement in New Condition B is so narrow) New Condition B is dead letter law.

### 29.12.4 *Commentary*

Why did Parliament not simply repeal Condition B, rather than amend it out of existence in a way which needs pages to analyse and discuss? Perhaps the full extent of what was done was not realised. Perhaps it was, but it was feared that repeal would raise fiercer objections. However that may be, the rational course would either be to repeal Condition B completely and gain the benefit of simplicity or to return to old Condition B, which had a role to play in aiding commercial life and the economy.

## 29.13 Foresight and purpose

### 29.13.1 *Two senses of purpose*

Clause 14(1) of the draft Offences Against the Person Bill (a 1998 Home Office consultation paper) defines intention in a way which illustrates one possible meaning of the word "purpose":

> A person acts *intentionally* with respect to a result if—
> (a) it is his *purpose* to cause it, or
> (b) although it is not his purpose to cause it, he knows that it would occur in the ordinary course of events if he were to succeed in his purpose of causing some other result.

This distinguishes between "intention" and "purpose".[57] Purpose is narrower. If a person has the purpose of causing another result, but knows the tax saving would occur if they succeed in their purpose of causing the

57 Bentham's terminology was direct and oblique intention: *The Principles of Morals & Legislation*, Chapter VIII (Of Intentionality). See Kaveny's excellent "Inferring Intention from Foresight" 120 LQR 81 and Bratman, "Intention, Plans & Practical Reason", (1987), Chapter 10 (Intention and expected side effects).

other result, they have the *intention* to obtain the tax saving but not the purpose.

"Purpose" is not always understood this way:

> The word [purpose] can be used to designate either
> [1] the main object which a man wants or hopes to achieve by the contemplated act, or ...
> [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.[58]

Here the word "purpose" is understood in the same wider sense as "intention" (as defined above, ie foresight does count as purpose) and (I think) "object" is used in the narrower sense.[59]

### 29.13.2 *"Purpose" in the motive defence*

In RI 201 HMRC say:

> "Purpose" is taken to be the end it is sought to achieve by the transaction.[60]

This adopts (I think) the narrower concept of purpose and it is suggested that this is correct. Purpose in the motive defence is what a person wants

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58 *Chandler v DPP* [1964] AC 763 at p.804, emphasis added.

59 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 writing and statutes:

> "Will, volition, motive, purpose, object, view, intention, intent, specific intent or intention, wish, desire; necessity, coercion, compulsion, duress–such terms, which do indeed overlap in certain contexts, seem frequently to be used interchangeably, without definition ..."

*DPP v Lynch* [1975] AC 653 at p.688. See John Avery Jones "The mental element in anti-avoidance legislation" [1983] BTR 22.

60 This is based on *Newton v Commissioner of Taxation of the Commonwealth of Australia* [1958] AC 450 at p.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".

or hopes to achieve (not merely foresight). In practice, the issue arises in Condition A cases.[61]

## 29.14 Consequence and purpose

A consequence of a transaction is not necessarily its purpose. This was stated judicially in the "celebrated"[62] passage in *IRC v Brebner*:

> [1] My Lords, I would only conclude my speech[63] by saying, when the question of carrying out a genuine commercial transaction, as this was, is considered, the fact that there are two ways of carrying it out – one by paying the maximum amount of tax, the other by paying no, or much less, tax – it would be quite wrong, as a *necessary* consequence, to draw the inference that, in adopting the latter course, one of the main objects is, for the purposes of the section, avoidance of tax.
> [2] No commercial man in his senses is going to carry out commercial transactions except upon the footing of paying the smallest amount of tax involved.
> [3] The question whether in fact one of the main objects was to avoid tax is one for the Special Commissioners to decide upon a consideration of all the relevant evidence before them and the proper inferences to be drawn from that evidence.[64]

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61 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.

62 *IRC v Willoughby* [1995] STC at [167], 74 TC at [89].

63 For completeness, the TC report reads "judgment" and the AC reads "speech". "Speech" is strictly the correct term.

64 *IRC v Brebner* 43 TC 705 at p.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 the transactions in securities code. (This is stated in *Marwood Homes v IRC* [1999] STC (SCD) 44 at [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 [transactions in securities rules]. This follows from the

The point being made here is not (or not just) that mere foresight of a tax advantage is not a tax avoidance purpose.[65] Lord Upjohn goes further in point [3]: he states 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[66] of the transaction.

At what point does a conscious choice of a tax advantageous course become a tax avoidance purpose in its own right in addition to the commercial purpose? Lord Upjohn does not give an answer to this: to say at [3] that it is a question of fact for the Commissioners, if true, is not exactly helpful.

It is suggested that a useful test may be to ask: does the tax advantage form an incidental or subsidiary aspect of achieving the commercial transaction (as opposed to being an end in its own right)? If so, there is no tax avoidance purpose. This is an evaluative test which is perhaps easier to state than to apply, but it may sometimes be helpful. It overlaps with an avoidance/mitigation distinction, since an advantage which is judged to be incidental or ancillary to a commercial or family transaction is less likely to be contrary to the intention of Parliament: it is more likely to constitute mitigation than avoidance.

I suggest the point made in *Brebner* is really this: where one of the reasons for a transaction is a commercial (non-tax) reason, one should be

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> definition of tax advantage in [what is now s.732 CTA 2010] 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 ... were directly within the spirit of s 242."

This does follow from a natural reading of the definition of "tax advantage" now in s.732 CTA 2010 (the income tax equivalent has changed). 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.)

65 The point made at 29.13 (Foresight and purpose).

66 *Brebner* is a case on the transactions in securities motive defence. The wording is not quite the same as motive defence condition A: s.734(3) CTA 2010 refers to the "main objects" and Condition A refers to "purposes". However, it is considered there is no significant distinction between them. This was presumably the view adopted in *Willoughby* in the Court of Appeal where *Brebner* was cited in a Condition A context.

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 and a commercial transaction is less likely to be. 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.[67] In practice, this issue arises in Condition A cases.[68] It is considered that the *Brebner* principle continues to apply to New Conditions A and B. It is true that the terms of New Condition B (that incidental purposes are to be disregarded) suggest that incidental purposes in New Condition A are *not* to be disregarded. But the *Brebner* principle is identifying matters that are not "purposes" at all.

### 29.14.1 *A choice principle?*

The *Brebner* dictum is sometimes regarded as supporting a "choice principle":

> Choosing between two alternatives – if one is carrying out a commercial or a family or an investment transaction, choosing the most tax-efficient – is not avoidance.[69]

But this formulation goes too far: if a UK settlor creates a trust for their family – a family transaction – they have to choose between UK and foreign trustees; but the choice of foreign trustees by the UK settlor is avoidance.[70]

One can accept a choice principle if it is combined with the concept of the intention of Parliament, ie if the settlor makes choices within the

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67 *Mangin v IRC* [1971] AC 739 at p.751 and p.756, restating the *Brebner* principle in the context of an extremely free reading of a New Zealand provision.

68 Because in a commercial transaction, incidental tax avoidance purposes are in any event disregarded.

69 Baker "Tax avoidance, tax mitigation and tax evasion", accessible *www.taxbar.com*.

70 It seems that the choice principle has been abandoned in Australia, as a "false dichotomy": see Myers "Tax avoidance and the High Court since Sir Garfield Barwick" accessible *www.law.unimelb.edu.au/taxgroup/AllanMyers07-04-05Web.pdf*.

intention of Parliament, there is no tax avoidance; this is equivalent or very similar to the concept of "special tax regime".[71]

In an earlier edition I suggested a distinction between:

(1) a tax saving which arises because the transfer *is made* (ie it would not arise if the transfer had not been made)[72]; and

(2) a tax saving which arises because the transfer is made *in one particular way* (ie it would not arise if the transfer were made in some other way).[73]

This does not work, because classifying a transfer in category (1) or (2) is an arbitrary or evaluative exercise.

## 29.15 Purpose: advisors and agents of transferor

In a case where a transferor is acting by attorney, the purpose of the attorney should, on normal agency principles, be attributed to the transferor.

In the case where:

(1) a company makes a transfer, and

(2) there is no quasi transferor,[74]

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 (eg parents, professionals) and executes documents without more than a vague idea of approving proposals put to them and not properly understood, they have adopted the purpose of their advisors or (which comes to the same thing) the purpose of their advisors is to be attributed to them. 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

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71 See 29.16.2 (Special tax regime).

72 Such as the saving of the settlor's own tax liabilities arising from the transfer; see 29.22.1 (No avoidance of settlor's tax liabilities).

73 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).

74 In such a case of course there would be no *individual* "transferor" who is within s.720: see 26.3.2 (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.

scheme, he must fall fairly within the section".[75]

For the purposes of New Conditions A and B, s.737 ITA provides:

> (5) In determining the purposes for which the relevant transactions or any of them were effected, the intentions and purposes of any person within subsection (6) are to be taken into account.
> (6) A person is within this subsection if, whether or not for consideration, the person—
> (a) designs or effects, or
> (b) provides advice in relation to,
> the relevant transactions or any of them.

This only restates the law applicable to the Old Conditions A and B; it makes no difference to the position.

The significance of taking tax advice is discussed in *Ebsworth v HMRC* [2009] UKFTT 199 (TC):

> 13. Much was made, particularly in cross-examination, of certain of the notes made by Mr. Ebsworth's tax advisers. For the reasons discussed below I did not find them particularly illuminating in reaching my decision as they were what one would expect from a tax adviser engaged to advise on tax rather than as a commercial or other adviser. Taking tax

75 57 TC 1 at pp.47, 49. The same point is made in *Burns v HMRC* [2009] STC (SCD)165 at [20] and [39]. The same principle applies for the transactions in securities rules; see *Addy v IRC* 51 TC 71 at p.81g. Likewise for the settlement provisions: see 69.25 (Purpose of advisors and agents of settlor). In *Federal Commissioner of Taxation v Consolidated Press Holdings* (2001) 207 CLR 235 the High Court of Australia said it was "both possible and appropriate to attribute the purpose of a professional advisor to the taxpayer". I stress this because the opposite view was taken in *Philippi v IRC* 47 TC 75 where the Court of Appeal said at p.114:

> "Young Mr. Philippi ... said that he never had any idea of tax in his mind when he made that transfer. It was true that it was saving him a great deal in UK tax ... but that had not occurred to him; the only reason why he had made the transfer was because his father and other members of the family had told him that he ought to do so. He appears to have had no idea why they gave him that advice. The Commissioners accepted ... his evidence that what he had done he did on his father's advice."

Assuming that this implausible story is true (though "young Mr Philippi" was aged 23 at the time of the transfer) the Court should have held that he had adopted the (tax avoidance) purpose of his father. The point was not argued and *Philippi* should not be followed on this issue.

> advice does not of itself make tax avoidance one of the main objects of the transactions concerned....
> 62. The fact that Mr. Ebsworth sought tax advice (with Mrs. Ebsworth) does not of itself mean that tax avoidance was a main object of the transactions. [The paragraph then cites Lord Upjohn in *Brebner*].

## 29.16 Avoidance/mitigation distinction

This section sets out the most important judicial and other statements on the avoidance/mitigation distinction.

### 29.16.1 *Intention of Parliament*

*IRC v Willoughby* is now the authoritative general statement on the subject:

> Tax avoidance within the meaning of section 741 ICTA is a course of action designed to conflict with or defeat the evident intention of Parliament.[76]

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.[77]

HMRC have also adopted this approach:

> Tax avoidance is any action taken to obtain a tax advantage in a way that Parliament did not intend or would not have intended had the matter been put before it. This definition is based upon the report on tax avoidance produced by the Tax Law Review Committee in 1997.[78]

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76 70 TC 57 at p.117.

77 Tax avoidance: A Report by the Tax Law Review Committee (1997) para 1.13, citing *IRC v Willoughby*.

78 IR152 Trusts: An Introduction (withdrawn on 30/09/04) accessible *webarchive.nationalarchives.gov.uk/20070402085841/hmrc.gov.uk/pdfs/ir152.htm*. HMRC have altered the nuance by deleting the words "plainly" and "possibly" from the TLRC formulation, but that does not alter its essential nature.

There have been some attempts to be more specific.

### 29.16.2 *Special tax regime*

Morritt LJ said:

> The genuine application of the taxpayer's money in the acquisition of a species of property for which Parliament has *determined a special tax regime* does not amount to tax avoidance merely on the ground that the taxpayer might have chosen a different application which would have subjected him to less favourable tax treatment.
> (*IRC v Willoughby* [1995] STC at 183, emphasis added)

This repeats the test of the intention of Parliament (what Parliament has "determined" is, I think, the same as what Parliament has intended). It brings the added refinement of identifying the "special tax regime" which Parliament intended to apply. Professor Willoughby's offshore bonds seem a reasonably clear[79] example of a "species of property for which Parliament had determined a special tax regime".

This category can be generalised into all occasions where Parliament has determined a "special tax regime" (regardless of whether there is any particular "species of property" involved):

> The adoption of a course of action which avoids[80] 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.[81]

The existence of a special relieving regime is neither a necessary nor a sufficient condition of tax mitigation. It is only a factor to consider. There is no relieving provision for bed and breakfast transactions, which are accepted as mitigation.[82] Conversely, as the Special Commissioner rightly said in *Carvill v IRC*:

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79 Though it might be argued that Parliament had intended the chargeable events regime for normal bonds but not for personal portfolio bonds.

80 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".

81 *O'Neil v IRC* [2001] STC 742.

82 See 29.16.4 (Other indicia of tax avoidance).

> It is not enough to say that if you find a relieving provision then it is the evident intention of Parliament that the taxpayer should be entitled to use it whatever the circumstances. As *Furniss v. Dawson* [1984] AC 474 shows it is quite possible to mis-use a relieving provision. To give an example in the same area as this case, suppose the Appellant had formed Personal Holdings solely to give him a non-resident employer in order to obtain the foreign emoluments deduction. If that company had been funded entirely by the UK companies and had done nothing other than employ the Appellant, it might be the case that the Appellant would have been avoiding tax because he was misusing a relieving provision. That example of course is deliberately different from the facts of this case where Personal Services was funded from non-UK profits with no corporation tax deduction for services which benefited the UK companies. [Counsel for HMRC] went as far as claiming that Parliament's purpose in enacting the foreign emoluments deduction was to encourage, or at least not discourage, people from abroad to work in the UK so that someone in the Appellant's position who had spent all his working life in the UK, could never qualify. While this may have been in Parliament's mind, I cannot accept that the relief was not available to a non-domiciled person working for a non-UK resident employer whose remuneration is borne by a non-resident, however long the non-domiciled person has been resident (I note that the amount of relief was reduced after nine years' residence). ... the taxpayer must do more than point to the existence of a relieving provision; he must be using, rather than misusing, the relieving provision in a way consistent with Parliament's evident intention.[83]

### 29.16.3 *Economic consequences*

Lord Nolan said in *Willoughby*:

> The hallmark of tax avoidance is that the taxpayer reduces his liability to tax without incurring the *economic consequences* that Parliament *intended* to be suffered by any taxpayer qualifying for such reduction in his tax liability. The hallmark of tax mitigation, on the other hand, is that the taxpayer takes advantage of a fiscally attractive option afforded to him by the tax legislation, and genuinely suffers the *economic consequences* that Parliament *intended* to be suffered by

83 [2000] STC (SCD) 1543 at [91]

> those taking advantage of the option.[84]

This repeats the test of the intention of Parliament with the added refinement of identifying "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.[85]

The non-recourse loan in *Ensign Tankers* is an example of a transaction without economic consequences and in *Challenge* Lord Templeman gave another example which will be particularly relevant to the practical examples considered below:

> When a taxpayer makes a settlement, he deprives himself of the capital which is a source of income and thereby reduces his income. If the settlement is irrevocable and satisfies certain other conditions the reduction in income reduces the assessable income of the taxpayer. The tax advantage results from the reduction of income.[86]

These are transactions with obvious economic consequences.

Professor Willoughby's investment in his bond had some "economic consequences" as compared to a direct investment in the underlying assets

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84 70 TC 57 at p.116 (emphasis added).

85 *IRC v Challenge* [1986] STC 548 cited in *Ensign Tankers v Stokes* [1992] STC at p.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* [2003] HKCFA 46 accessible *www.ird.gov.hk/eng/pdf/facv4_2003.pdf* to cast doubt on the correctness of *Ensign Tankers*, but that does not affect the point here.)

86 *IRC v Challenge* [1986] STC at 554–555.

though one might have thought they were not very substantial.[87]

Incidentally, one wonders what economists would think of the term "economic consequences". One suspects it is what John Kay derides as "DIY economics".[88]

### 29.16.4 *Other indicia of tax avoidance*

It is suggested that "economic consequences" and "special tax regime" are categories of tax saving steps which do accord with the intention of Parliament but are not an exhaustive categorisation of mitigation. They should be regarded as indicia or "badges" of mitigation (like the badges of trade). One can think of others. The Tax Avoidance Schemes (Prescribed Descriptions of Arrangements) Regs (2004, 2006 and amended again in 2009) are interesting series of attempts to identify indicia of tax avoidance for the purposes of disclosure obligations. The indicia include:

(1) confidentiality from other promoters; and
(2) premium fees (typically linked to tax savings).

The OECD also identified secrecy[89] as a common characteristic of

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87 Lord Nolan identified the following economic consequences:

> "The reality in truth is that the bond holder has a contractual right to the benefits promised by the policy, no more and no less. It is therefore quite wrong to describe the bond holder as having, in the words of the Appellants' printed case 'in substance all the advantages of direct personal ownership without the tax disadvantages'. The significance of this misdescription would become all too apparent if—perish the thought—Royal Life were to become insolvent and unable to meet its obligations to the bond holders."

Before 2008 I described this as unconvincing, as the insolvency of Royal Life seemed so remote a possibility as to be discounted. But the 2008 recession showed that Lord Nolan was right.

88 See Kay, *The Truth About Markets*, (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.

89 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.
(3) Secrecy against HMRC in order to avoid or frustrate any investigation. Of course dishonest breach of a duty of disclosure marks a point where avoidance

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.[90]

Neither secrecy nor premium fees are normally associated with the commonplace transactions discussed below. But if, exceptionally, that was the case then it would be a factor suggesting that the transaction should be characterised as tax avoidance.

An important indicia is familiarity and use. Once a tax avoidance arrangement becomes common, it is almost always stopped by new legislation within a few years. If something commonly done is contrary to the intention of Parliament, it is only to be expected that Parliament will stop it. So that which is commonly done and not stopped is not likely to be contrary to the intention of Parliament. It follows that tax reduction arrangements which have been carried on for a long time are unlikely to constitute tax avoidance.

There are arguments against this view. It also seems strange that the same act might be stigmatised as tax avoidance if challenged by HMRC or Parliament shortly after it is first done; but if such acts become the general practice over a long period of time then the intention of Parliament is decided differently. Nevertheless, it is submitted that the better view is to have close regard to this factor. Judges have a strong intuitive sense that that which everyone does, and has long done, should not be stigmatised with the pejorative term of "avoidance". This, I suggest, is the

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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.

90 OECD Report by Committee of Fiscal Affairs (1980 ) cited in OECD International Tax Avoidance and Evasion (1987), p.17.

true reason why the courts classify bed-and-breakfast transactions and back-to-back loans as mitigation and not tax avoidance.[91] 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.[92]

Category (1) is obviously mitigation and category (3) is obviously avoidance. It is suggested that category (2) should be classified as mitigation rather than avoidance. An example is a transfer of a land-owning company (instead of its land) to reduce the rate of stamp duty from land rates (in short, 4%) to share rates (0.5%). The Government considered imposing stamp duty at land rates on shares in land-owning companies to prevent this, but decided not to proceed with the idea.[93] 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).

## 29.17 Failed indicia of tax avoidance

### 29.17.1 *Spirit of the statute*

Other approaches in distinguishing tax avoidance and tax mitigation are to seek to identify "the spirit of the statute" or "misusing" a provision. I take this to mean exactly the same as the "evident intention of Parliament"

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91 *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.

92 *Tax Avoision* (1979, IEA) p.81.

93 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.

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*.[94] Either way, the expression is best avoided in this context (and indeed in any context).

### 29.17.2 *Artificial transactions and devices*

Another approach is to seek to identify "artificial" transactions. But while tax avoidance frequently involves transactions that can be described as "artificial", this is not always the case. You can have tax avoidance without much (if any) artificiality[95] 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.[96]

The Royal Commission is right. The problem is not that the word "artificial" is meaningless. But it can only be used where there are standards of what is non-artificial (or "natural"). For a striking illustration, 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:

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94 "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.

95 eg an appointment of non-resident trustees or a transfer to a non-resident company.

96 Cmd. 9474 para 1024.

> an *artificial* and an unnatural equality between men and women.[97]

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.

In fact the word "artificial" is often used to describe a transaction carried out for tax avoidance purposes. A transaction is not categorised as tax avoidance because it is artificial: it is described as artificial because it is tax avoidance. For instance:

> such elaborate arrangements would not have been entered into other than for the purpose of tax avoidance. The arrangements had no genuine commercial purpose. ... The arrangements can, therefore, correctly be described as artificial.[98]

The same objection applies to that particular obstacle to clear thinking, the term "device".[99]

### 29.17.3 *"Genuine"*

The word "genuine" is often used to describe the antithesis to a tax avoidance transaction.[100]

## 29.18 Intention of Parliament v intention of Government

I suggest two broad approaches to "tax avoidance" can usefully be distinguished:

(1) "Tax avoidance" as politicians, civil servants (and perhaps most non-tax lawyers) use the term. This means a tax reduction arrangement which is contrary to the intention or wish of the *Government of the day* (ministers or civil servants, primarily HMRC). For a revealing example of this usage see the National Audit Office Report (Countering VAT Avoidance, 1992):

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97 Cited in "Victorian Wives and Property" Lee Holford, in *A Widening Sphere* Ed Vicinus, Methuen, 1980. The proposal did not become law until 1882.

98 *R on the application of Huitson v HMRC* [2010] STC 715 at [11].

99 *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."

100 For example see 29.25 (UK settlor and UK beneficiaries).

> 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.[101] 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 was openly accepted in the former ITH:

> **103. Avoidance in international context**
> *Within the Revenue we do not categorise avoidance in quite the narrow way that the Courts have done.* Of course we make a distinction between mitigation and avoidance. However, if a taxpayer takes advantage of the law to get a tax advantage which is not, *in our understanding*, within the spirit of the legislation, we tend to look on that as avoidance.
> (Emphasis added)

The avoidance/mitigation distinction is not self-explanatory, it is not a given. It is a construct defined and determined by reference to values and

101 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.

attitudes of the tax culture in which we live. The difference between the approaches (1) and (2) is partly: *whose* values and tax culture does one apply, and: *to what materials* does one refer to ascertain these values? The taxation of PETs offers an example. In 1973, C.T. Sandford wrote:

> At present gifts made more than seven years prior to death pay no tax (with the possible exception of capital gains tax). ... Is there evidence that such gifts are contrary to the intention of Parliament? Both circumstantial evidence and logic point to this conclusion. Thus if Parliament were indifferent to the making of gifts prior to death, would there have been successive increases in the gifts *inter vivos* period, which, since 1894, has risen in four successive stages from one to the present seven years?

Sandford considered and dismissed some policy arguments in favour of an estate duty and concluded:

> A reasonable interpretation would be that the gifts *inter vivos* provision was intended to prevent as many gifts as possible from circumventing estate duty.[102]

The repeal of CTT and return to an estate duty under the name of Inheritance Tax shows that lifetime giving since 1986 cannot now be regarded as "tax avoidance". I suggest that lifetime giving was not "avoidance" (in the strict sense) of estate duty even in 1973. If Parliament intended to tax all lifetime gifts it would *not* have increased the lifetime gift period to seven years. It is obvious that such an increase would not stop tax-free lifetime giving. Parliament would certainly not have enacted a taper relief under which gifts made more than four years before death pay a reduced rate! How then did Professor Sandford reach the wrong conclusion? Perhaps because he wished to advocate the imposition of a capital transfer tax. When one wishes to support a tax reform, the temptation to describe the old law as permitting "avoidance" is irresistible (as a tool of advocacy) and also has a certain underlying logic. There is tax avoidance in a political if not a lawyer's sense. If some future Government abolishes PETs, and returns to some form of CTT, it seems safe to predict that those supporting the reform will castigate lifetime

102 IFS, *Hidden Costs of Taxation*, 1973, p. 113.

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).

Understood in this way the term "tax avoidance" is vague but not, I think, hopelessly so, as, for instance, the currently popular phrase "the right amount of tax".

## 29.19 How to ascertain "the evident intention of Parliament"?

This is the problem at the heart of the concept of "tax avoidance". If this term means an action contrary to the intention of Parliament, one must identify that intention. C.T. Sandford addressed the problem:

> But here we meet the major difficulty. ... As individuals we may feel certain that a particular action is contrary to the intention of the law; but the *objective* interpretation of that intention can only be found in the words the law uses.[103]

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.

### 29.19.1 *Two levels of intention*

Now, it may be objected that a concept of "tax avoidance" based on what is contrary to "the intention of Parliament" is not coherent. The object of statutory construction is always said to be to find "the intention of

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103 IFS, *Hidden Costs of Taxation*, 1973, p.114 (emphasis in original).

Parliament".[104] A successful tax avoidance scheme, even as blatant a scheme as *Fitzwilliam*,[105] 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.[106]

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".[107] A.A. Shenfield recognised this (perhaps grudgingly):

> What the complainant against avoidance means by the intentions of a law is not what may be deduced from what it says, but what parliament

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104 See *Cross on Statutory Interpretation*, Oxford University Press (3rd. ed, 1995), chapter 2.

105 67 TC 614.

106 A.A. Shenfield, *The Political Economy of Tax Avoidance*, Institute of Economic Affairs, Occasional Paper 24, 1968, pp.20–21.

107 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).

> 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 ...[108]

## 29.20 Reduction, deferral and unsuccessful avoidance

### 29.20.1 *Reduction*

The motive defence provisions refer to "avoidance" alone but comparable statutory provisions refer to "avoidance *or reduction*" of tax.[109] 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.[110] 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.

### 29.20.2 *Deferral*

Arrangements to defer tax may constitute "avoidance".[111] Indeed the classic avoidance case *Furniss v Dawson* might be characterised as involving mere "deferral" of tax. However, the fact that tax is merely deferred, and will or may later be paid, may be a factor which supports the conclusion that the arrangement is to be characterised as mitigation and not avoidance.

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108 *Ibid*, note 94.

109 The earliest of these was s.35 FA 1941 (Excess Profits Tax); the formula is found in modern provisions: s.773(2)(b) ITA and as part of the more lengthy formula in s.732 CTA 2010.

110 Contrast the statutory expression "mitigate or remit" a penalty.

111 The Special Commissioner so held in *IRC v Willoughby* 70 TC at p.84. There was wisely no appeal on this point.

### 29.20.3 *Unsuccessful avoidance*

The OECD correctly states:

> Successful tax reduction is neither a sufficient nor a necessary test of tax avoidance. It is not sufficient because this would cover acceptable tax planning [ie mitigation] and it is not necessary because an avoidance scheme designed to reduce tax may not succeed.[112]

## 29.21 Practical examples: introduction

We can test these general principles by trying to apply them in some practical cases. There is no test like the test of practice. I first consider transfers to six types of non-resident trust (here called "trust transfers"):

(1) Trusts where settlor is excluded:[113]
- (a) Foreign settlor: UK and foreign beneficiaries;
- (b) Foreign settlor: only UK beneficiaries;
- (c) UK settlor: UK beneficiaries;
- (d) UK settlor: foreign beneficiaries.

("Foreign" here refers to someone not resident or domiciled in the UK and not expecting to become resident or domiciled.)

(2) Trusts where the settlor is a beneficiary:
- (a) Settlor foreign domiciled but UK resident;
- (b) Settlor foreign domiciled and non-UK resident.

This by no means covers all the possible circumstances of trust transfers, but one can extrapolate from these to others which may arise.

It may be helpful to summarise the questions that arise on a trust transfer. One must ask: Is the purpose to avoid (1) income tax? (2) CGT? (3) inheritance tax? It is obviously necessary to consider each tax separately; I will consider CGT and IT first, and then IHT. Thus what seemed like a single issue (is there tax avoidance?) raises 3 sub-issues; that is an inevitable consequence of the rule that taxation includes any tax.[114]

However, a tax charge does not arise in isolation, but is charged in

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112 OECD Report by Committee of Fiscal Affairs (1980) cited in OECD's International Tax Avoidance and Evasion (1987), p.17.

113 It is assumed that the spouse of the settlor is also excluded.

114 See 29.9 (Meaning of "taxation" in the motive defence).

different ways on the settlor, trustees[115] 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 three issues raises nine sub-issues. Further, post-*Willoughby* one must consider whether there is a factual subjective purpose to reduce any of these tax liabilities and then whether the purpose (if present) is to be classified as avoidance or mitigation. So what seemed like a single issue (is the purpose of a trust transfer to avoid taxation?) actually turns out to raise 18 sub-issues (is the purpose to save IT/CGT/IHT by settlor/trustees/beneficiaries and, if so, is it mitigation or avoidance?).

## 29.22 Trust transfers where settlor excluded

Transfers to a trust from which the settlor is excluded have two common features which are relevant for the motive defence:

### 29.22.1 *No avoidance of settlor's tax liabilities*

The trust transfer will usually bring a tax advantage to the settlor (compared to the position if there is no transfer). As far as the settlor's tax liabilities are concerned, since she is excluded from the trust, any tax advantage she might obtain in this way is mitigation not avoidance. It is not in principle the intention of Parliament that she should pay tax in respect of income/gains/capital from which she is excluded.[116] However, HMRC rightly say that the purpose of a trust transfer may be to avoid tax liabilities of the trustees and beneficiaries and here closer investigation is needed.

### 29.22.2 *Non-tax reason for creating trust*

There will usually be non-tax reasons for the settlor to make a trust, rather

115 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.

116 See Lord Templeman's dictum in 29.16.3 (Economic consequences). The exceptional case of s.86 TCGA is discussed below.

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.

## 29.23 Foreign settlor; UK and non-UK beneficiaries

This section considers a transfer to a trust whose beneficiaries include (but are not primarily) UK resident and domiciled beneficiaries, and exclude the settlor.

### 29.23.1 *Avoidance of trustees' tax*

In deciding whether the trust transfer yields a tax advantage for the trustees, one obviously cannot compare the actual position (appointment of foreign trustees) with the position if the transfer had not taken place. One must compare it with something else the settlor might have done (which in this context must be the appointment of UK trustees). That seems a reasonable comparable; the settlor has a choice: to transfer to trustees in the UK or elsewhere and they must do one or the other. In the absence of UK tax, there will often be no reason to prefer the one to the other.

The choice of UK trustees (rather than foreign trustees) would not in principle yield any greater CGT before 2007/08.[117] There is no question of CGT avoidance for dispositions before the FA 2006.

The position is slightly more complicated for dispositions after 2006. The choice of exclusively UK trustees of a discretionary trust will yield CGT (and income tax on foreign source income) not due from non-resident or mixed resident trustees.[118] However, if one trustee (even a

117 As long as the UK trustees were professionals: see the 4th edition of this book at 5.8 (Professional trustees treated as non-resident).

118 See 4.4 (Trustee residence for income tax and CGT). The IT position for trustees before 1989 was thought by HMRC to be the same, and was held in *Dawson v IRC* 62 TC 301 to be only slightly (and for present purposes not materially) different.

minority trustee) is resident outside the UK, the trustees are not (in short) subject to CGT or income tax on foreign income. Does that mean that the choice of non-resident trustees is income tax avoidance? It is submitted that the answer is plainly no. Section 475 ITA assists in the appointment of non-resident trustees, suggesting that this cannot be contrary to the intention of Parliament. To hold otherwise would be to suggest that the settlor has a duty to maximise UK income tax and CGT liability. Any tax saving here must be mitigation. It is relevant to note that the reason for the abolition of the rule that professional trustees should be regarded as non-resident was not to prevent avoidance: it was to satisfy a requirement of EU law.[119]

### 29.23.2 *Avoidance of beneficiaries' income tax liabilities*

In deciding whether the trust transfer yields an income tax advantage for the beneficiaries, one obviously cannot compare the actual position (transfer to trust) with the position if the transfer had not taken place. One must compare it with something else the settlor might have done.

The actual position of UK resident and domiciled beneficiaries is that they will pay tax on income distributions from the trust, but no tax on accumulated income and (in the absence of s.731 ITA) no income tax on capital payments. This is a clear income tax advantage if the transfer to a discretionary trust is compared with a transfer to the beneficiaries or to a transfer to an interest in possession trust.

Is the purpose of the transferor to obtain this advantage? Normally their 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.[120]

The actual position of UK resident foreign domiciled beneficiaries is that they will pay tax on remitted income distributions from the trust, and (in the absence of s.731 ITA) no income tax on capital payments even if remitted. This could be an income tax advantage if the transfer to a discretionary trust is compared with a transfer to the beneficiaries or to a transfer to an interest in possession trust, but the advantage may be small or nil.

Is the purpose of the transferor to obtain this advantage? Normally their

119 HMRC announcement 23 March 2006.

120 See 29.13 (Foresight and purpose).

purpose will be to obtain non-tax advantages, and even foresight of this somewhat attenuated tax advantage will not constitute purpose.

### 29.23.3 *If there is a tax saving purpose is it avoidance or mitigation?*

Returning to the practical example of a transfer to a trust by a foreign settlor, with both UK and foreign beneficiaries. Is the purpose (if it exists) of saving income tax by the beneficiaries to be classified as avoidance? The difference between being a beneficiary of a discretionary trust and owning capital outright is normally[121] 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;[122] it is impossible for the settlor to make a discretionary trust anywhere without tax avoidance elsewhere – which, if not absurd, is somewhat startling.

### 29.23.4 *Avoidance of beneficiaries' CGT liabilities*

The CGT position is complicated by tax reforms. Before 1998, capital payments from the trust would be free of tax to the beneficiaries (because the usual charge did not apply to a trust with a foreign domiciled settlor). This was expressly set out in s.87 TCGA.[123] One must take that as a special tax regime intended by Parliament. Pre-1998 transfers cannot be regarded as involving CGT avoidance by the beneficiaries.

After 1998, capital payments to UK domiciled beneficiaries give rise to CGT by reference to trust gains regardless of the domicile of the settlor and in 2008 the charge was extended further. This could be taken to

121 It would be different if the trustees (perhaps guided by a strongly worded letter of wishes) closely follow the wishes of a beneficiary.

122 Assuming they are in a jurisdiction with a tax system comparable to the UK.

123 And in the predecessor legislation: s.17 Capital Gains Tax Act 1979.

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 2006, s.69(2) TCGA is even stronger than it is now. So the better view is that any CGT saving is mitigation.

## 29.24 Foreign settlor; only UK beneficiaries

The next case to consider is a transfer to a trust whose beneficiaries are all UK resident and domiciled. A trust transfer primarily motivated by non-tax advantages (asset protection) should not normally be regarded as having the purpose of tax reduction.

In an unusual case, however, that might be one of the settlor's purposes. Indeed, it could be their primary purpose. It can happen be that the settlor creates a trust primarily for a UK beneficiary, and the only reason they do this is tax considerations. Asset protection does not concern every settlor. They would make an absolute gift to a UK beneficiary but for UK tax reasons only they make a transfer to a trust for their benefit. The transfer is solely UK tax driven.[124]

In these (factually unusual) circumstances the question arises whether the tax saving purpose is avoidance or mitigation. Section 69(2) TCGA and s.475 ITA show the intention of Parliament to be that the choice of foreign trustees by a non-resident and non-domiciled settlor should not be regarded as avoidance of trustees' IT or CGT. These sections apply regardless of the residence and domicile of the beneficiaries. The inference should probably be carried across that there is likewise mitigation not avoidance of beneficiaries' IT and CGT liabilities; but the point is arguable.

## 29.25 UK settlor and UK beneficiaries

Contrast now a settlor who is UK resident and domiciled, making provision for UK beneficiaries. Assume the settlor is not to be a beneficiary. Again, they will often prefer a trust to outright gifts, for non-

124 This might be made evidentially clear by contemporary correspondence, or if, perhaps, the settlor's gift to a UK child is settled and their 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.

tax reasons, and the choice is UK or non-resident trustees. If they choose the latter, their purpose (or one of their 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.[125]

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.[126] If only this were done more often!

## 29.26 UK settlor; foreign beneficiaries

Now consider a UK settlor making a trust (from which they are 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.

## 29.27 UK settlor; UK and foreign beneficiaries

Where there is a mixture of UK and non-UK beneficiaries I suggest the starting point is that one would expect the settlor to make their trust here, so a transfer to foreign trustees would be regarded as avoidance. (In such

125 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.

126 See 29.17 (Failed indicia of tax avoidance).

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.)

## 29.28 Transfer to trust; settlor a beneficiary

### 29.28.1 *Remittance basis taxpayer settlor-beneficiary*

The next case concerns remittance basis taxpayer settlor who transfers assets to a non-resident trust under which they are 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 CGT advantage that the settlor moves from the remittance basis to the s.87 capital payment remittance basis. To obtain that advantage may well one of the purposes of the trust. If so, is it CGT "avoidance"? It must have been a decision of Parliament *not* to apply s.86 TCGA to a foreign domiciled settlor and the decision was confirmed in 2008 (where a proposal to extend s.86 to foreign domiciled settlors was contained in FD Draft Clauses (January 2008) and dropped in the Finance Bill). It is suggested that there is no CGT "avoidance". This is a "statutory invitation" in plain terms.

### 29.28.2 *Non-resident non-domiciled settlor-beneficiary*

Where the settlor is the principal beneficiary and neither domiciled nor resident then UK tax saving is not likely to be a purpose during the life of the settlor, because no saving in fact arises. After the death of the settlor there may be a saving if there are UK beneficiaries. The position then becomes like that of a trust where the settlor is excluded, and the discussion above is relevant.

## 29.29 Appointing non-UK trustees of UK trust: 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[127]). 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.

## 29.30 When is a trust transfer made for the purpose of avoiding IHT?[128]

### 29.30.1 *Change of situs without alteration of ownership*

The transfer of money by a foreign domiciled person from a UK bank to

127 There is no particular significance in selecting five years as illustrative of a medium term period, but it is consistent with the CGT temporary non-residence rules; see 8.1 (Temporary non-residence).

128 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 p.145. The same would apply if the transfer is made by trustees of a trust with a non-domiciled settlor. The same would apply to a sale of UK situate property and re-investment in non-UK situate property.

### 29.30.2 *Transfer to trustees*

The residence of trustees is almost wholly irrelevant for IHT.

A gift by a settlor to a trust from which they are excluded is mitigation of their own IHT[129] 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.[130]

A gift by a settlor to a trust from which they are 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 that the GWR provision does not apply here.[131]

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129 See 29.22.1 (No avoidance of settlor's tax liabilities).

130 The avoidance/mitigation issue did not arise in connection with the gift to a trust in *Beneficiary v IRC*, because reducing tax was not a purpose in the mind of the transferor/settlor, even though it was a consideration for his advisers, and even though the principal beneficiary was UK resident at the time; see [1999] STC (SCD) 134 at [145h] - [146].

131 See 54.12 (GWR death charge: excluded property rules for settled property).

## 29.31 Transfer of assets from non-resident trust 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.

### 29.31.1 *Is the transfer a commercial transaction?*

Transfers to trust subsidiaries arise in a wide variety of circumstances and may be made for the purpose of obtaining non-tax advantages:

(1) Advantages of trust administration:
   (a) Segregation of trust funds of trustee (or occasionally combining trust funds) for ease of management.
   (b) Avoiding conflict of law and other problems of trustees holding assets (especially land) in foreign jurisdictions. (The problem is most serious in civil law jurisdictions which may not understand or even recognise trusts, but problems could also arise in common law jurisdictions.)

(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,[132] the conclusion that the transfer has a

132 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 *www.archive.official-documents.co.uk/document/cm41/4109/4109-i.htm*. Trusts managed in Switzerland generally use underlying companies for Swiss law

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.

29.31.2 *Is the transfer for tax avoidance?*

Transfer of UK assets[133] 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[134] 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 likely CGT disadvantage,[135] and a possible income tax disadvantage,[136] so any tax reduction may be regarded as part of a "package deal", with advantages and disadvantages. This does not savour of tax "avoidance".

The contrary view is taken in *Burns v HMRC* [2009] STC (SCD) 165 at [59]:

> I would certainly accept that if a non-domiciled person arranged to hold foreign situs, rather than UK situs, assets, and then died, no tax

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reasons.

133 Similar considerations apply to a transfer of foreign assets with a view to realisation and re-investment in UK assets.

134 An exceptional case would be if the property was put in the company shortly before a ten year anniversary and taken out shortly thereafter.

135 See 45.35.4 (Should trustees hold assets through a trust subsidiary?)

136 Loss of tax credits and double taxation relief; sometimes, possible charge under income tax benefit in kind rules.

> advantage would have been sought. Thus if a UK house was sold, and a French house purchased, that would simply be a case of genuinely changing the assets held, and were some [TAA] point to hinge on whether the change was effected for the purpose of avoiding UK tax, the answer would be that it was not. And if UK bank deposits were withdrawn and deposits placed elsewhere, then again, that would be a pure investment switch, and not a step the purpose of which would involve the purpose of achieving a UK tax advantage. Indirectly retaining a UK real property, and simply achieving the technical change in status by putting the property into a non-UK resident company in a case where one of the purposes is to achieve the potential Inheritance Tax advantage, implicit by effecting those steps, does seem to me to cross the border between mitigation and tax avoidance. This is because it has involved no real change of investment, as in the two previous examples, but the retention of the UK property, accompanied by a step to change the normal tax consequences of that. Thus where it is shown that the CTT or IHT considerations were one of the purposes of the transfer, or other where the appellants have not displaced the reasonable presumption that UK advantages were one of the purposes, I conclude that those purposes involve tax avoidance and not merely mitigation.

This is obiter (for on the facts of the case there was clearly income tax avoidance). The relevant cases and materials are not discussed. The Commissioner has confused tax avoidance with tax advantage. At some time the point will need to be judicially considered in more depth.

*(2) Escaping additional rate income tax (on UK source income of discretionary trust)*

The striking thing about this tax is that there is generally[137] no effective method for HMRC to collect it and in practice no one expects it to be paid in cases where all the beneficiaries are outside the UK.[138] 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

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137 Except in the case of UK land.

138 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.

income tax at the higher rate.
In *Burns v HMRC* [2009] STC (SCD) 165 at [58] the Special Commissioner said:

> I deal first with the feature of trying to cap the level of charge to income tax at the basic rate. This advantage seems to me to be in the category of tax avoidance. ... it seems to me to be difficult to argue that a transaction designed to reduce income tax by the mechanism of the transfer of UK property to a non-resident person (virtually a paraphrase of the opening wording of section 739) is mere mitigation.

### 29.31.3 *Transfer by trust to which s.624 applies*

If the purpose of the transfer to a trust subsidiary is to avoid a charge under s.624 ITTOIA, this is considered to be avoidance and not mitigation.

### 29.31.4 *Transfer of non-UK assets to trust subsidiaries*

When non-UK assets are transferred to a trust subsidiary, the UK tax advantage may be less or nil or there may only be tax disadvantages in the loss of double taxation reliefs. In the absence of an intention to re-invest in the UK the purpose cannot as a matter of fact be a tax reduction purpose.

## 29.32 Non-resident foreign domiciled individual transfers UK property to offshore company

A foreign domiciled non-UK resident individual who transfers UK assets to a non-resident foreign incorporated company may also enjoy comparable tax advantages:
(1) Obtaining IHT excluded property status.
(2) Avoiding higher rate income tax.
Such transfers also give significant advantages which have nothing to do with tax. In particular, in the case of UK land, avoiding personal liabilities arising from direct ownership. In such cases, the motive defence may well apply. But if a purpose of the transfer is to reduce IHT or IT, it is considered that this is mitigation not avoidance; the arguments are the same as above.

## 29.33 Transfer by UK resident foreign domiciled individual to offshore company

Suppose a foreign domiciled UK resident individual transfers UK assets to a non-resident foreign incorporated company.

If a purpose was to reduce IHT, the transfer is considered to be IHT mitigation. A transfer to reduce income tax (because the company pays only basic rate income tax) is considered to be IT avoidance.

## 29.34 Transfer to UK resident foreign incorporated company

There are many reasons why assets may be transferred to UK resident foreign incorporated companies.

A foreign domiciliary starting a new UK resident company for trade or investment would prefer a non-UK incorporated company so as to own non-UK situate property. This is a commercial transaction and clearly satisfies Old Condition B. New Condition B is (almost) a dead letter,[139] but in an appropriate case there is a reasonable case that New Condition A (or A and B) is satisfied.

A foreign domiciliary (F) wishing to sell a UK unincorporated business may enter into an arrangement under which:

(1) F gives the business to a UK resident foreign incorporated company.
(2) F sells the company (not UK situate property).

If the purpose is to avoid CGT (by utilising s.162 TCGA relief) then the claim for the motive defence is weak.

## 29.35 Transfer from one trust to another trust

There are many reasons why funds may be transferred between trusts. It is impossible to generalise as to whether such transfers are made for tax avoidance: one must look at the reason for the transfer.

One reason such transfers are made is where a single trust holds several sub-funds for different branches of a family. The transfer avoids the unfairness which arises under a single trust, that gains accruing to one share are taxable on a beneficiary of another share who receives a capital payment. It is considered that a transfer for this reason does not have the

139 See 29.12.3 (New Condition B).

motive of CGT “avoidance”.

## 29.36 Time to ascertain purpose of transferor

What matters is the purpose of the transferor at the time of the transfer.[140] It is quite common that a transfer is made by a foreign settlor for foreign beneficiaries, unimpeachably for non-UK tax reasons, and later some of the beneficiaries move to the UK. Then they will find the trust qualifies for the motive defence and is a useful vehicle for income tax purposes. There are three possibilities:

(1) The change of purpose may be accompanied by a new transfer of assets carried out for a tax avoidance purpose. In that case the transfer of asset provisions may apply in relation to the new transfer.
(2) There may be no further transfer of assets but there may be associated operations carried out for a tax avoidance purpose. The question whether this brings the transfer of asset rules into operation is discussed in para 29.38 (Associated operations: introduction).
(3) There may be a change of purpose without any new transfer or associated operation. In that case the motive defence remains available and the transfer of assets provisions do not bite at all.

## 29.37 Time to ascertain intention of Parliament and changes in law

The concept of tax avoidance as an act contrary to the intention of Parliament raises the question of *at what time* Parliament’s intention is to be ascertained. The intention of Parliament may change and the same act could be tax avoidance at one time but not at another. Of course, it needs an Act of Parliament to make this change. For the purpose of the motive defence, tax avoidance must mean an act contrary to the intention of Parliament at the time the transfer took place. This is consistent with the rule that one examines the purpose of the transferor at the time of the transfer.[141] Otherwise changes in the intention of Parliament would often have considerable retrospective effect: a transfer which was not tax avoidance when it was made would retrospectively be treated as made for a tax avoidance motive (or indeed vice versa).

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140 The point was made in *Herdman v IRC* 45 TC 394; but it is plain from the terms of the statute.

141 See 29.36 (Time to ascertain purpose of transferor).

Of course this rule may also favour HMRC. A transfer to avoid (say) Selective Employment Tax would fail the motive defence and that would continue to be the case even after the abolition of that tax.

A distribution or disposal made in 2007/08 to avoid the new rules in the FA 2008 from 2008/09 is not tax avoidance because (1) it is not contrary to the intention of parliament to avoid *future* tax laws: the intention of Parliament is to be determined at the date of the transfer;[142] (2) Parliament clearly anticipated and accepted that such disposals and appointments would be made and took no steps to counteract them.

### 29.37.1 *Transfer by non-resident before 1996*

Parliament decided in 1936 not to apply s.720 ITA to transfers made by non-resident transferors, and that was (after some vacillation) held to be the law.[143] 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.[144] 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.[145] The explanation is that a transfer by a non-resident before 1996 does not normally involve income tax avoidance. However, there are special circumstances where a transfer by a non-resident may be for income tax avoidance[146] and, of course, a pre-1996

142 See 29.37 (Time to ascertain intention of Parliament and changes in law).

143 See 26.5.2 (Transferor not ordinarily resident when transfer made). For convenience, non-resident is used to mean non-ordinarily resident.

144 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.

145 s.81 FA 1997. There is an exemption only for income arising before 1996.

146 Examples of special cases are:
(1) a transfer in anticipation of becoming UK resident or
(2) a transfer made just before the enactment of the new legislation (when the change of the law was predictable).
Another view could be that such transfers constitute tax avoidance from after the 1952 and 1970 consolidations, which Parliament enacted on the basis of the *Congreve* and *Herdman* decisions (later reversed) that transfers by non-residents were caught. But that offends common sense and the principle that a consolidation does not alter the law.

transfer made for CGT or IHT avoidance would also be caught.

### 29.37.2 *Transfer before 1981; transferor having no power to enjoy*

Similar considerations apply to a transfer before 1981 to which s.720 ITA did not apply (because the transferor had no power to enjoy the income of the asset transferred). Parliament decided in 1936 not to apply the transfer of asset provisions to transfers unless the transferor had power to enjoy, and that was (again after some vacillation) held to be the law.[147] So such a transfer should not constitute income tax avoidance. In 1981 Parliament brought in s.731 ITA which applied to pre-1981 transfers.[148] 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.

## 29.38 Associated operations: introduction

The motive defence is relatively straightforward when there is a single transfer. It becomes more complicated if there are also associated operations to consider. It is necessary to consider separately the cases where:

(1) The transfer and associated operations are all made before 5 December 2005 (see the next section).
(2) The transfer and the associated operations are all after 4 December 2005.[149]
(3) The transfer is before 5 December 2005 and the operation is on or after that date.[150]

## 29.39 Associated operations and motive defence before 5 December 2005

Section 739 ITA provides:

147 See 24.3 (Meaning(s) of "settlor-interested").

148 s.45 FA 1981; there is an exception for income arising before 1981.

149 See 29.40 (Transfer and associated operations both after 4 December 2005)

150 See 29.44 (Transfer before and operation after 5 December 2005).

> (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.
> (4) 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.

Old Condition A refers to any "relevant transactions" and Old Condition B refers to "the transfer and any associated operations" (which comes to the same thing).[151] I will use the expression "any associated operations".

The transfer and associated operations in issue 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.

### 29.39.1 *Associated operations subject to motive test: Critical operations*

The first task to identify the associated operations to which the motive test must be applied. For pre-2005 transactions (which are not affected by the 2006 reforms) the statute refers to "*any* associated operations" but this is a reference only to associated operations as a result of which a charge arises under s.720 or s.731 ITA. That is, in other words, the associated operations which must be relied on in order to satisfy the conditions set out in those sections. That is, the transfer and operations as a result of which:

(1) (in any case) income accrues to the person abroad; and
(2) (a) (in a s.720 case) the transferor has power to enjoy; or
(b) (in a s.731 case) the individual receives a benefit, or income can

151 Because the term "relevant transactions" is defined to mean the transfer and associated operations; see 25.10 (Significance of associated operations). The difference in the wording of old condition A and B is just a quirk of the drafting, there is no difference in meaning.

be used to benefit them.

I refer to an associated operation which meets these criteria as a "**critical operation**".

There may and generally will be many operations associated with the transfer, but unless they are critical operations they are irrelevant and should be ignored.

In *Herdman v IRC* 45 TC 394:

(1) T transferred shares to an Irish company (the person abroad) in consideration of an issue of new shares and a loan. This was an innocent transfer (the purpose was to avoid Irish tax).

(2) The company accumulated income. This was (arguably) an operation associated with the transfer, and the purpose was (then) regarded as UK tax avoidance.[152]

The motive defence was upheld. Lord Reid said:

> [1] It was admitted by Counsel that [what is now s. 720] can only apply if [T] has "by means of" these operations "acquired any rights by virtue of which" he had "power to enjoy" this income during the relevant period. I think that Counsel was clearly right in making this admission.
>
> [2] I cannot see how it can be said that [T] acquired any rights at all by means of these associated operations. By means of the transfer of the shares to the new company he acquired two rights. He acquired shares in the new company in the Republic and he became an unsecured creditor of that company for over £76,000. Neither right gave him any right in or to particular assets of the new company. The way in which that company dealt with its assets did not alter either of these rights. It may have made them more valuable and it may have made it easier for the company to pay its debts, but it did not change [T's] rights.[153]

Point [1] states the general rule (only critical operations need pass the motive test) and point [2] applies it to the facts of the case. The statement of law at [1] needs to be translated to reflect the revised statutory wording, which was recast in 1969, and rewritten in 2007, but the principle that only critical operations need pass the motive test) survived the 1969

152 After *Willoughby* the purpose should be regarded as mitigation and not avoidance.

153 45 TC 394 at p.413.

reforms.[154] In fact, I think the principle is (slightly) more clearly stated under ITA than it was under ICTA, because of the words in s.739(2): An individual is not liable for income tax under this Chapter ... *by reference to the relevant transactions* if condition A or B is met. It is only the transactions *by reference to which the TAA provisions apply* which need to meet old condition A and B.

In *Carvill v IRC*[155]:

(1) T transferred T's majority shareholding in a company to a Bermudian company (B Ltd) in exchange for shares, so T was a majority shareholder in B Ltd ("the original transfer").
(2) T became a 100% shareholder in B Ltd by (a) purchasing shares and (b) B Ltd purchasing its own shares.
(3) B Ltd entered into arrangements to remunerate T via a personal services company and a brokerage sharing agreement.

Steps (2) and (3) were held not to be associated operations, but if they had been associated operations it would not have mattered as they were not critical operations. No income arose to B Ltd because of the operations and T did not acquire a power to enjoy because of them.[156]

HMRC accept this. RI 201 provides:

> The law was amended in 1969 following a decision of the Courts (in *IRC v Herdman* 45 TC 394) that only the transfer and any associated operations giving a power to enjoy at the outset were relevant for determining whether the terms of [the motive defence] were satisfied. The amendment to the legislation sought to bring all associated operations into consideration when [the motive defence] was invoked. Because of doubts[157] expressed as to the effectiveness of this amendment, it has been the Revenue's practice in considering whether a defence under [the motive defence] is available to *consider only the transfer and any associated operations which directly establish a power to enjoy the income of the overseas person under any particular sub-head in [s 723 ITA]*.

154 See 29.40.1 (The 1969 reforms).

155 [2000] STC (SCD) 143 at [80]–[85], 75 TC 477 (Special Commissioners).

156 See [81]-[83].

157 The "doubts" were in fact a decision of the Special Commissioners on the point; see 29.40.1 (The 1969 reforms).

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)[158] 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 a critical one (since it causes income to accrue to the person abroad) so the motive defence does not apply.

Suppose:
(1) T transfers assets to a non-resident company in return for shares in that company ("the first transfer"). Suppose the first transfer is innocent (no tax avoidance purpose). Income accruing to the company is not caught by the TAA provisions as the motive defence applies.
(2) T transfers the shares in that non-resident company to a non-resident trust ("the second transfer"). The second transfer has a tax avoidance purpose.

The second transfer is an operation associated with the first. But that associated operation is not a critical operation. 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.[159]

Take the same transactions, but assume that the first transfer (to the company) had a tax avoidance motive, and the second transfer (to the trust) was innocent. Income of the company is within the TAA provisions. The motive defence does not apply. It is not enough to find an innocent associated operation. Dividends from the company to its shareholders are caught since the income arises by virtue of the tainted transfer to the company and an associated operation (the dividends).

158 See 25.11.4 (Transfer to UK trust followed by migration of trust before 6 April 2006) and 25.11.6 (Transfer to company followed by migration of company).

159 Of course income arising to the trustees as a result of the second transfer is caught by the TAA provisions. The fact that the first transfer was innocent does not help. This is self-evident but if authority is needed see the decision of the Special Commissioners in *IRC v McGuckian* [1994] STC 900. There was (wisely) no appeal on that point.

## 29.40 Transfer and associated operations both after 4 December 2005

### 29.40.1 *The 1969 reforms*

To understand the post-2005 regime, it is helpful to go back to 1969, when the first attempt at reform was made. Harold Lever (then Financial Secretary to the Treasury) argued:

> If we are to have a section [720 ITA], it has to bite on all settlements abroad which at any time are used for avoidance of tax even though originally started for innocent purpose. Supposing a man has transferred money to set-up a Bible society in Bulowayo and his heir being more sophisticated and perhaps more materialistic, finds himself with a settlement set up for unimpeachable purposes and decides that it would make a useful vehicle for the avoidance of all income tax and surtax. The *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.[160]

The example is facetious (Lever was known for his wit). The common (if less exotic) example is that:
(1) a settlement is set up by a foreign settlor for foreign beneficiaries; and
(2) subsequently beneficiaries come to the UK.
If this was not envisaged at the time of the settlement, even HMRC must concede that condition A was satisfied by the original transfer. Nothing that happened later would alter that defence. So, as Morritt LJ commented (obiter) in *IRC v Willoughby* 70 TC at p.97:

> In the FA 1969, legislation was enacted, s.33, to nullify the [Herdman] decision ... on the point.

However, the Special Commissioners rejected this in an unreported decision.[161] Thus the 1969 Act failed to achieve its intention.

160 Hansard, 17 July 1969, cols 955–6.

161 I have been unable to obtain a copy of this decision, though no doubt HMRC have it in their files. If any reader could supply a copy, it would be most helpful to see it.

### 29.40.2 *The 2006 reforms*

HMRC tried again in what I call **"the 2006 reforms"** (because they were introduced in the FA 2006, though with effect from December 2005).

Section 737(8) ITA provides:

> If—
> (a) apart from this subsection, an associated operation would not be taken into account for the purposes of this section, and
> (b) the conditions in subsections (2) to (4) [New Conditions A and B] are not met if it is taken into account, because of—
> (i) the associated operation, or
> (ii) the associated operation taken together with any other relevant transactions,
>
> it must be taken into account for those purposes.

EN Draft Clauses (2005) explained:

> certain associated operations that might potentially be disregarded when applying the [pre-2005 motive defence] have to be taken into account for the purposes of the new test. These are associated operations that have an avoidance purpose, but might not directly affect the application of the charging provisions.[162]

A post-4 December 2005 transfer which qualifies for the motive defence loses that defence if:
(1) there is an associated operation;
(2) that operation does not satisfy New Condition A or B.
Trusts and companies which qualify for the motive defence must ensure that from 5 December 2005 any acts by them meet Condition A (or Condition B if relevant). In short, they should do no act which might be regarded as having a tax avoidance purpose. It is important that new associated operations do meet the New Conditions. The transitional rules are harsh.

These conditions are extremely difficult to apply; this may be why

162 Para 62.The explanation in EN FB 2006 is more curtailed. The provision alters the former law. EN Draft Clauses (2005) claimed (outrageously) that this change was "clarifying and confirming the correct interpretation of the existing statute" but that was inconsistent with RI 201 and EN FB 2006 more or less abandoned that position.

almost 40 years passed before the second attempt to alter law established in 1969. The Blair/Brown administrations, it seems fair to say, were unaware or unconcerned about uncertainty and complexity in tax legislation, particularly anti-avoidance legislation.

### 29.40.3 *Associated operations subject to motive test: Significant operations*

The first task to identify the associated operations to which the motive test must be applied. For post-2005 transactions the statute refers to "*an* associated operation" and it is clear that some operations which are not critical operations (under the old law) are now made subject to the motive test.

The task is to identify what counts as "an associated operation" for the purposes of s.737(8) ITA. The statutory definition of associated operation does not answer this as if it is read literally it is far too wide to be workable. 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.[163] It cannot be that the Crusader's (arguable)[164] tax avoidance purpose would prevent the transfer in 2000 from qualifying for relief!

There must obviously be some connection between the associated operation, and the transfer: the mere fact that they relate to the same property cannot be enough. The position is reminiscent of the Settlement Provisions which define "settlement" as including any disposition, leaving the Courts to devise their own test for what is caught (in that case, the Courts eventually settling on a "bounty" test).

Here, it is suggested, the test that the Courts ought to impose should be that the transfer and associated operations form part of one arrangement, or are "put in train" by the transferor.[165] I refer to associated operations which meet that requirement as **"significant operations"**. Thus all significant operations must satisfy new conditions A and B, in order to qualify for the motive defence.

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163 See 25.9 (Associated operation: definition).

164 Feudal duties would be "taxation"; see 29.9 (Meaning of "taxation" in the motive defence). 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?).

165 See 25.11.1 (Transfer from A to B followed by transfer from B to person abroad).

In short, in my terminology the effect of the 2006 reforms is to extend the motive test from critical operations to significant operations.

## 29.41 When do associated operations have a tax avoidance purpose?

Note the extreme consequences of an associated operation motivated by tax avoidance. Even if the associated operation concerns only a small amount, the *entire* trust may lose the benefit of the motive defence. This unfairness ought to colour the approach of the courts to construing the section.

### 29.41.1 *Investment strategy*

Buying and selling investments in the ordinary course of managing investments is not tax avoidance.

Suppose trustees wish to invest in UK equities, but do so via a UK unit trust or OEIC in order to hold property which is excluded property for IHT. The acquisition of a unit trust or OIEC is not tax avoidance. It is considered that the position is the same if the trustees acquire a non-UK unit trust or OEIC to avoid UK source income.

Suppose a trust, all of whose beneficiaries are abroad, wishes to invest in UK land. The trustees invest via a trust company in order to avoid inheritance tax and the trust rate of income tax on the rent. It is suggested that this is mitigation rather than avoidance. If this is not the case, then the effect on the UK economy could be quite remarkable. It would often be the case that well advised trustees would avoid investing in UK land in order to retain the motive defence. On the other hand, if the land was purchased using an artificial SDLT avoidance scheme, that would be caught.

### 29.41.2 *Distribution strategy*

It is considered that retention of income within a company is not an "operation" but even if it is, it would not be tax avoidance. It is considered that accumulation of income in a common form discretionary trust[166] is not an "operation" but even if it is, it would not be tax avoidance.

Suppose a discretionary trust is within the motive defence. A foreign domiciled beneficiary (not the settlor) is UK resident. If the trustees pay capital to that beneficiary instead of distributing income, in order to avoid an IT charge, this is not tax avoidance. If the trustees lend to the beneficiary interest free in order to avoid an income receipt or reduce the amount of a capital payment, this is not tax avoidance. If the loan is at interest, to avoid a capital payment, this is not tax avoidance. An arrangement might be avoidance if trustees lend unsecured to a beneficiary in circumstances where the beneficiary is either insolvent or so lacking in assets that the beneficiary is not in practice ever likely to be able to repay the sum lent.[167]

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.[168]

Suppose a discretionary settlor-interested trust is within the motive defence, and the settlor comes to the UK. The trustees retain trust income abroad (if it was remitted to the UK there would be a tax charge under the s.624 remittance basis). This is not tax avoidance.

Suppose a non-resident company owned by a non-resident individual pays a large dividend the year before the individual becomes UK resident. That is not tax avoidance.[169] But if the individual lends the proceeds back to the company, that is a circular and artificial transaction, and the loan may be regarded as for a tax avoidance purpose.

### 29.41.3 *Inter-group transactions*

For company group transactions, it is useful to refer to the "white list" of

166 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".

167 Alternatively the loan in such a case may in fact be categorised as an outright distribution.

168 Alternatively the distribution may in fact be categorised as income.

169 That will be clearer from 2012/13 when the temporary non-resident rules govern this area.

transactions which HMRC accept as outside para 2(4A) Sch 7 FA 2003[170] (so they qualify for SDLT group relief). Para 23040 SDLT Manual provides:

> **23040. Restrictions on availability Paragraph 2(4A) Schedule 7 FA 2003** [September 2006]
> ... This guidance gives some examples of transactions where it is accepted that group relief is not denied by Para 2(4A) Schedule 7 FA 2003.
> It should be noted that the examples are intended only to give general guidance and do not use technical or statutory language, nor should they be interpreted as if they were a statute.
> They also assume that the transactions described do not form part of any larger scheme or arrangement which might have tax consequences....
> Examples of transactions where group relief is not denied by Para 2(4A) Schedule 7 FA 2003
> (1) The transfer of a property to a group company having in mind the possibility that shares in that company might be sold more than three years after the date of transfer
> (2) The transfer of a property to a group company having in mind the possibility that shares in that company might be sold within three years of the date of transfer, with a consequent claw-back of group relief, in order that any increase in value of the property after the intra-group transfer might be sheltered from SDLT
> (3) The transfer of property to a group company having in mind the possibility that either (1) or (2) might occur
> (4) The transfer of a property to a group company prior to the sale of shares in the transferor company, in order that the property should not pass to the purchaser of the shares
> (5) The transfer of property to a group company in order that commercially generated* rental income may be matched with commercially generated losses from a Schedule A business
> (6) The transfer of property to a group company in order that commercially generated* chargeable gains may be matched with

170 This provides:

> Group relief is not available if the transaction—
> (a) is not effected for bona fide commercial reasons, or
> (b) forms part of arrangements of which the main purpose, or one of the main purposes, is the avoidance of liability to tax.
> "Tax" here means stamp duty, income tax, corporation tax, capital gains tax or [SDLT].

commercially generated allowable losses

(7) The transfer of property to a non-resident group company in the knowledge that future appreciation or depreciation in value will be outside the scope of corporation tax on chargeable gains

(8) Transactions undertaken as part of a normal commercial securitisation

(9) The transfer of the freehold reversion in a property to a group lessee in order to merge the freehold and the lease, and thus prevent the lease being subject to the wasting assets rules as respects corporation tax on chargeable gains

(10) The transfer of property to a group company in order that interest payable on borrowings from a commercial lender on ordinary commercial terms may be set against commercially generated* rental income

(11) Borrowings on ordinary commercial terms
   (a) from a commercial lender, or
   (b) intra-group in circumstances which would have been commercial had they arisen between unconnected third parties

*Including income, gains and losses which are generated intra-group on transactions which would have been commercial had they been entered into by unconnected third parties

"Transfer" means the transfer of a freehold, in Scotland ownership of land, or the assignment, in Scotland assignation, of a lease.

Cases involving the grant of a lease will need to be considered on their facts.

It is difficult to take point (7) seriously, but even apart from that, it is clear that HMRC do not strain to classify ordinary tax planning as avoidance.

## 29.42 Consequences of tainted operation

Where there is a tainted operation associated with a transfer, all the income arising as a result of the transfer in principle comes within the scope of ss.720 and 731. 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[171] because of section 720 or 727 for a tax year (the "taxable year") because condition B in section 737(4) (genuine commercial transaction: post-4 December 2005 transactions) is not met, and
(b) subsections (2) and (3) apply.

The relief only applies for s.720 (and 727) and not for s.731 ITA. Section 741 continues:

(2) This subsection applies if—
(a) since the relevant transfer there has been at least one tax year for which the individual was not so liable by reference to the relevant transactions effected before the end of the year, and
(b) the individual was not so liable for that year because—
(i) condition B in section 737(4) was met, or
(ii) condition B in section 739(4) (genuine commercial transaction: pre-5 December 2005 transactions) was met.

The relief only applies if Condition B is satisfied; not if Condition A is satisfied. In practice 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,[172] and
(b) partly to associated operations not falling within para (a).

Assuming the conditions of s.741 are satisfied one moves on to the relief in s.742:

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171 "Liable to tax" is defined in s.741(5) ITA:
"References in this section to a person being liable to tax for a tax year because of section 720 or 727 include references to the individual being so liable had any income been treated as arising to the individual for that year under section 721 or 728."

172 Defined in s.741(4) ITA:
(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.
...

> (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.

The drafter has given up here.

## 29.43 Income arising before tainted operation

This section considers how the TAA provisions apply where an innocent post 4-December 2005 transfer is followed by a tainted operation subsequently.

The position where a pre-5 December 2005 transfer is followed by a tainted operation on or after 5 December 2005 raises additional issues discussed at 29.44 (Transfer before and operation after 5 December 2005).

### 29.43.1 *Income before tainted operation: s.720*

Suppose:

(1) an innocent transfer is made on or after 5 December 2005, and
(2) an associated operation made today fails the New Conditions ("the tainted operation").

At first sight *all* income back to the date of the transfer comes into charge under s.720 ITA.[173] HMRC say in a letter dated 7 April 2006 to the representative bodies that only income of the year in the year of the tainted operation and subsequent years is charged:

> **Transitional arrangements, whether income charged retrospectively**
> Representation: It is suggested that the transitional arrangements of

173 In practice HMRC would be limited to a four year period.

> [s.740 ITA] have the effect that income could be brought into charge retrospectively. [Section740(4) ITA] could be interpreted as meaning that if an associated operation after 5 December 2005 fails the exemption test in [s.737 ITA], all of the income arising from 5 December 2005 could be charged (even where the subsequent associated operation takes place many years later).
> Response: The legislation does not apply retrospectively in the manner suggested. [Section 741C ICTA][174] provides the general rule that section [720] applies in this type of case as it would apply apart from section [736 to 742 ITA]. In those circumstances section [720] would take the income arising in the relevant year of assessment.

This is far from clear in the legislation, but it is a sensible result.

### 29.43.2 *Income before tainted operation: s.731*

Suppose:

(1) An innocent transfer was made on or after 5 December 2005.
(2) A tainted associated operation is made subsequently.
(3) An individual (not the transferor) receives a benefit in the same year as the associated operation or subsequently.

The individual 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 to work.

174 Now s.740(3) ITA. The wording is not quite the same, but that has not altered the position.

## 29.44 Transfer before and operation after 5 December 2005

Section 740 ITA provides:

> (1) This section applies if the relevant transactions include both pre-5 December transactions and post-4 December transactions.
> (2) An individual is not liable to tax under this Chapter for the tax year by reference to the relevant transactions if—
> (a) the condition in section 737(2) (exemption where all relevant transactions are post-4 December 2005 transactions) is met by reference to the post-4 December 2005 transactions, and
> (b) the condition in section 739(2) (exemption where all relevant transactions are pre-5 December 2005 transactions) is met by reference to the pre-5 December transactions.

Thus in principle one applies the New Conditions to post-4 December 2005 transactions and the Old Conditions to pre-5 December 2005 transactions.

An important question is whether the motive defence test must be met:
(1) by all significant associated operations; or
(2) only by critical operations (my terminology).
At first s.737(8) ITA appears to answer the question,[175] but it does not, because s.737(1) provides:

> This section applies if all the relevant transactions are post-4 December transactions.

It is suggested that the *Herdman* principle still applies to pre-5 December 2005 transfers even if the operation takes place subsequently. That is, only critical associated operations have to pass the motive test and other associated operations are ignored. This does not deprive s.740 ITA of meaning, for it now governs the position where there are post-4 December 2005 critical operations. For instance, suppose:
(1) there was a transfer to a UK trust (an innocent transfer) before 5 December 2005;
(2) non-resident trustees are appointed (a critical association operation) post-4 December 2005.

175 See 29.40.2 (The 2006 reforms).

In deciding whether the motive defence applies one asks whether the associated operation satisfies New Conditions A and B.

The position is not clear cut and HMRC could make the following points:

(1) Section 740(2)(b) incorporates s.737(2) the New Conditions A and B, but by doing so it necessarily incorporates s.737(3) to (7) which supplement s.737(2). So it is possible to say that s.740(2)(b) also incorporates s.737(8).

(2) The transitional rules in s.740, see below, arguably make better sense if s.727(8) is applied. But the rules are so harsh that it is suggested that the taxpayer-favourable construction is to be preferred.

### 29.44.1 *Transitional rules*

Section 740(3) ITA provides:

> If subsection (2)(b) applies but subsection (2)(a) does not, this Chapter applies with the modifications in subsections (4) to (6).

This brings in three transitional rules where:

(1) the pre-5 December 2005 transactions met the Old Conditions; but

(2) post-4 December 2005 transactions do not meet the New Conditions.

The provision in s.740(4) ITA is not discussed because it was spent even before the ITA took effect; see the 9th edition of this work para 28.44.2.

### 29.44.2 *Transitional rule: s.731*

Section 740(5) ITA provides a transitional rule for s.731 ITA:

> In determining the relevant income of an earlier tax year for the purposes of section 733(1) (see Step 4),[176] 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.

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176 See 27.12 (Computation of charge).

(3) An individual (not the transferor) receives a benefit in the same year as the associated operation or subsequently.[177]

The beneficiary is taxable under s.731 ITA by reference to all the relevant income from the date of the transfer (or from 1981, if later). This harshly retrospective rule was actually intended. EN FB 2006 para 33 provides:

> [The effect of s.740(5) ITA is:] for the purposes of [s.731 ITA] where the individual receives a benefit in a year of assessment ending after 5 December 2005, the process of determining relevant income under the general rule for years up to and including that year must take account of relevant income that arose in years of assessment ending before that date, as well as later years.

It will often be impossible for the quantum of relevant income to be ascertained exactly, as the records will not exist. But the issue may in practice be fudged by agreement with HMRC.

Section 740(6)(7) ITA which deal with this were also spent before ITA took effect; see the 6th edition of this work para 19.48.3.

## 29.45 Tax return: disclosure of motive defence claim [178]

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 any tax return on the basis that the motive defence applied; one was not required to prove the motive defence applied to the satisfaction of the Board before completing the tax return on that basis. However, if an individual completes a self assessment return, it has been necessary since 1998/99 to indicate on that return that they have taken advantage of the motive defence.[179]

In the 2010/11 tax return, notification that the motive defence is in point

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177 There is no charge if the benefit is received in a tax year before the operation: see 29.43.2 (Income before tainted operation: s.731).

178 See also for s.720 income, 26.16 (Tax return disclosure) and for s.731 income, 27.39 (Tax return disclosure).

179 RI 201 notes this point:
"Taxpayers are required to disclose clearly in their self-assessment return if there is any income or benefit assessable under [the TAA provisions], and whether reliance is being placed on [the motive defence] to exclude income or benefit from assessment."

is given by completing box 46 in the Foreign pages (form SA106). The words next to box 46 state:

> If you have omitted income from boxes 11, 13 and 42 because you are claiming an exemption in relation to a transfer of assets, enter the total amount omitted (and give full details in the 'Any other information' box on your tax return)

It is only correct to complete box 46 if the motive defence is needed. It is not correct to complete the box if the TAA provisions do not apply to impose a charge for some other reason, such as the remittance basis, because that is not an "exemption".[180]

The International Manual provides:

> **600040 - Transfer of assets abroad** [October 2010]
> **Overview of ITA2007/S736 - 742 - exemption from liability**
> ...There is no provision for a "clearance" or other advance ruling on the application of the exemption provisions. Details of the amount considered to be exempt from charge should be entered on the Foreign Pages of the Self Assessment tax return. In the "white spaces" of the return, the individual should enter particulars of transfers and associated operations that would result in a charge absent an exemption, and provide factual details about the transaction explaining the basis for considering a condition for exemption to be met.

There is strictly no legal obligation to give precise figures or indeed any figures for the income which (assuming the claim is valid) will not be

180 HMRC take this view. HMRC Foreign Notes (SA106 notes 2010/11) provide: "Box 46 If you have omitted income from boxes 11, 13 and 42 because you are claiming an exemption in relation to a transfer of assets, enter the total amount omitted. The provisions described at boxes 10 to 13 and 42 do not apply if you can show from all the circumstances that none of the purposes of the transfer and any associated operations was to avoid tax. But an exemption is only due if actual income would otherwise be chargeable. If you omit income *for this reason* from boxes 11, 13 and 42, you must enter the total amount of income you have omitted in box 46. You must also provide relevant details and an explanation in the 'Any other information' box of your tax return, or on a separate schedule, including details of the assets transferred and any associated operations, the person abroad concerned, the circumstances of the relevant transactions and the basis for your claim to exclusion."

taxable. However, a failure to give figures will no doubt lead to further enquiries. If estimated figures are given, this should be stated. On the occasion when the claim is first made, sufficient details should be given for HMRC to review the case. Once a claim is agreed, I see no reason to give any details at all in subsequent tax returns. I suggest the words "n/r" be put in box 46 and a note in the additional information section states that since the claim was agreed, no information need be provided as it is irrelevant.

It often happens that the box is left blank when it should be completed, as the need to do so in this very complicated area is overlooked. There is no tax penalty, provided the claim is valid, as no additional tax is thereby due. It is suggested that the box should be completed on the next tax return, with a note in the "additional information" box to explain the position.

### 29.45.1 *HMRC action when motive defence box is completed*

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 explains HMRC's administrative arrangements for dealing with a claim:

> **600050 - Transfer of assets abroad** [October 2010]
> **Mandatory referral to CAR Trusts & Estates Bootle**
> CAR Trusts & Estates (Technical) Bootle is responsible for the operation of the legislation contained in Chapter 2 Part 13 ITA 2007, the provision of Technical Advice thereon and any litigation involving transfer of assets legislation.
> All enquiry work involving possible application of the transfer of assets legislation is undertaken by or in conjunction with the specialist team in CAR Trusts & Estates (Compliance) Bootle. Special Investigations offices and CAR High Net Worth Units also undertake review work in this area in relation to cases handled by them.
> The individual Self Assessment tax return will often be the first point

> of identification of cases where the legislation may apply, and as such those handling receipt of returns have a vital role to play in identifying potential application of this legislation. Offices should not however attempt to determine liability to the Income Charge or the Benefits Charge or discuss the application of the provisions with agents without first contacting CAR Trusts & Estates Bootle.
> Any case in which it is identified that transfer of assets does or may apply must be referred to CAR Trusts & Estates (Technical) Bootle who will arrange any necessary risk assessment of the case and advise on whether and how this aspect is to be taken forward.
> CAR HNWU and Special Investigations offices do not have to make a referral of their own cases in accordance with the previous paragraph but should consult with CAR Trusts & Estates (Technical) Bootle for advice as necessary, and in every case where litigation may be a possibility....
> **(This text has been withheld because of exemptions in the Freedom of Information Act 2000)**
> You must also submit your papers if you receive an application to exemption from liability under 'Income Charge' or 'Benefits Charge' . You should not enter into correspondence with the taxpayer or his agent on the application of the exemption provisions. Any enquiry from a taxpayer or professional adviser about the scope and effect of the legislation, or its application to a particular taxpayer, should be referred directly to CAR Trusts & Estates (Technical) Bootle.

In practice, expect an enquiry to be opened unless the issue has been resolved in earlier years.

## 29.46 Dealing with HMRC enquiries

The individual must "satisfy an officer of the Revenue and Customs" that Condition A or B is met.[181] This imposes the burden of proof on the taxpayer. That makes no difference as the burden of proof generally rests on the taxpayer, and in any event, disputes are rarely decided by the burden of proof.[182]

Contemporary correspondence and background documentation may be relevant to the factual issue of whether the transferor had the purpose of

181 ss. 737(2), 739(2) ITA.
182 See 2.4.3 (Proof of intention).

reducing tax. It will not shed much light on the issue of whether the purpose should be classified as avoidance or mitigation. Some factors such as confidentiality or tax related agreements may shed light on this, or at least, on whether the parties regarded the matter as tax avoidance.[183] 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.

## 29.47 Appeals

Section 751 ITA provides:

> On any appeal that is notified to the tribunal, the jurisdiction of the tribunal includes jurisdiction to affirm or replace any decision taken by an officer of Revenue and Customs in exercise of the officer's functions under—
> (a) section 737 (exemption: all relevant transactions post-4 December 2005 transactions),
> (b) section 738 (meaning of "commercial transaction"),
> (c) section 739 (exemption: all relevant transactions pre-5 December 2005 transactions),
> (d) section 742 (partial exemption where later associated operations fail conditions),
> (e) section 743(2) (no duplication of charges: choice of persons in relation to whom income is taken into account).

183 See 29.16.4 (Other indicia of tax avoidance).

The wording makes clear that jurisdiction of the tribunal is appellate and not supervisory. The wording of New Conditions A and B ("not be reasonable to draw the conclusion ...") does not impose a *Wednesbury* unreasonableness test.

A decision of the tax tribunal is, on ordinary principles, binding on the parties (subject to an appeal) only in relation to the assessments under appeal. It does not bind the parties in other respects, and in *Carvill v IRC* [2000] STC (SCD) 143, a Special Commissioner allowed a motive defence appeal even though a previous appeal relating to earlier years had been decided against the taxpayers. The taxpayers then sought to recover from HMRC the tax paid under the earlier assessments, but this rightly failed. There must be some finality in tax, even when wrong decisions are reached by the courts. See *Carvill v IRC (No. 2)* [2002] STC 1167 and *R (on the application of Carvill) v IRC* [2003] STC 1539. That issue will rarely, if ever, arise again in practice.

A more common problem is where tax has been paid under the TAA provisions for a number of years without consideration being given to the motive defence, and then it occurs to a taxpayer that a motive defence is applicable. It is considered that the principle in *Carvill (No. 2)* only applied where a motive defence had been litigated and decided by the tribunal, and in the absence of litigation on the point it should be possible to put in an error or mistake claim under usual principles.

An appeal will be made by the individual subject to tax (not the trustees or company within s.731 ITA who have no *locus standi*). If the trustees fund an appeal by the individual against assessment under s.731, will that funding constitute a benefit? (If so it will in turn be subject to income tax under s.731 if the appeal is unsuccessful?) The answer depends on the facts. If the reason the trustees fund the appeal is in order to sort out their tax planning for the future, or in order to benefit other beneficiaries, then no taxable benefit is received by the appellant, the benefit is received by all the beneficiaries and there is no rational means of apportionment. At the other extreme, if the trust fund is (more or less) wound up by a capital payment, and the appeal procedure is specifically to benefit one beneficiary, then the trustees financing the appeal would constitute a benefit.[184]

184 Or else it may be subject to CGT as a capital payment.

## 29.48 Can an individual disclaim the motive defence?

An interesting question (which would have surprised those who framed the transfer of asset provisions) is whether it is possible for an individual to disclaim the motive defence. There are at least two circumstances where the application of the TAA provisions may reduce a tax charge:

(1) A UK resident transferor who receives a distribution from a non-resident company may be more lightly taxed under s.720: they are 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.

(2) A UK domiciled and resident beneficiary who received a capital payment from an offshore trust would until 2008/09 prefer to be taxed under s.731 than under s.87 TCGA, which may apply if s.731 does not, because the IT rates (40%) were lower than the effective CGT rates (64%).

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 surprising result that a transfer for tax avoidance may be less harshly taxed than one which was not.

However, this view would cause considerable difficulties. Suppose a non-resident trust has relevant income of £1m and trust gains of £1m, and capital payments of £1m are made in Year 1 to beneficiary A and in Year 2 to beneficiary B. A and B are both resident and domiciled in the UK. Suppose the trust is in principle within the motive defence because the transfer to it was not for tax avoidance purposes. Before 2008/09 A would probably wish to disclaim the motive defence, if A could, so the capital payment to A was subject to income tax, and they avoided the s.87 interest surcharge. However, it would be in the interest of B to argue that the motive defence did apply, so that the payment to A "washed" the capital gain and the payment to B was tax free. It is evident that the offshore trust rules simply do not work if the motive defence can be disclaimed by one beneficiary and claimed by another. Nor do they work fairly if it can be disclaimed by one beneficiary in a manner which binds all the others. So the better view is that the motive defence (if applicable on the facts) is compulsory and binds all parties.

The same applies where it suits HMRC to argue that the motive defence is satisfied, and the taxpayer argues that it is not. This in fact happened in *Swift v HMRC* where HMRC successfully argued that the motive defence applied.[185]

## 29.49 Motive defence: commentary

The reader who studies this long and difficult chapter will almost certainly agree with the author that the 2006 reforms were wrong headed in policy though clumsy drafting adds its mite to the confusion.

What should be done? The best solution would be to return to the (relatively) simple pre-2006 position.

185 The taxpayer argued unsuccessfully that he had a tax avoidance purpose, but did not take the point that the motive defence could be disclaimed: [2010] SFTD 553 at [22] - [28]. The case is not yet final.

CHAPTER THIRTY

# LIFE POLICIES AND CONTRACTS

## 30.1 Policies – Introduction

This chapter considers:
(1) policies of life insurance,
(2) life annuity contracts, and
(3) capital redemption policies.

ITTOIA refers to these as "policies and contracts" but I abbreviate the expression to **"policies"**.[1] The asset is often described in the insurance industry as a bond; statute has adopted that term in the expressions "personal portfolio bond" and "guaranteed income bond". I prefer not to use the word bond since it is also used to describe debentures and indeed strictly includes any obligation undertaken by deed.

Policies fall within Chapter 9 Part 4 ITTOIA, sometimes called the "chargeable event" regime. This contains almost 100 sections and is, I think, the longest chapter in ITTOIA. The reader will not be surprised if I say that a full discussion needs a very long book to itself. This chapter focuses on the matters closest to the theme of this work.

The provisions are sometimes very crude. Partial surrender is a particular

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1 A note on terminology. IPT Manual provides:
**1115 Fundamental Concepts: what is a life policy** [February 2008]
The word policy in connection with insurance has a long history. It is the formal document in which an insurer (that is, insurance company or friendly society) sets out the terms of its obligations in consideration of the stipulated premiums. For an insurance contract to be made, or varied, between an insurer and policyholder requires the completion of the standard contract law offer and acceptance. There is no practical distinction between contract and policy; the latter simply evidences the former. Lord Donaldson confirmed this in the judgment referred to at IPTM1110. [*Scher v Policyholders Protection Bond* [1994] 2 AC 57.]

trap.[2] This is the only place I have seen in the HMRC Manuals where districts are warned "not to attempt any discussion or explanation as to the equity of the treatment for tax".[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. This is popularly called a life insurance wrapper.

On situs for IHT see 70.19 (Insurance policy); on situs for CGT see 71.15 (Insurance policy).

The taxation of policies held by UK resident companies is not discussed.

## 30.2 Policies – definitions

### 30.2.1 *Meaning of "life insurance"*

The definition of life insurance[4] needs a long chapter to itself. IPT Manual provides:

> **1115. Fundamental concepts: what is a life policy?** [February 2008]
> According to the 1774 Life Assurance Act, a policy of life insurance is an insurance policy on life. There is no further definition in the Taxes Acts. If a policy pays benefits on the death of an individual, either whenever it happens, or within a specified term, then it is potentially within the scope of the chargeable event legislation.

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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 In the former Assessment Procedures Manual para 3147a (withdrawn in 2009).

4 A note on terminology. The General Insurance Manual provides

"**1060. Legal basis of insurance: Indemnity** [January 2009]
It used to be said that there was a distinction between
[1] insurance, meaning insurance against a financial loss, and
[2] assurance, meaning the assurance of a fixed or minimum sum upon the occurrence of a specified event that is bound to occur.
The text of the [Policies of Assurance] Act 1601, however, shows that the term "assurance" was applied to what is manifestly indemnity insurance. More recently the distinction has faded further under the influence of the EU, where the official English texts of the relevant Directives consistently use the term "life insurance". For most practical purposes therefore insurance and assurance can be treated as interchangeable terms. In the Taxes Acts, however, the term "assurance" is usually confined to life business.

It is not relevant for tax purposes that such a policy may also provide insurance against other risks, such as disability and critical illness, although that might affect its regulatory or accounting treatment.
Funeral plan contracts where a customer pays a sum to a funeral provider to provide a funeral in due course are not contracts of insurance, although similar arrangements if made with an insurer as a whole of life policy are, according to the regulatory rules of the Financial Services Authority (FSA).[5]

## 30.2.2 *Meaning of "capital redemption policy"*

A full discussion of the term "capital redemption policy" (defined in s.473(2) ITTOIA) is not attempted here. IPT Manual provides:

**1120. Fundamental concepts: what is a capital redemption policy?**
Capital redemption policies, though issued by insurance companies, are not strictly speaking insurance products. They were once known as investment bond contracts, which is more descriptive but needs to be distinguished from the type of life policy investment bond described at IPTM1100. Under capital redemption policies, one or more fixed sums is paid to an insurer under a contract pursuant to which one or more specified amounts is paid out at some later time or times, on the basis of an actuarial calculation. Typically the contracts take the form of

- an annuity certain, where a capital sum is used to buy an annuity for a fixed term not contingent on life, see IPTM4200, or
- a sinking fund where regular sums are paid in to secure a capital sum at some later date, for example against the need to find a premium payment to renew a lease.

The statutory definition of capital redemption business is at Section 458(3) ICTA 1988. Contracts within such business are long term insurance business but not life business. A capital redemption policy that creates a debtor/creditor relationship, with an agreement to return the sum advanced, is known as a capital redemption bond and is similar in nature to a relevant or deeply discounted security, see SAIM3000. However, such bonds, which may only be sold by an insurer, are removed from the scope of the deeply discounted securities income tax charge of Section 427 ITTOIA onwards.[6]

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5 There is also an interesting discussion in the General Insurance Manual para 1010, not set out here for reasons of space, and in part 7 of the Law Commission paper "Insurable Interest" (14 January 2008).

6 See too the explanatory notes to the draft legislation published in the Pre-Budget Report, 5 December 2005:
15. A capital redemption policy is a contract, issued by an insurer, which is made in the course of capital redemption business. Under a capital redemption policy, for consideration of a sum or sums of money, the issuer of the policy guarantees to pay out a larger sum on a specified future date or to make a series of payments. Payment is independent of any contingency linked to human life.

### 30.2.3 *Meaning of "annuity"*

A full discussion of the term "life annuity" (defined in s.473(2) ITTOIA) is not attempted here. IPT Manual discusses the meaning of "annuity", a word used in many tax contexts:

> **1130. Fundamental concepts: what is an annuity?**
> There is no single definition in the taxes acts. There is an ancient definition in Stroud's Judicial Dictionary, quoting Coke on Littleton:
>
> > An annuity is a yearly payment of a certaine summe of money granted to another in fee, for life, or yeares, charging the person of the grantor onely.
>
> From an early case called *Foley v Fletcher*[7] the judgment of Watson B at 784-5 is often quoted:
>
> > But an annuity means where an income is purchased with a sum of money, and the capital has gone and has ceased to exist, the principal having been converted into an annuity.
>
> From this and other cases, notably *Southern-Smith v Clancy*, 24 TC 1, the following factors emerge as needing to be present
> - the payments must be made under a legal obligation
> - those payments must be 'pure income profit'
> - they must be capable of being characterised as 'annual', so being capable of recurrence on a periodic basis by reference to an annual time frame
> - the purchase sum must pass absolutely to the provider
> - no debtor/creditor relationship is created in relation to that sum; it is replaced by the annuity
> - the annuitant's only right is to demand payments when due
> - the payments must not be instalments of pre-existing debt.

### 30.2.4 *Rights, parts and shares*

Section 464(3) ITTOIA provides:

> If there has been a surrender or assignment of only a part of or share in

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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.

7 (1858) 157 ER 678; 28 LJ Ex 100; 3 H & N 769 accessible *www.commonlii.org/uk/cases/EngR/1858/1107.pdf*

rights under the policy or contract, the references in this section and those sections to the rights are references to that part or share.[8]

ITTOIA EN comments:

> 417. *Subsection (3)* provides that references in sections 464 to 467 to a surrender or assignment of rights refer, where appropriate, to a surrender or assignment of a part of, or share of, the rights. A *part* of the rights means one or more discrete rights provided by the policy or contract. A *share* in the rights means part of the ownership, where there are multiple owners, of such a discrete right or rights or of all the rights in the policy or contract.

## 30.3 Outline of provisions

ITTOIA EN summarises the layout of the provisions:

> 409. The Chapter is laid out as follows-
> • charge to tax under Chapter 9 (sections 461 to 463)
> • person liable etc. (sections 464 to 472)
> • policies and contracts to which Chapter 9 applies (sections 473 to 483)
> • when chargeable events occur: general (sections 484 to 490)
> • calculating gains: general (sections 491 to 497)
> • part surrenders and assignments: periodic calculations and excess events (sections 498 to 509)
> • transaction-related calculations and part surrender or assignment events (sections 510 to 514)
> • personal portfolio bonds (sections 515 to 526)
> • reductions from gains (sections 527 to 529)
> • income tax treated as paid and reliefs (sections 530 to 538)
> • deficiencies (sections 539 to 541)
> • supplementary (sections 542 to 546)

### 30.3.1 *The charge*

The charge is in s.461(1) ITTOIA:

8 This is repeated in s.468(6) ITTOIA. (If s.464(3) had ITTOIA-wide application this would have been unnecessary.)

> Income tax is charged on gains treated as arising[9] from policies and contracts to which this Chapter applies.

Section 463(1) ITTOIA provides:

> Tax is charged under this Chapter on the amount of the gains arising in the tax year.

### 30.3.2 *Policies and contracts to which provisions apply*

This takes us to s.473(1) ITTOIA:

> This Chapter applies to—
> (a) policies of life insurance,
> (b) contracts for life annuities, and
> (c) capital redemption policies.

Sections 478–483 ITTOIA (not discussed here) specify various types of policies to which the provisions do not apply.

### 30.3.3 *When gains arise*

Section 462(1) ITTOIA provides:

> For the purposes of this Chapter, a gain from a policy or contract arises when a chargeable event occurs in relation to the policy or contract (see section 484).

For full surrenders the gain arises in the tax year of the surrender. For partial surrenders the gain arises in the tax year of the policy anniversary.

### 30.3.4 *Chargeable event*

"Chargeable event" is a label which brings in a complex set of rules.

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9 The general usage of the tax legislation is that chargeable gains "accrue" but income "arises". In the chargeable events legislation, gains are regarded as income and so the word used is "arise". There is no difference in meaning.
Under the chargeable events legislation gains are sometimes said to "arise" and sometimes described as "treated as arising".

Section 484(1) ITTOIA sets out the starting point:

> The following are chargeable events—
> (a) in the case of any kind of policy or contract—
> (i) the surrender of all rights under the policy or contract,
> (ii) the assignment of all those rights for money or money's worth,
> (iii) the falling due of a sum payable as a result of a right under a policy or contract to participate in profits, if there are no remaining rights under it,
> (iv) a chargeable event treated as occurring under section 509(1) (chargeable events in certain cases where periodic calculations show gains),
> (v) a surrender or assignment treated as a chargeable event under section 514(1) (chargeable events where transaction-related calculations show gains), and
> (vi) a chargeable event treated as occurring under section 525(2) (chargeable events where annual personal portfolio bond calculations show gains),
> (b) in the case of a policy of life insurance, a death giving rise to benefits under it,
> (c) in the case of a policy of life insurance or a capital redemption policy, its maturity,
> (d) in the case of a contract for a life annuity which provides for the payment of a capital sum on death, the death, and
> (e) in the case of a contract for a life annuity which provides for a capital sum to be taken as a complete alternative to the annuity payments (or any further annuity payments), taking the capital sum.

Thus there are ten types of chargeable event. They fall into two categories:

(1) **Calculation events.** Section 491(4) ITTOIA provides the terminology:

> In this Chapter—
> "calculation event" means an excess event, a part surrender or assignment event or a personal portfolio bond event,

Thus there are three types of calculation event: Section 491(4) then defines these three types:

[a] "excess event" means a chargeable event within section 509(1),

[b] "part surrender or assignment event" means a chargeable event within section 514(1), and

[c] "personal portfolio bond event" means a chargeable event within section 525(2).

The terminology of [a] and [b] is unhelpful, but it is hard to think of better labels for the tortuous rules in ss.509 and 514. Calculation events are therefore within s.484(1)(a)(iv), (v) or (vi).

(2) Other events: that is, chargeable events other than calculation events. It is useful to have a label for these, but no short label fits the bill. I call them "**the seven disposal-events**", because these events are disposals (in the natural sense or at least in the CGT sense of the word).

Sections 484-489 ITTOIA contain exemptions. These are not discussed here, but s.487 is important because it contains an exemption for inter-spouse transfers (based on the CGT spouse exemption).

Logically there should be two stages, first to ascertain whether there is a chargeable event and secondly to compute the gain. But the two stages overlap, because in three calculation event cases the question of whether there is a chargeable event depends on whether there is a gain.

It should be noted that an assignment for no consideration is not a chargeable event. This is the opposite of the CGT position.

### 30.3.5 *Computation of gains*

The computation of gains is complex and artificial and often bears no relation to the commercial gain. It is not the same as the computation of gains for CGT purposes, so one must take care not to confuse chargeable gains (the CGT term) and gains under the chargeable events legislation. It is confusing that the legislation calls them both "gains". The term "**chargeable event gains**" is useful when one needs to distinguish the two types of gains.

There are five different methods of computation for different types of chargeable events. The computation rules are not discussed here.

SA904(Notes) (headed Notes on Trusts & Estate Foreign for the year ended 5 April 2010) comments on how to deal with foreign currency gains:

> Gains on foreign life insurance policies, life annuities and capital redemption policies should be calculated in the currency in which the policy or life annuity is denominated and the gain converted into sterling at the rate of exchange applicable at the time of the chargeable event (which may not be at the time the transaction occurred).[10]

This is different from method of computation of chargeable gains.

Once one has identified a chargeable event, and computed the chargeable event gain, the next stage is to ascertain the person liable for the charge.

## 30.4 Liability of individuals and individual "creators"

Section 465(1) ITTOIA provides:

> 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.

I call these "**individual bond conditions A to C**" to distinguish them from the myriad other conditions in ITTOIA.

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10 Similarly, the IPT Manual provides:

> **9220 Calculation of gains and other amounts for policies in foreign currencies**
> Where a tax representative or insurer reports a gain in sterling, it should compute the gain by calculating the amount of the chargeable event gain in the currency in which the policy is denominated and then convert it into sterling at the conversion rate on the date of the event. This method ensures that currency fluctuations during the life of the policy are disregarded.
> Where a tax representative or insurer reports other amounts in sterling, for instance the premiums paid where there has been an assignment, they should be translated at the rate applying on the date of the chargeable event.

Similarly, IPT Manual:

> **3700 Foreign policies: differences in treatment**
> Some policies are denominated in a foreign currency. In such cases, any chargeable event gain should be computed in the foreign currency and then converted to sterling at the rate that applies at the date of the chargeable event. This method should be adopted rather than any other method such as converting each transaction to sterling at the rate applying on the date the transaction occurred.
> For instance, if premium of €10,000 was paid into a policy on 10 May 2002 and the policy was surrendered for €12,500 on 3 January 2005, the chargeable event gain on the surrender is €2,500. This should then be converted to sterling at the conversion rate applying on 3 January 2005 to arrive at the amount of taxable gain.

### 30.4.1 *Individual bond condition A: individual beneficial owner*

Section 465(2) ITTOIA provides:

> Condition A is that the individual beneficially owns the rights under the policy or contract in question.

Individual bond condition A – gain charged on individual if they are beneficial owner – is natural and sensible.

Sections 469–471 ITTOIA deal with joint ownership.

### 30.4.2 *Individual bond condition B: trust ownership*

Section 465(3) ITTOIA provides:

> Condition B is that those rights are held on non-charitable trusts which the individual created.

There are two strange features about individual bond condition B, where a policy or contract is held in a trust. First, 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.[11]

Secondly, surprisingly, the creator is charged on the gain accruing to their 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 they or those closely connected to them are beneficiaries. But following the increase in the trust tax rate to 50%, this rule can favour the taxpayer in relation to UK resident trusts and in a very rough and ready way it can mitigate the unfairness of taxing lower rate beneficiaries at the top trust rate.

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11 The reason for the non-standard 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 69.32 (Trust made by company: are shareholders settlors?), 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.

Section 672 ITTOIA deals with trusts with two or more settlors.

### 30.4.3 *Individual bond condition C: debt charged on security*

Section 465(4) ITTOIA provides:

> Condition C is that those rights are held as security for the individual's debt.

Individual bond condition C – gain charged on individual if held as security for the individual's debt – is a rough and ready solution to the problem of imposing the tax charge where the economic ownership lies. CGT has the opposite rule: s.26 TCGA.

### 30.4.4 *Remittance basis taxpayer*

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 a remittance basis taxpayer and the gain arises from an offshore policy. This is a surprising inconsistency with the general scheme of taxation for foreign domiciliaries. I wonder if this was due to a historical oversight. However that may be, the law set out in ITTOIA is clear.

It follows that a policy or contract which will give rise to a gain under the chargeable event provisions is not a suitable form of investment for:
(1) an individual who is a remittance basis taxpayer; or
(2) a trust whose creator is a remittance basis taxpayer,[12]
unless the individual expects to be non-resident in the year of the chargeable event. If the individual has no short or medium term intention of realising a gain (ie the policy is a long term investment) then the tax disadvantage can be set against the practical convenience of the policy.

The RDR Manual correctly provides:

12 But it may be suitable if held by a non-resident company held by the trust: see below.

**33540 - Remittance Basis: Identifying Remittances: Specific Topics: Chargeable Event gains**

Gains arising on a chargeable event, for example, the surrender of all rights under a policy of life insurance are chargeable to tax on the arising basis regardless of whether the policyholder is domiciled in the UK or not. The remittance basis does not apply.

Under a special rule (ITTOIA05/s507) policyholders are able to make partial surrenders or assignments of broadly up to 5% of accumulated premiums with any tax charge postponed until maturity or other later realisation. This is known as the '5% deferral rule' or the 'excess rule'. When the policy comes to an end any earlier withdrawals are taken into account in calculating the end gain.

However when considering the position of a remittance basis user you will need to consider what income or gains they used to pay the premium due under the contract or policy. Where an individual purchases an overseas life insurance, or other income-generating, policy and subsequently part of that policy is surrendered for a cash payment and that money is brought to the UK, such payments will be treated as taxable remittances to the extent that the purchase of the original premium was made with the individual's untaxed foreign income and gains that would have been taxed on the remittance basis if remitted to the UK.

So if the premium was paid using the individual's foreign income or foreign gains that were untaxed when they arose, because the individual was a remittance basis user in that year, then any of the 5% withdrawal will be a taxable remittance if the money is brought to, or received or used in, the UK. The amount attributable to the '5% withdrawal' indirectly derives from the original premium paid, so Conditions A and B of s809L apply.

**Withdrawals in excess of 5% or full surrenders**

If the individual withdraws more than 5% of accumulated premiums then, the amount in excess of 5% or the actual gain if a full surrender, will be chargeable to income tax under the chargeable event legislation. It is charged on the arising basis whether it is remitted or not.

### 30.4.5 *Individual non-resident in year of chargeable event*

The charge only applies "if the individual is UK resident in the tax year in which the gain arises": s.465(1) ITTOIA.

Before ITTOIA, it was clear from ESC B53 that the split year concession did not apply. Now ESC B53 is obsolete, in relation to individuals, and this point is not expressly stated in ESC A11 which at face value applies a split year treatment in all cases including this one. However, it is likely that HMRC will not change their practice, and their decision to do that could not be challenged.

The temporary non-residence rule[13] does not apply. This is not an anomaly: it mitigates the unfairness of the lack of a remittance basis.

### 30.4.6 *Non-resident period relief*

There is a relief for the individual who is UK resident in the year that the gain arises (so they are 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[14] is reduced for the purposes of this Chapter if the policy holder was not UK resident throughout the policy period.
> (2) The amount of the reduction is the appropriate fraction of the gain.
> (3) The appropriate fraction is (A ÷ B) where—
> A is the number of days on which the policy holder was not UK resident in the policy period, and
> B is the number of days in that period.

The relief applies where individuals are charged on the gain as beneficial owners or security owners (bond conditions A or C). It does not help individuals who have had non-resident periods but who are charged as creators of a trust (bond condition B). Section 529(1) ITTOIA provides:

> Section 528 does not apply if, when the chargeable event occurs or at any time during the policy period, the policy is or was held—
> (a) by a non-UK resident trustee,
> (b) by non-UK resident trustees,[15] or
> (c) by a foreign institution.[16]

13 See 8.1 (Temporary non-residence).

14 These terms are defined in s.476(3) ITTOIA.

15 It is clumsy and of course unnecessary to refer to trustee(s) both in the singular and the plural; but it does not matter.

16 For completeness, there is transitional relief for policies held on 19 March 1985: see para 106 Sch 2 ITTOIA.

## 30.5 Liability of UK trust

If the creator of the trust is alive and UK resident, they will be taxed on the gain.[17] Section 467 ITTOIA provides for the situations where the creator is not taxable:

> (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.

I refer to **"trust policy conditions A, B, C or D"** to avoid confusion with the myriad other conditions in ITTOIA. It is considered that these conditions must be satisfied immediately before the event, ie "immediately before" governs the phrase"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.

The rate of tax is in principle 50%.[18] 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. A trust migration is effective if done before the chargeable event; it is not necessary to wait until the following tax year.

### 30.5.1 *Trust policy condition A (charitable trust)*

Section 467 ITTOIA provides

> (2) Condition A is that the rights under the policy or contract are held by the trustees on charitable trusts.

### 30.5.2 *Trust policy condition B (absent settlor)*

Section 467 ITTOIA provides

17 See 30.4 (Liability of individuals and individual "creators").
18 Section 482 ITA type 7: see 22.2.3 (Other income taxed at top rates).

(3) Condition B is that—
(a) those rights are held by the trustees on non-charitable trusts, and
(b) one or more of the absent settlor conditions is met.
(4) The absent settlor conditions are that the person who created the trusts—
(a) is non-UK resident,
(b) has died, or
(c) in the case of a company or foreign institution (see section 468(5)), has been dissolved or wound up or has otherwise come to an end.

### 30.5.3 *Trust policy conditions C and D*

Section 467 ITTOIA provides:

(5) Condition C is that—
(a) the rights under the policy or contract are held by the trustees on non-charitable trusts,
(b) condition B does not apply, and
(c) neither section 465 nor section 466 applies.
(6) Condition D is that the rights under the policy or contract are held as security for a debt owed by the trustees.

## 30.6 Non-resident trusts and companies

Non-resident trustees are outside the scope of the charge on a chargeable event because s.467 (which imposes the charge on trustees) applies only to UK resident trustees.

A non-resident company is outside the scope of the charge under ITTOIA (which does not apply to companies). It is outside the scope of the charges in CTA 2009 (which only apply to corporation tax).[19]

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19 For completeness, ESC C33 provides:

**"Non-UK resident companies and chargeable event gains on life insurance policies, life annuity contracts and capital redemption policies**

1 A "gain" may be treated as arising in connection with a policy of life insurance, a life annuity contract or a capital redemption policy when a "chargeable event" occurs or is treated as occurring. Chapter 2 of Part 13 of ICTA defines "chargeable events" and sets out how a "gain" is calculated where the chargeable person is a company. It also contains the other provisions relating to chargeable events referred to below. A gain may also be treated as arising on a company in connection with a personal portfolio bond under the Personal Portfolio Bond (Tax) Regulations, SI

In the absence of express provision, the chargeable event gain would not fall within the TAA provisions because the receipt by the person abroad (assuming they are non-resident) is capital and not income or (more fundamentally) the chargeable event gain is not income.[20] However, s.468 ITTOIA deals with this. It is helpful to consider trusts and companies separately.

### 30.6.1 *Non-resident trust*

Section 468 ITTOIA provides:

> (1) This section applies if a gain is treated as arising under this Chapter and ...
> (a) trustees who are non-UK resident would be liable for tax in respect of the gain as a result of section 467 if the trustees were UK resident immediately before the chargeable event in question occurs, ...
> (2) Chapter 2 of Part 13 of ITA 2007 (which prevents avoidance of tax where an individual who is ordinarily UK resident benefits from a transfer of assets) applies with the modifications specified in subsection (3) or (4).

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1999/1029 reg 5.
2 This concession is about the circumstances in which a gain may be treated as part of the total income of a company.
These are when—
– a company is the beneficial owner of the rights conferred by a policy or contract;
– the rights are held on trusts created by an individual or a company; or
– the rights are held as security for a debt owed by a company.
3 The provisions that deem a gain to be part of the income of an individual or a company are not restricted to UK residents. Except as set out in para 4, however, HMRC will not pursue liability to tax on a gain that is treated as income of a company that is not resident in the UK at any time during the period for which the gain would otherwise have been charged.
4 A tax liability may arise if a policy or contract is held as property used by, or held by, a UK branch or agency of a company that is not resident in the UK.
5 Nothing in this concession affects—
– a gain that is treated as constituting income payable to non-resident trustees or to a company or other institution resident or domiciled outside the UK; and
– the tax treatment of a benefit that an individual ordinarily resident in the UK receives from the trustees, the company or other institution."

The concession is now redundant following the rewrite of the ICTA provisions and the rule is statutory rather than concessionary.

20 See 25.13 (Capital receipts deemed to be income).

> (3) In a case within subsection (1)(a), Chapter 2 of Part 13 of ITA 2007 applies as if—
> (a) the gain were income becoming payable to the trustees, and
> (b) that income arose to the trustees in the tax year in which the gain arises. ...

This incorporates ss.720[21] and 731 ITA.

### 30.6.2 *Non-resident company or institution*

Section 468 ITTOIA provides (so far as relevant):

> (1) This section applies if a gain is treated as arising under this Chapter and ...
> (b) immediately before that event occurs—
> (i) a foreign institution[22] 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.
> (Emphasis added)

It is curious that (i) and (iii) refer to *shares* in rights. Contrast ss.465(2) and 467(2) ITTOIA.[23] On a traditional approach to statutory construction the (i) and (iii) do not apply if the foreign institution beneficially owns the *entire* policy. The gap is more or less filled by s.468(1)(b)(ii) as if a foreign company owns a policy, the rights are held for its purposes. If necessary a court might decide there was a slip in the drafting, which on a modern approach to construction could be corrected. Perhaps the drafting will be corrected some time.

Assuming s.468(1)(b) ITTOIA is satisfied, we read on:

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21 Section 720 ITA is not needed here because a transferor within s.720 would normally be taxed as the creator of the settlement, but the overlap does not matter. It is similar to the overlap of s.624 ITTOIA and s.720 ITA.

22 "Foreign" is defined in s.468(5) ITTOIA: "In this Chapter 'foreign institution' means a company or other institution resident or domiciled outside the UK." The word institution is not defined.

23 See 30.4 (Liability of individuals and individual "creators") and 30.5 (Liability of UK trust).

> (2) Chapter 2 of Part 13 of ITA 2007 (which prevents avoidance of tax where an individual who is ordinarily UK resident benefits from a transfer of assets) applies with the modifications specified in subsection (3) or (4). ...
> (4) In a case within subsection (1)(b), Chapter 2 of Part 13 of ITA 2007 applies as if—
> (a) the gain were income becoming payable to the institution, and
> (b) that income arose to the institution in the tax year in which the gain arises.

Section 720 ITA is needed here, as the transferor would not otherwise be taxed on the gain. The extension of the scope of s.720 in 2005 caught those described in the 4th edition of this work as "bold enough to plan on the assumption that the current law will still apply when a policy is surrendered at some time in the future".

### 30.6.3 *Transferor's s.731 defence: gains arising before 5 December 2005*

Suppose:
(1) gains arose before 5 December 2005 to a foreign company or trust within s.731; the transferor was not subject to tax on those gains as they arose;[24] and
(2) the *transferor* receives a benefit.

A transferor is outside the scope of s.731: see 27.9 (Transferor's s.731 defence). Under the pre-5 December 2005 law, I suggested that the transferor's s.731 defence would not apply when s.720 did not apply. Now that s.720 does apply, the transferor's defence should apply even to pre-5 December 2005 gains. This could be something of a windfall for transferors; but since unrealised gains were brought within the s.720 charge from 5 December 2005, HMRC can hardly complain that realised gains now fall within the transferor's defence.

### 30.6.4 *Section 720 and s.731 remittance bases*

The s.720 remittance basis does not apply to a gain within s.720, because the gain does not meet the requirement that the income of the person

24 See the 4th edition of this book, para 20.5.

abroad "would be relevant foreign income if it were the individual's".[25]

For the same reason, a benefit which relates to the gain does not qualify for the s.731 remittance basis.[26]

### 30.6.5 *Income accruing to life company*

So far we have considered the taxation of chargeable event gains accruing to non-resident trusts or companies which hold policies.

The payment to a non-resident life company (or a subsidiary of such a company) is in principle a transfer of assets within the TAA provisions. The TAA provisions would in principle apply if:

(1) income arising as a result of the payment can be identified (ie if the sum paid is segregated); and

(2) the motive defence does not apply.

In a straightfoward case of the payment of a premium, the application of the motive defence is well established. However *IRC v Willougby* decided only that Professor Willoughby's bond was not taken out for tax avoidance purposes in the straightforward circumstances of his case. If there were tax avoidance in the true sense the TAA provisions will apply: the fact that a policy is taken out does not preclude the possibility of tax avoidance.

See 28.8 (Life policies).

## 30.7 Section 624 and chargeable event gains

Section 624 ITTOIA never applies to a chargeable event gain. To see why, it is helpful to distinguish:

(1) UK resident settlor;

(2) non-UK resident settlor:

   (a) non-resident trustees;

   (b) UK resident trustees.

Where the settlor is UK resident they are 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,

25 See 26.14 (Section 720 remittance basis).

26 See 27.34 (Section 731 remittance).

section 624 does not apply because the gain is not "income" and so it is not "income arising under a settlement".

Where the trustees are UK resident, but the settlor is not resident, the gain is deemed to be income of the trustees. In these circumstances the s.624 non-resident settlor defence will apply.[27]

## 30.8 Liability of personal representatives

Section 466 ITTOIA provides:

> (1) Personal representatives are liable for tax under this Chapter if
> [a] the rights under the policy or contract are held by them and
> [b] the condition in subsection (2) is met
> (and accordingly the gain is treated for income tax purposes as income of the personal representatives in that capacity).
> (2) The condition is that if an individual were liable for tax on a gain in respect of the policy or contract, section 530(1) (individual treated as having paid tax at the basic rate) would be disapplied as a result of—
> (a) section 531(1) (exceptions from section 530 for policies and contracts specified in section 531(3)), or
> (b) para 109(2) of Schedule 2 (contracts in accounting periods beginning before 1st January 1992).
> (3) For cases where the condition in subsection (2) is not met, see section 664 of this Act and [section 947 of CTA 2009] (under which the gain is treated as part of the aggregate income of the estate for the purposes of Chapter 6 of Part 5 of this Act and [Chapter 3 of Part 10 of CTA 2009] respectively).

The condition in subsection (2)(b) is a transitional rule now of limited scope.

In order to understand the condition in subsection (2)(a) one needs to follow a trail of statutory provisions. First, ss.530 and 531 ITTOIA:

> **530 Income tax treated as paid etc.**
> (1) An individual or trustees who are liable for tax on an amount under this Chapter are treated as having paid income tax at the basic rate on

27 That is, the gain is such that if the settlor were actually entitled thereto, they would not be chargeable to income tax by reason of being non-resident: see 24.7 (Non-resident settlor).

that amount.

...

I refer to this as a "**s.530 tax credit**".

> **531 Exceptions to section 530**
> (1) Section 530 does not apply to gains from the kinds of policies and contracts specified in subsection (3), except for the purposes of calculating relief under section 535 (top slicing relief).
> (2) Subsection (1) is subject to—
> section 532 (relief for policies and contracts with European Economic Area insurers), and
> section 534 (regulations providing for relief in other cases where foreign tax chargeable).
> (3) The policies and contracts are—
> (a) a policy of life insurance issued or a contract for a life annuity made by a friendly society in the course of tax exempt life or endowment business[28],
> (b) a foreign policy of life insurance that does not meet conditions A and B,
> (c) a contract for a life annuity (other than one within para (a)) which has at any time not formed part of any insurance company's or friendly society's basic life assurance and general annuity business the income and gains of which are subject to corporation tax, and
> (d) a foreign capital redemption policy.

If we focus on foreign life policies, the relevant provision is (3)(b). The question is whether the foreign policy does not meet conditions A and B (which I will call "**foreign policy conditions A and B**"). Section 531(5) provides:

> Condition A is that the policy falls within para (a) of the definition of "foreign policy of life insurance" in section 476(3) (policy issued by a non-UK resident company).

So we turn to s.476(3) ITTOIA:

> In this Chapter—

28 Terms defined in subsection (4); the definitions need not be considered here.

> "foreign policy of life insurance" means—
> (a) a policy of life insurance issued by a non-UK resident company, and
> (b) a policy of life insurance which forms part of the overseas life assurance business of an insurance company or friendly society ...

A foreign policy will typically fall within that definition, so it will meet the condition in s.476(3)(a). The meaning of "overseas life assurance business" can be found in s.431D(1) ICTA:

> **431D Meaning of "overseas life assurance business"**
> (1) In this Chapter "overseas life assurance business" means so much of a company's relevant life assurance business as is with a policy holder or annuitant not residing in the UK (but not including the reinsurance of such business).

I think we conclude that most foreign policies will satisfy foreign policy condition A. That takes us to foreign policy condition B:

> (6) Condition B is that the conditions in para 24(3) of Schedule 15 to ICTA (conditions that are required to be met for certain policies issued by non-UK resident companies to be qualifying policies) are met throughout the period between—
> (a) the date on which the policy was issued, and
> (b) the date on which the gain arises.

It is easy to become tangled in the double double negatives, but I think the chain of reasoning goes as follows:

(1) Foreign policies will not (usually) satisfy condition B.
(2) So they fall within s.531(3)(b) ("a foreign policy of life insurance that does not meet conditions A and B").
(3) So they do not qualify for a s.530 tax credit.
(4) So they do meet the condition in s. 466(2).
(5) So that PRs are liable for the chargeable event gain.

This could be avoided by an assent to a beneficiary.

Section 466 ITTOIA is not expressed to be limited to UK resident PRs. However s.368 ITTOIA provides:

> (1) Income arising to a UK resident is chargeable to tax under this Part whether or not it is from a source in the UK.
> (2) Income arising to a non-UK resident is chargeable to tax under this

> Part only if it is from a source in the UK.
> (3) References in this section to income which is from a source in the UK include, in the case of any income which does not have a source, references to income which has a comparable connection to the UK.
> (4) This section is subject to any express or implied provision to the contrary in this Part (or elsewhere in the Income Tax Acts).

Thus non-resident PRs are not chargeable. ITTOIA EN confirms that this is intended:

> 421. Chapter 1 of Part 4 of this Act provides a general territorial limitation on the scope of the Part. As regards income arising outside the UK, it limits the charge to such income arising to a UK resident. See section 368 (territorial scope of Part 4 charges) and the related commentary on that Chapter. [Section 465 ITTOIA] overlaps and supplements that Chapter to ensure that a non-UK resident individual is not liable to tax under this Chapter on any gains, whether arising in the UK or elsewhere.

## 30.9 Planning for immigrant to UK

### 30.9.1 *Immigrant policyholder who has become resident in the UK*

The advisers of a foreign domiciled person who has recently come to the UK should check whether they or any trust they have created has a policy or contract. If so, the position needs to be reviewed.

An assignment of the policy or contract from an individual to a trust (resident or not) does not help, since the individual remains liable as creator.

One simple form of planning is to arrange there is no chargeable event in a year when the individual is UK resident. The partial surrender of up to 5% of the premium paid for the policy or contract per year is not a chargeable event. The surrender, assignment for money or money's worth and maturity of the policy or contract is normally a chargeable event but this can be anticipated and perhaps postponed to a year when the individual is non-resident. A death giving rise to benefits under the policy is also a chargeable event unless the policy is a qualifying policy. In such a case one would be at risk that the individual may die while UK resident, giving rise to the tax charge on their estate.

Another course is for the individual to surrender their policy shortly after becoming UK resident; most of the gain will qualify for non-resident period relief.[29]

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.[30] An assignment for no consideration is not a chargeable event.

### 30.9.2 *Planning before becoming UK resident*

There are further possibilities if the individual acts before the tax year in which they become UK resident. One possibility is to surrender the policies.

## 30.10 Personal portfolio bonds

Urgent action needs to be taken if the individual (or trust created by them) holds a "personal portfolio bond" as defined in s.516 ITTOIA. This topic cannot be pursued here.

## 30.11 CGT exemption for policies

Sections 204 and 210 TCGA provide exemptions for policies and contracts. In outline, policies are exempt unless assigned for consideration (known as secondhand policies).

## 30.12 IHT on policy held by foreign domiciliary

The IHT Manual provides:

> **30039 - Policies effected by a person who dies domiciled outside the UK** [October 2007]
> Under the proviso to the [Revenue Act][31] 1884 s.11 as amended by the [Revenue Act] 1889 s.19 a grant of representation (IHTM05001) in the UK is not necessary in order to recover money payable under a policy

29 See 30.4.6 (Non-resident period relief).

30 See 30.6.2 (Non-resident company or institution).

31 The Manual wrongly refers to the Customs & Inland Revenue Acts.

of life assurance effected with any insurance company by a person who dies domiciled[32] outside the UK. For the purposes of this section, any policy under which a sum of money becomes payable on a death may be treated as a policy of life assurance, and any association of persons which issued policies in the ordinary course of its business, whether incorporated or not, may be treated as an insurance company.

These provisions do **not** confer any exemption from IHT. Where policy moneys are situate in the UK, tax is nonetheless payable though the moneys may be receivable without the production of a UK grant of representation.

The insurance company can however be liable for the tax where

[1] it retains policy moneys for the benefit of the beneficiary for investment purposes, outside the terms of the life assurance contract, in which case IHTA s.200(1)(c) may apply to the company as a vestee, or

[2] it received prior notice that the policy in question is subject to a statutory charge for tax under s.237 IHTA.[33]

Where there is other estate in the UK in respect of which a UK grant is necessary, but the UK representatives are only administrators acting under a power of attorney and in point of fact have not intermeddled with the policy moneys and, without knowledge of the claim for tax in respect of such moneys, have parted with the assets collected by them to their principal (the foreign executor), the claim in respect of the policy moneys should not be pursued against the UK administrators.

Similar conditions apply in Scotland to a Factor or Attorney authorised by executors abroad to give up an Inventory (in such cases it is the executors who are confirmed, not the Factor or Attorney).

Refer to TG [Technical Group] for consideration

- all enquiries on this topic
- any case where it is apparent that policy moneys have been paid out without a grant being produced.

**(This text has been withheld because of exemptions in the Freedom of Information Act 2000)**

The withheld text may well state that IHT in many cases is uncollectable and set out the circumstances in which no attempt should be made to collect it. In practice a well advised foreign domiciliary (not deemed domiciled) will not acquire or retain a UK situate policy. However a

32 The deemed domicile rule does not apply for this purpose.

33 In practice it is unlikely that either [1] or [2] will be the case.

person who is deemed UK domiciled may find this useful, as the executors can fund IHT more easily if they can first recover the money due under the policy and then pay the IHT and obtain a grant.

CHAPTER THIRTY ONE

# OFFSHORE FUNDS: DEFINITIONS

## 31.1 Offshore funds – Introduction

Before December 2009 I wrote that this subject needed a long book to itself. That is no longer the case: several volumes would now be needed to cover the subject properly.

I formerly added that it would be an unrewarding work because the rules are not well observed in practice. However this is true of many of the areas touched on by the FA 2008, so offshore funds are not now so different.

This chapter considers the definition of offshore fund and associated expressions. The following chapter considers the taxation of offshore funds.

The definitions discussed in this chapter were introduced in the FA 2008,[1] where they survived for two years before being rewritten into TIOPA.

The tax legislation is in the Offshore Funds (Tax) Regulations ("OFTR"). The OFTR naturally referred to the then current provisions of the FA 2008. Rewrite Acts did not update statutory references in secondary legislation so those references will remain indefinitely in the regulations. The obsolete references take effect as references to the corresponding new provisions[2] but readers need to work out for themselves what those are (I

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1 The FA 2008 sensibly jettisoned the reform in the FA 2007, which was thoroughly botched. The 2007 definition (discussed at 23.3 of the 7th edition of this work) is still relevant for transitional relief.

2 Para 5(1) Sch 9 TIOPA provides:
"Any reference (express or implied) in any enactment, instrument or document to a superseded enactment in its application for relevant tax purposes is to be read, so far as is required for those relevant tax purposes, as including, in relation to times, circumstances or purposes in relation to which any corresponding rewritten provision has effect, a reference to the rewritten provision."
Para 9(1) Sch 9 TIOPA provides: "In this Part—

will insert them in brackets). The Offshore Funds Manual is similarly out of date though eventually its references might be updated.

While the drafting in the FA 2008 was not beyond criticism, the reader may well question whether this rewrite was worthwhile, and be grateful that the rewrite project has at last come to an end; but there it is.

The TIOPA definitions only apply for the purposes of Part 8 TIOPA so they need to be incorporated by reference when the same terms are used elsewhere.

## 31.2 Meaning of "participant"

Section 362 TIOPA provides a commonsense definition:

> (1) In this Part references to "participant", in relation to arrangements (or a fund), are to a person taking part in the arrangements (or the arrangements constituting the fund), whether by becoming the owner of, or of any part of, the property that is the subject of the arrangements or otherwise.
> (2) In this Part references (however expressed) to participation, in relation to arrangements (or a fund), are to be read in accordance with subsection (1).[3]

Offshore Funds Manual provides:

> **02600: Meaning of mutual fund: introduction**
> ... 'Participants' are those persons who take part in the arrangements – that is, the investors - and it makes no difference whether they directly own the underlying property of the arrangements or not. So, for example, there is no difference between a participant who has a share in a mutual

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"enactment" includes subordinate legislation (within the meaning of the Interpretation Act 1978),
"relevant tax purposes" means, in relation to a superseded enactment, tax purposes for which the enactment has been rewritten by this Act, and
"superseded enactment" means an earlier enactment which has been rewritten by this Act for certain tax purposes (whether it applied only for those purposes or for those and other tax purposes)."

3 So reg.3(1) OFTR incorporates this definition by reference:
"In these Regulations "offshore fund" has the meaning given by section 40A(2) of FA 2008 (read with the provisions of the relevant group of sections)."

fund constituted by a company (in which case under most forms of company law the participant would not have an ownership interest in the underlying property) and on the other hand, an interest in a trust or other contractual arrangement which may well give the participant a direct ownership right (FA2008/S40A(5)).

## 31.3 Meaning of "offshore fund"

### 31.3.1 *Basic definition*

Section 355(1) TIOPA provides:

> In section 354 "offshore fund" means—
> (a) a mutual fund constituted by a body corporate resident outside the UK,
> (b) a mutual fund under which property is held on trust for the participants where the trustees of the property are not resident in the UK, or
> (c) a mutual fund constituted by other arrangements that create rights in the nature of co-ownership[4] where the arrangements take effect by virtue of the law of a territory outside the UK.

This definition only applies for the purposes of s.354, so it needs to be incorporated by reference when the expression "offshore fund" is used elsewhere.[5]

In this work:
(1) **"a corporate fund"** means an offshore fund within (a) - a company.
(2) **"a non-corporate fund"** means an offshore fund within (b) or (c) - a unit trust or co-ownership arrangement.

For completeness: Section 363A TIOPA provides a special residence rule for the benefit of EU offshore funds (in short, deeming such funds to be non-UK resident and thus disapplying the usual management and control

4 Section 355(3) TIOPA provides:
"In this section ... "co-ownership" is not restricted to the meaning of that term in the law of any part of the UK."

5 So reg.3(1) OFTR provides:
> "In these Regulations "offshore fund" has the meaning given by section 40A(2) of FA 2008 (read with the provisions of the relevant group of sections)."

The definition is similarly incorporated in s.378A(7) ITTOIA.

test.) EN FB 2011 provides:

> The UCITS IV directive provides that an investment fund authorised under the provisions of Article 5 of that directive may have a manager which is not resident in the same State as that in which the fund is established and regulated.
> 6. [Section 363A] ensures that the affected offshore funds and their investors will not be subject to any tax consequences in the UK as a result of having a UK resident management company.

### 31.3.2 *Power to vary definition*

The drafter (perhaps as a result of the lack of success of the earlier statutory definitions) did not have much confidence in the statutory definition, and conferred wide powers to vary the rules by statutory instrument. These powers have not yet been exercised.

### 31.3.3 *Partnerships*

A general or limited partnership might fall within limb (c) of the definition but s.355(2) TIOPA takes it out:

> Subsection (1)(c) does not include a mutual fund constituted by two or more persons carrying on a trade or business in partnership.

A LLP might fall within limb (a) of the definition but s.355(3) TIOPA takes it out:

> In this section—
> "body corporate" does not include a limited liability partnership.[6]

Partnerships are excluded because partnership income and gains accrue to the partners: there is no scope or need for offshore fund rules. SAI Manual provides:

> **6370 Offshore income gains: The tax charge** [August 2008]
> Where an offshore income gain is realised by a partnership, each partner should be separately assessed in respect of his share of the ... income.

6 This is otiose but it does not matter.

### 31.3.4 *Luxembourg Fonds Commun de Placement*

Offshore Funds Manual 02400 provides:

> Types of mutual funds that come within the definition of an offshore fund at FA2008/S40A(2)(c) would include, for example, contractual arrangements such as Luxembourg Fonds Commun de Placement ('FCPs')...

On this topic see 35.7 (Luxembourg Fonds Commun de Placement).

## 31.4 "Mutual fund"

The key term is "mutual fund". Section 356(1) TIOPA provides:

> (1) In section 355 "mutual fund" means arrangements with respect to property of any description (including money) that meet conditions A, B and C.
> (2) Subsection (1) is subject—
> (a) to the exceptions made by or under sections 357 and 359, and
> (b) to sections 360 and 361.

I refer to "**mutual fund conditions A to C**" to avoid confusion with any other conditions.

### 31.4.1 *Mutual fund condition A: mutuality*

Section 356(3) TIOPA provides:

> Condition A is that the purpose or effect of the arrangements is to enable the participants—
>
> (a) to participate in the acquisition, holding, management or disposal of the property, or
> (b) to receive profits or income arising from the acquisition, holding, management or disposal of the property or sums paid out of such profits or income.

The intention, broadly, is that mutual funds should have the characteristics of pooled investments.

### 31.4.2 *Mutual fund condition B: day-to-day management*

Section 356 TIOPA provides:

> (4) Condition B is that the participants do not have day-to-day control of the management of the property.
> (5) For the purposes of condition B a participant does not have day-to-day control of the management of property by virtue of having a right to be consulted or to give directions.

### 31.4.3 *Mutual fund condition C: realisation at NAV*

Section 356(6) TIOPA provides:

> Condition C is that, under the terms of the arrangements, a reasonable investor participating in the arrangements would expect to be able to realise all or part of an investment in the arrangements on a basis calculated entirely, or almost entirely, by reference to—
> (a) the net asset value of the property that is the subject of the arrangements, or
> (b) an index of any description.

Offshore Funds Manual 02725 provides:

> There is no definition within the legislation of 'almost entirely' as any sort of percentage limit of variation from NAV could be susceptible to arrangements seeking to avoid the intention of the offshore funds rules. It depends on what the arrangements are intended to provide. For example, buy-back arrangements normally take effect when there is a large discount to NAV, but may also be used in very exceptional circumstances to buy back at a very small discount or at NAV which, on its own, may not mean that the arrangements constitute a mutual fund. OFM05250 provides further guidance on share buy-backs and share issuance. ...
> **Realisation of investment on a basis calculated at or close to NAV**
> It is not necessary that the investor obtains NAV directly from the fund. Where a reasonable investor could expect to receive NAV on selling their interest on a secondary market the fund will be an offshore fund if all other conditions are satisfied. For example, Exchange Traded Funds (ETFs) are usually operated in such a way that the quoted prices are at NAV or very close to NAV because market makers are able to create or redeem units (and in that sense such funds are open-ended), and so ETFs would be expected to qualify as mutual funds. On the other hand, arrangements where a fund offered to buy back shares to keep a

discount on the share price within a reasonable limit would not make the fund a mutual fund unless it was clear to a reasonable investor at the time that they invested (or on alteration of the terms of an investment) that there were such arrangements and that they were intended to ensure that such purchases were at NAV or almost or very close to NAV.

**Shares trading close to NAV**

The mere fact that shares in a closed-ended arrangement sometimes trade at or close to NAV does not mean that Condition C is satisfied unless that is as a result of arrangements being in place such that a reasonable investor could expect to receive NAV or close to NAV on selling their interest.

**Warrants and options**

Warrants or options that give an investor the right to sell shares back to an issuer for a particular price will not cause Condition C to be satisfied unless the price is determined by reference to NAV so that the investment can be realised at or close to NAV. Similarly, rights that carry the option to convert to other classes of interest would only satisfy Condition C if the new rights themselves permitted an investor to realise their investment at or close to NAV.

**Realisation of investment by reference an index**

In some cases an investor may have a right to redeem an investment at an amount not representing the assets directly invested in, but which is expressed in terms of an index. The fund manager may then invest the assets so as to produce a return as nearly as possible matching the index which is offered. In such a case Condition C will also be met. Again, this is subject to exceptions where conditions 'X' or 'Y' apply....

Offshore Funds Manual 02300 provides:

It is expected that relatively few fixed share capital companies will fall within the new definition. So, for example, an investment in a trading or investment company or group with fixed share capital and that was not limited life (even if local law provides for continuation votes) would not come within the definition. But under the characteristics based approach, entities that have fixed share capital and that are structured in such a way that they share characteristics of open-ended share capital arrangements will be within the definition. So, fixed share capital companies that are predicated on the basis that investors will get a net asset value return or a return which is very close to net asset value may fall within the new definition. That will also be the case where there are no redemption rights but the arrangements have a limited life and a reasonable investor could expect to get a net asset value return on winding up (unless one of the exceptions in FA2008/S40E applies).

## 31.5 Winding up exemption

There are some exceptions to mutual fund condition C.

Section 357(1) TIOPA provides:

> Arrangements are not a mutual fund for the purposes of section 355 if—
> (a) condition D is met, and
> (b) condition E or F is met.

I refer to **"winding up conditions D to F"** to avoid confusion with the other conditions.

Offshore Funds Manual 02725 provides:

> **... Open-ended and closed-ended arrangements**
> Condition C, when read in conjunction with section 40E(1), provides a clear distinction between a mutual fund and a company organised in the way that, for example, an investment trust company in the UK is organised. Such a company is a closed-ended company, in the sense that it does not allow investors to redeem their shares on request, nor does it issue new shares on request (but see OFM05300 onwards where such closed-ended companies have a limited life). This contrasts with an open-ended investment company which is designed to enable investors to realise NAV and does so through its ability to issue or redeem shares.
> A reasonable investor in what may generally be regarded as a closed-ended company that meets Conditions A or B would normally only expect to be able to realise NAV on the liquidation of the company. So section 40E(1)(a) excludes from section 40B ('meaning of 'mutual fund' etc') any case where a reasonable investor would only be able to realise the investment in the arrangements in the event of a winding-up, dissolution or termination of the arrangements, and where certain other conditions (condition 'X' or 'Y') apply (section 40E(1)(b) - see OFM03100 onwards).

Offshore Fund Manual 03105 provides:

> ... Section 40E(1)(a) has the effect that 'open-ended' arrangements (i.e. those that enable investors to realise NAV by disposing of their interest to the fund manager) cannot come within the exceptions provided by 40E.
> The conditions 'X' or 'Y' do, however, except certain types of closed-ended arrangements from the meaning of a 'mutual fund'.
> The exceptions can also apply to arrangements where a reasonable investor could expect to realise their investment at or close to NAV as a result of the intention of a fund to dispose of its assets in tranches followed by a final distribution of any remaining assets, as opposed to a liquidation of all of the fund's assets on a winding-up (see OFM02730).

### 31.5.1 *Winding up condition D (no liquidation date)*

Section 357 TIOPA provides:

(2) Condition D is that, under the terms of the arrangements, a reasonable investor participating in the arrangements would expect to be able to realise all or part of an investment in the arrangements on a basis mentioned in section 356(6) only in the event of the winding up, dissolution or termination of the arrangements.....
(8) For the purposes of this section the fact that arrangements provide for a vote or other action that may lead to the winding up, dissolution or termination of the arrangements does not, by itself, mean that the arrangements are designed to wind up, dissolve or terminate on a date stated in or determinable under the arrangements.

Offshore Funds Manual 03110 provides:

The most important exception, provided by condition X (section 40E(2)), is that a reasonable investor cannot expect the arrangements to terminate on or by a date fixed in advance.
This condition means, for example, that ordinary shares in any company with defined share capital (that is, not an open-ended company with variable share capital) and which does not have a limited life, will not be an offshore fund.
Condition X requires that the arrangements are not such that they are designed to terminate on a date that is stated or determinable under the arrangements. As elsewhere "arrangements" has a wide meaning and is not limited to the documents establishing the fund, so can include all agreements and understandings. Similarly, "determinable" has a wide meaning. So for example, if a fund prospectus stated that the fund was intended to wind-up after it had realised all of its assets, but those assets consisted of debt instruments none of which was longer dated than 5 years then the termination date would be determinable (unless, of course, it was clear that the fund would reinvest the proceeds of asset realisations and was not 'limited life' in any other regard).
**Asset realisations**
It will not be sufficient to satisfy condition X for a fund to state that an intention to dispose of its assets on or by a certain date is subject to market conditions or some similar caveat where it is clear that a long-stop date exists, or there is no specific and realistic possibility that would lead a reasonable investor to conclude that the fund would not necessarily be able to dispose of its assets by the date stated. For example, if a fund's assets consist of short-dated debt instruments, or commercial leases with a life of 20 years then, unless the fund was reasonably likely to re-invest funds from disposals, condition X could not be satisfied. Where there is no such long-stop date implicit from the nature of the assets themselves then condition X may still not be satisfied if a fund stated an intention to dispose of its assets in, say, four years' time 'subject to market conditions' or some other broad statement.
HMRC will consider particular cases where a fund manager or its advisers believe that there are tangible and specific reasons why such a statement should lead to condition X being satisfied but this is expected to apply in exceptional

circumstances only. An example of the circumstances when a broad statement relating to whether assets could be realised on or by a given date may be sufficient to satisfy condition X would be if a fund held significant assets in a country about which there were real and significant concerns regarding any future government's policy in respect of the assets in question (such as public declarations of an intention to nationalise particular industries or companies in which the fund holds significant investments).

**Continuation votes**

Where arrangements provide for a continuation vote or similar action to determine whether they will persist beyond a given date that will not, in itself, mean that condition X is not met. So, if a reasonable investor, considering all of the facts, could not have any expectation that a continuation vote would fail then, provided the continuation vote was not for a determinable period and absent any other factors, the arrangements could not be said to have a determinable life and condition X could then be satisfied. HMRC accept that it could usually be expected that condition X would be satisfied where continuation votes are provided for because continuation resolutions may well be passed if a fund is performing well, and a reasonable investor would be expected to invest on the basis that a fund would be successful. However, if arrangements or understandings are in place so that it could be expected that a continuation vote would not be passed then there would be a determinable date..

### 31.5.2 *Winding up condition E (no fixed termination date)*

Section 357(3) TIOPA provides:

Condition E is that the arrangements are not designed to wind up, dissolve or terminate on a date stated in or determinable under the arrangements.

### 31.5.3 *Winding up condition F (no income)*

Section 357(4) TIOPA provides:

Condition F is that—
(a) the arrangements are designed to wind up, dissolve or terminate on a date stated in or determinable under the arrangements,
(b) subsection (5), (6) or (7) applies, and
(c) the arrangements are not designed to produce a return for participants that equates, in substance, to the return on an investment of money at interest.

### 31.5.4 *Subsection (5): no income-producing assets*

Section 357(5) TIOPA provides:

> This subsection applies if none of the assets that are the subject of the arrangements is a relevant income-producing asset (see section 358).

Section 358 TIOPA provides the definition:

> (1) This section has effect for the purposes of section 357.
> (2) An asset is a relevant income-producing asset if it produces income on which, if it were held directly by an individual resident in the UK, the individual would be charged to income tax (but see subsections (3) and (4)).
> (3) An asset is not a relevant income-producing asset if the asset is hedged, provided that no income is expected to arise from—
> (a) the asset (taking account of the hedging), or
> (b) any product of the hedging arrangements.
> (4) Cash awaiting investment is not a relevant income-producing asset, provided that the cash, and any income that it produces while awaiting investment, is invested as soon as reasonably practicable in assets that are not relevant income-producing assets (as defined by this section).

This is designed to exclude funds which invest in assets intended to give a purely capital growth based return.

Offshore Funds Manual 02725 provides:

> **Realisation of investment by reference an index**
> ...In many cases investments designed to produce an indexed return are likely to be non-income producing (that is, they reflect capital growth only) in which case the exception provided by FA2008/S40E(4) – condition Y1 – will apply (see OFM03100 onwards). Where an investment is by reference to an index that reflects both capital growth and income returns then condition Y1 would not apply, but condition Y3 might – see OFM03130.

### 31.5.5 *Subsection (6): no entitlement to income*

Section 357(6) TIOPA provides:

> This subsection applies if, under the terms of the arrangements, the participants in the arrangements are not entitled to the income from the

assets that are the subject of the arrangements or any benefit arising from such income.

Offshore Funds Manual 03125 provides:

An example of an arrangement satisfying this condition might be the capital shares or units in an arrangement which splits the rights to capital and income between the holders of different classes of interest, where the holders of capital shares or units are not entitled to any of the income or any benefit arising from the income.

### 31.5.6 *Subsection (7): income distributed*

Section 357(7) TIOPA provides:

This subsection applies if—
(a) under the terms of the arrangements, after deductions for reasonable expenses, any income produced by the assets that are the subject of the arrangements is required to be paid or credited to the participants, and
(b) a participant who is an individual resident in the UK would be charged to income tax on the amounts paid or credited.

## 31.6 Share buy backs and share issuance

Offshore Funds Manual provides:

**OFM05250 Particular arrangements: share buy-backs and share issuance**
The price or value of shares in fixed share capital companies may reflect either a discount or a premium to the net asset value of the underlying assets. It may also be the case in some circumstances that there is either directors' or investors' discretion to allow or require the buy-back of shares if there is a discount of a certain level between the net asset value of the arrangements and the share price. Provided the share buy-back arrangements are made to prevent the discount becoming too large by reference to net asset value, and provided a reasonable investor cannot expect to realise their investment either entirely or almost entirely by reference to net asset value (or by reference to an index), and there is no determinable termination date, then such arrangements will be outside the definition of an offshore fund for UK tax purposes (as Condition C at FA2008/S40B(5) will not be satisfied). Similar considerations apply where the shares trade at a premium.
For example, if a foreign equivalent of an investment trust was trading at a discount of 15% to NAV and bought its own shares on the open market to reduce the discount then, absent any factors that could lead to an investor being able to

expect to redeem their investment at or close to NAV, this would not cause Condition C at FA2008/S40B(5) to be satisfied: it is clear that before the company commenced to buy its own shares that some investors would not have been able to redeem their interest at NAV and that any subsequent reduction in the discount would be due to normal operation of the market. Without any factors indicating that the company would act to reduce the discount either having been in place prior to this market activity or at some point in the future, a reasonable investor could not expect to realise their investment at or close to NAV.

However, share buy-back arrangements that are specifically designed to provide tracking to net asset value will cause the company or share class to come within the definition of offshore fund. This would include any arrangements introduced as a result of changes to the constitution of a scheme. If a change in the terms of a scheme result in it coming within the definition of an offshore fund then UK investors are treated as if they had always held an interest in an offshore fund. If the fund becomes a reporting fund then investors may be able to make an election under regulation 48(2) to crystallise any offshore income gain at that point, with any subsequent gain being subject to chargeable gains treatment (provided the fund remains a reporting fund). See OFM 09100 and OFM11500 for further guidance.

When considering an investor's rights, account should be taken of all scheme documents, promotional documentation or communications to determine what guarantees or undertakings may have been given to the investor.

An undertaking or guarantee, etc, to buy back or redeem only a part of an investor's holding entirely or almost entirely by reference to the net asset value of the property or an index of any description can still constitute an expectation, so for example if the fund manager undertook to redeem or buy back an investor's shares in tranches the arrangements could still be within the definition.

Warrants or options that give an investor the right to sell shares back to an issuer for a particular price will not cause Condition C to be satisfied unless the price is determined by reference to NAV so that the investment can be realised at or close to NAV. Similarly, rights that carry the option to convert to other classes of interest would only satisfy Condition C if the new rights themselves permitted an investor to realise their investment at or close to NAV.

Where no guarantees or undertakings are given when the arrangements are set up or the scheme terms are amended, a subsequent buy-back or issue of shares would not, by itself, give rise to an expectation that a reasonable investor could realise their investment either entirely or almost entirely by reference to net asset value (or by reference to an index) and so such arrangements would fall outside the definition of an offshore fund.

## 31.7 Companies in course of liquidation

Offshore Funds Manual provides:

**OFM05330 Particular arrangements: limited life companies: company liquidations**

An investor may have invested in a company or other arrangement which subsequently goes into liquidation, at which point the investor might reasonably expect to realise their investment at net asset value. However, if a company or other arrangement is outside the definition of an offshore fund before it goes into liquidation, then being in liquidation will not by itself bring that company or arrangement into the definition of an offshore fund. This also applies in the case of self-managed wind downs with the subsequent appointment of a liquidator to complete the liquidation.

This treatment would also extend to the purchase of shares in a company after it has entered a self-managed wind down or liquidation. This may not be the case, though, for wind downs and liquidations that are intentionally extended or contrived.

Some overseas companies can be liquidated or reconstructed at any time. If there is a decision to do so, at the point of the approval of the reconstruction or liquidation the investors may obtain net asset value. However, the relevant point is whether a reasonable investor can expect the company to be liquidated or reconstructed in order to deliver net asset value. It is necessary to consider the reasonable investor's expectation to realise their investment either entirely or almost entirely by reference to net asset value (or by reference to an index) when the company was established (or when there was a change in the investor's rights).

## 31.8 Umbrella arrangements

### 31.8.1 *Meaning of "umbrella arrangements"*

Section 363 TIOPA provides:

(1) In this Part "umbrella arrangements" means arrangements which provide for separate pooling of the contributions of the participants and the profits or income out of which payments are made to them.
(2) In this Part references to a part of umbrella arrangements are to the arrangements relating to a separate pool.

### 31.8.2 *Treatment of "umbrella arrangements"*

Section 360 TIOPA provides:

(1) This section has effect for the purposes of this Part.
(2) In the case of umbrella arrangements (see section 363)—
(a) each part of the umbrella arrangements is to be treated as separate arrangements, and
(b) the umbrella arrangements are to be disregarded.

(3) Subsection (2)(a) is subject to section 361.

Regulation 5 OFTR provides:

In these Regulations, in relation to an offshore fund constituted by a part of umbrella arrangements (within the meaning of section 40C of FA 2008)—

(a) a reference to the assets of an offshore fund is to such of the assets of the umbrella arrangements as under the arrangements form part of the separate pool to which that part of the umbrella arrangements relates;
(b) a reference to the income of an offshore fund is to the income arising from those assets; and
(c) a reference to a participant in an offshore fund is to a person for the time being owning an interest in that separate pool.

Offshore Funds Manual 04000 provides:

'Umbrella arrangements' means arrangements which provide for separate pooling of the contributions of investors and the profits or income out of which payments are made to them. References to part of an umbrella arrangement are to the arrangements relating to a separate pool (or 'sub-fund'). Umbrella arrangements will not themselves be treated as an offshore fund. Instead –

• Each sub-fund and each class of interest is treated as an offshore fund in its own right,
• The umbrella fund is not treated as an offshore fund,
• The overall arrangements are disregarded.

The same approach applies to an individual cell of a protected cell company.
For umbrella arrangements and protected cell companies, it would usually follow that each sub-fund has the same residence status as the overall arrangement. In the case of a non-resident company it would be expected that each sub-fund would also be non-resident if it was under the "central management and control" of the directors of the company which constitutes the overall arrangement. In the case of a unit trust scheme, the trustees of the overall trust arrangements will usually also be the trustees of each separate arrangement, and so their residence status determines the residence of the fund, but where there are different trustees for each sub-fund then each must be considered separately. The "central management and control" test is also applicable to unit trusts.

## 31.9 Arrangements comprising more than one class of interest

Section 361 TIOPA provides:

(1) This section has effect for the purposes of this Part.

(2) Where there is more than one class of interest in arrangements (the "main arrangements")—
(a) the arrangements relating to each class of interest are to be treated as separate arrangements, and
(b) the main arrangements are to be disregarded.
(3) In relation to umbrella arrangements, "class of interest" does not include a part of the umbrella arrangements (but there may be more than one class of interest in a part of umbrella arrangements).

Regulation 6 OFTR provides:

In these Regulations, in relation to an offshore fund constituted by a class of interest in the main arrangements (within the meaning of section 40D of FA 2008)—

(a) a reference to the assets of an offshore fund is to the assets of the main arrangements;
(b) a reference to the income of an offshore fund is to such of the income of the main fund as is attributable to interests of that class under the arrangements constituting the main arrangements; and
(c) a reference to a participant in an offshore fund is to a person for the time being owning an interest of that class.

Offshore Funds Manual 04500 provides

"Class of interest" is not limited to share classes. There may be other forms of interest which entitle an investor to realise their investment on a basis calculated entirely or almost entirely by reference to the net asset value of the scheme property or an index. For example, certain types of loan may give a return which tracks NAV or is based on an index. A class of interest may also be created as a result of new issues or conversions of existing rights.
It is possible for an entity, particularly a company, to have a class of interest such as ordinary shares which does not constitute a mutual fund and another class of interest which does constitute such a mutual fund.
However, a particular class of shares can only constitute a single class of interest even if different types of holders of those shares enjoy different rights. For example, in the case of an exchange traded fund, the creation unit holders who act as market makers might have the right to redeem or issue shares directly but if that same class of shares were acquired by another investor on the secondary market then they would still form part of the same class of interest and satisfy Condition C because, as a consequence of the market makers' ability to redeem or create units, all other investors would expect to be able dispose of their interest at or close to NAV. (See also OFM05100 regarding exchange traded funds).

## 31.10 "Reporting" and "non-reporting" funds

Regulation 4 OFTR provides:

> (1) Offshore funds consist of—
> (a) non-reporting funds (see Part 2 of these Regulations), and
> (b) reporting funds (see Part 3 of these Regulations).
> (2) In a period of account, an offshore fund is a non-reporting fund unless it is a fund to which Part 3 of these Regulations applies...

Regulation 50 OFTR provides:

> In these Regulations a "reporting fund" means an offshore fund to which this Part applies for a period of account.

A discussion of the requirements to qualify as a reporting fund is not considered here. There is a list of reporting funds on *www.hmrc.gov.uk/collective/reportingfundlist.pdf*. At the time of writing this list is not very long.

CHAPTER THIRTY TWO

# OFFSHORE FUNDS: TAXATION

## 32.1 Taxation of offshore funds – Introduction

This chapter considers the taxation of offshore funds.

The tax legislation is mainly in the Offshore Funds (Tax) Regulations SI 2009/3001 ("OFTR"). The ink had hardly dried before that was amended, in 2009, with a more substantial round of amendments in 2011.

The OFTR's obsolete references to the FA 2008 take effect as references to the legislation now in TIOPA.[1]

For the temporary non-residence rules, see 8.12 (Offshore funds).

I do not consider the position of offshore funds held by UK resident companies.

## 32.2 Definitions

See 31.2 (Meaning of "participant"); 31.3 (Meaning of "offshore fund"); 31.4 ("Mutual fund").

### 32.2.1 *Meaning of "interest in an offshore fund"*

Regulation 8(1) OFTR provides a commonsense definition:

> For the purposes of these Regulations the interest of a participant in an offshore fund is the investment held by a participant taking part in arrangements (or arrangements constituting a fund) to which the relevant group of sections applies.

1 See 31.1 (Offshore funds – Introduction).

## 32.3 Charge to tax on OIGs

The legislation distinguishes:

(1) offshore income gains ("**OIGs**"), which arise on a disposal of a non-reporting offshore fund and fall within the offshore funds rules; and

(2) chargeable gains, within the scope of CGT. I refer to this for clarity as "**CGT chargeable gains**" though strictly the term "chargeable gains" is only applicable to CGT. The HMRC Manuals sometimes use the term "capital gains" which is slightly less accurate, but no less clear.

Regulation 17(1) OFTR provides the charge to tax:

> There is a charge to tax if—
> (a) a person disposes of an asset,
> (b) either condition A or condition B is met, and
> (c) as a result of the disposal, an offshore income gain arises to the person making the disposal.

This provision refers to a "person" so it applies to individuals, trustees, companies and PRs. Regulation 17 continues:

> (2) Condition A is that the asset is an interest in a non-reporting fund at the time of the disposal.

Condition B concerns funds changing from non-reporting fund to reporting fund status:

> (3) Condition B is that—
> (a) the asset is an interest in a reporting fund at the time of the disposal,
> (b) the reporting fund was previously a non-reporting fund (becoming a reporting fund as the result of an application under regulation 52),
> (c) the interest was an interest in a non-reporting fund during some or all of the material period,[2]
> (d) an election under regulation 48 was not prevented by paragraph (5)

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2 Defined regulation 17(4):
"For the purposes of paragraph (3)(c) the "material period" means a period beginning with the day on which consideration was given for the acquisition of the asset or on 1st January 1984 (whichever is the later) and ending with the day on which the fund became a reporting fund."

> of that regulation, and
> (e) no election has been made under regulation 48(2).

Regulation 18(1) OFTR provides:

> The offshore income gain arising is treated for all the purposes of the Tax Acts as income which arises at the time of the disposal to the person making the disposal (or treated as making the disposal).[3]

An OIG is not income for trust law purposes, for instance proceeds of sale of an offshore fund represent a gain but are not payable to a life tenant.

> (2) The tax is charged on the person making the disposal (or treated as making the disposal).
> (3) In the case of a person chargeable to income tax, tax is charged under Chapter 8 of Part 5 of ITTOIA 2005 (miscellaneous income: income not otherwise charged) for the year of assessment in which the disposal is made ...

This incorporates s.687(1) ITTOIA:

> 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]

This is the charge on miscellaneous income (formerly D VI income).

Regulation 18(3) continues:

> but sections 688(1) and 689 of ITTOIA 2005 (income charged and

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3 In accordance with the principles of plain English drafting, reg.18(5) (somewhat unnecessarily) flags up some cross references:
"Paragraph (1) is subject to—
(a) regulation 19 (income treated as arising under regulation 17: remittance basis);
(b) regulation 20(1) (offshore income gain arising to non-resident trustees not treated as income of settlor);
(c) regulation 20(5) (application to gains of non-resident settlements);
(d) regulation 24(6) (application of section 13 of TCGA 1992)."

4 Similarly for CT, reg.18(4) OFTR provides:
"In the case of a person chargeable to corporation tax, tax is charged under Chapter 8 of Part 10 of CTA 2009 (miscellaneous income: income not otherwise charged) for the accounting period in which the disposal is made."

person liable) do not apply.

The disapplied sections provide:

> ***688 Income charged***
> *(1) Tax is charged under this Chapter on the amount of the income arising in the tax year.*
> *(2) Subsection (1) is subject to—*
> *(a) Chapter 1 of Part 7 (which provides relief on income from the use of furnished accommodation in an individual's only or main residence: see, in particular, sections 794 and 798),*
> *(b) Chapter 2 of that Part (which provides relief on income from the provision by an individual of foster care: see, in particular, sections 814 and 817), and*
> *(c) Part 8 (foreign income: special rules).*
> ***689 Person liable***
> *The person liable for any tax charged under this Chapter is the person receiving or entitled to the income.*

At first sight this is worrying since the disapplied sections (among other things) incorporate the remittance basis. However these sections are only disapplied because regulations 18(2) and 19 cover the same area.

## 32.4 Meaning of "disposal"

It will be recalled that there is a charge to tax if a person disposes of an offshore fund. Regulation 33 defines disposal:

> (1) There is a disposal of an asset for the purposes of these Regulations if there would be a disposal of an asset for the purposes of TCGA 1992.
> (2) Paragraph (1) is subject to the following provisions of this Chapter.

Special rules relating to reorganisations are not discussed here.

## 32.5 Death of individual

The CGT rule is that there is no disposal on death. Section 62 TCGA provides:

> (1) For the purposes of this Act the assets of which a deceased person was competent to dispose—

(a) shall be deemed to be acquired on his death by the personal representatives or other person on whom they devolve for a consideration equal to their market value at the date of the death, but
(b) shall not be deemed to be disposed of by him on his death (whether or not they were the subject of a testamentary disposition).

Regulation 34 OFTR undoes this and provides for a deemed disposal on death:

> 34.—(1) Notwithstanding anything in paragraph (b) of subsection (1) of section 62 of TCGA 1992 (general provisions applicable on death: no deemed disposal by the deceased), where a person dies and the assets of which the deceased was competent to dispose at the time of death include an interest in a non-reporting fund, then, for the purposes of these Regulations—
> (a) immediately before the acquisition referred to in paragraph (a) of that subsection, that interest shall be deemed to be disposed of by the deceased for such a consideration as is mentioned in that subsection; but
> (b) nothing in this regulation affects the determination, in accordance with regulation 32, of the question whether that deemed disposal is one to which this Chapter applies.

Regulation 34(2) incorporates other rules of s.62 TCGA:

> (2) Subject to paragraph (1), section 62 of TCGA 1992 applies for the purposes of these Regulations as it applies for the purposes of that Act, and the reference in that paragraph to the assets of which a deceased person was competent to dispose are to be construed in accordance with subsection (10) of that section.

The following provisions of s.62 therefore apply for OIGs:

> [(2) and (2A) deal with losses and need not be considered here.]
> (3) In relation to property forming part of the estate of a deceased person the personal representatives 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 personal representatives), and that body shall be treated as having the deceased's residence, ordinary residence, and domicile at the date of death.
> (4) 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.

(5) Notwithstanding section 17(1) no chargeable gain shall accrue to any person on his making a disposal by way of donatio mortis causa.

[subsections (6) to (9) deal with IoVs and need not be set out here]

(10) In this section references to assets of which a deceased person was competent to dispose are references to assets of the deceased which (otherwise than in right of a power of appointment or of the testamentary power conferred by statute to dispose of entailed interests) he could, if of full age and capacity, have disposed of by his will, assuming that all the assets were situated in England and, if he was not domiciled in the UK, that he was domiciled in England, and include references to his severable share in any assets to which, immediately before his death, he was beneficially entitled as a joint tenant.

The OFM correctly provides:

**OFM08600 Investors in non-reporting funds: disposals of interests: death of participant – regulation 34**
...An offshore income gain arises and resulting tax becomes payable before the estate of the deceased person is valued for inheritance tax purposes.

There is scope for deathbed planning: a lifetime gift to charity or to a spouse avoids the OIG charge on death, because no OIG arises on the disposal (applying CGT rules which brings into effect the CGT spouse exemption and the CGT charity exemption). By contrast if there is a gift by will to charity or to a spouse the OIG comes into charge on the death.

## 32.6 OIG remittance basis

Regulation 19 OFTR provides:

(1) This regulation applies to income treated as arising under regulation 17 to an individual in a tax year if—
(a) section 809B, 809D or 809E of ITA 2007 (remittance basis) applies to the individual for that year, and
(b) the individual is not domiciled in the UK in that year.

(2) The income is treated as relevant foreign income of the individual.

The significance of treating the income as RFI is that the income can qualify for the remittance basis. I refer to this as "**the OIG remittance basis**".

The remittance basis applies even if the offshore fund is a UK situate asset (the CGT situs rules are not relevant) but in practice that is not likely to 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, ie they will not care whether or not the asset disposed of is an offshore fund.

Regulation 19(3) contains two rules:

> (3) For the purposes of Chapter A1 of Part 14 of ITA 2007 (remittance basis)—
> (a) any consideration obtained on the disposal of the asset[5] is treated as deriving from the income

At first sight it is not clear why reg.19(3)(a) is needed. It seems self-evident. There is no equivalent in the CGT charge on gains accruing to individuals. But a reason will emerge.[6]

Regulation 19(3) continues:

> For the purposes of Chapter A1 of Part 14 of ITA 2007 (remittance basis) ...
> (b) unless the consideration so obtained is of an amount equal to or exceeding the market value of the asset, the asset is treated as deriving from the income.

Regulation 19(3)(b) is the equivalent of the CGT rule for deemed gains.[7]

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5 Reg 19(4) provides two somewhat unnecessary definitions:
"In paragraph (3)—
(a) "the asset" means the asset the disposal of which causes the income to be treated as arising, and
(b) "the disposal" means the disposal mentioned in sub-paragraph (a) of that paragraph."

6 See 32.12.6 (OIG s.87 remittance basis).

7 See 10.24 (CGT disposal not for market value).

## 32.7 OIG arising to UK trust

### 32.7.1 *UK resident trust (not settlor-interested)*

A UK resident trust is in principle subject to income tax on its OIGs.[8] Tax is charged at the trust rate, 50%: it falls within s.482 type 3, see 22.2.3 (Other income taxed at top rates).

### 32.7.2 *UK resident settlor-interested trust*

An OIG arising to UK trustees is not "income" in the general sense and in the absence of express provision it would not fall within s.624 ITTOIA which only applies to income. However reg.18 OFTR directs that the OIG is "treated for all the purposes of the Tax Acts as income" so it does fall within s.624 ITTOIA.

If the settlor is a remittance basis taxpayer the s.624 remittance basis applies, ie an unremitted OIG is not taxed on the settlor but on the trustees.[9]

The rate of tax in the absence of s.624 is 50%, so s.624 can only reduce the tax rate (or make no difference).

## 32.8 OIG non-residence defence

Regulation 22(1) OFTR provides a territorial limitation for non-residents:

> (1) The following enactments 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—
> (a) section 2(1) of TCGA 1992 (persons chargeable to capital gains tax)
> ...

Extended as reg. 22(1) 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

8 See 32.3 (Charge to tax on OIGs).
9 See 24.5 (Section 624 remittance basis).

which he is resident in the UK, or during which he is ordinarily resident in the UK.

This incorporates the CGT territorial limitations by reference.[10] By implication, a person not resident (and not ordinarily resident) is not chargeable to IT on offshore income gains. I refer to this rule as "**the OIG non-residence defence**".

## 32.9 OIG arising to non-resident trust

Where an OIG arises to a non-resident trust, the trustees are not subject to tax on the gain because of the OIG non-residence defence.

### 32.9.1 *Non-resident settlor-interested trust*

An OIG arising to a non-resident settlor-interested trust is not within s.624 ITTOIA, unlike a UK resident trust. Regulation 20(1) OFTR provides:

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10 For completeness: Regulation 22 OFTR 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. The regulation provides:

"(1) The following enactments 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—

(a) section 2(1) of TCGA 1992 (persons chargeable to capital gains tax) ...

(b) section 10 of TCGA 1992 (non-resident with a UK branch or agency);

(c) section 10B of TCGA 1992 (non-resident company with UK permanent establishment).

(2) Paragraph (1) is subject to paragraphs (3) and (4).

(3) In the application of section 10 of TCGA 1992 in accordance with paragraph (1), paragraphs (a) and (b) of subsection (1) (assets on the disposal of which chargeable gains are taxable) have effect with the omission of the words "situated in the UK and".

(4) In the application of section 10B of TCGA 1992 in accordance with paragraph (1), paragraphs (a) and (b) of subsection (1) (assets on the disposal of which chargeable profits arise for the purposes of corporation tax) have effect with the omission of the words "situated in the UK and"."

Section 1015 ITA could also restrict the territorial scope of the OIG charge, but the rules discussed here leave it no room to operate.

> If an offshore income gain arises to a settlement in a tax year and the trustees of the settlement are neither resident nor ordinarily resident in the UK in the tax year, the gain is not regarded as income for the purposes of Chapter 5 of Part 5 of ITTOIA 2005 (settlements: amounts treated as income of settlor).

The consequence is that a settlor who is liable under s.720 does not have an indemnity against the trust for the tax. One wonders if this has been thought through.

The whole of chapter 5 is disapplied, so where a capital payment is made to a minor child of the settlor, the settlor is not taxable under s.629 ITTOIA (instead the child would be taxable at the appropriate rate. This may lead to a significant saving).

## 32.10 Outline of OIG anti-avoidance provisions

The rule that non-resident trusts and companies are not subject to tax on OIGs presents an obvious means of tax avoidance. HMRC might have applied either the income tax TAA provisions or the CGT anti-avoidance provisions to deal with this. In fact they have applied both:
(1) The TAA provisions apply: reg.21
(2) The CGT anti-avoidance provisions apply (with some amendments):
    (a) Regulation 20 applies s.87 TCGA.
    (b) Regulation 24 applies s.13 TCGA.

Further rules are needed to deal with the many possible ways in which the anti-avoidance provisions may interact:
(1) Interactions between these IT and CGT anti-avoidance provisions potentially applying to the same OIG; and
(2) Interactions between:
    (a) the applicable anti-avoidance provision relating to an OIG and
    (b) s.731 or CGT s.87 (where a beneficiary receives a benefit and there is also relevant income or a CGT s.2(2) amount).

### 32.10.1 *Commentary*

The result of applying two sets of overlapping anti-avoidance provisions is so complicated that no-one could expect the rules which I seek to explain below to be applied in practice, except by the very largest trusts with a very large budget for UK professional advice. It also introduces a full set of anomalies and scope for tax planning.

Although it was the case before 2008 that both the TAA and the CGT anti-avoidance provisions applied, the 2008 reforms made both sets of provisions very much more complicated, so that the dual application presents much more complexity than before 2008.

The drafting of the OIG provisions was even more rushed than the rest of the 2008 legislation, leaving no time even for HMRC to properly consider the issues, let alone for consultation. There was an opportunity to rethink in the 2009 regulations, but HMRC had no desire to take it up. It seems to me that there can be no more devastating criticism of the rules than an attempt to explain them. The reader who labours through the next part of this chapter is likely to agree that the law ought to be simplified by applying either the income tax or the CGT anti-avoidance rules – CGT would be the better of the two, as OIGs are more like capital gains – but not both.

## 32.11 OIG TAA provisions

An OIG arising to a non-resident is not "income" so in the absence of express provision it would not fall within the TAA provisions even if it arose to a person abroad within s.720 or 731. Regulation 21(1) OFTR deals with this and thus applies the TAA provisions to OIGs:

> Chapter 2 of Part 13 of ITA 2007 (transfer of assets abroad) applies in relation to an offshore income gain arising to a person resident or domiciled outside the UK as if the offshore income gain were income becoming payable to the person.

It is helpful to distinguish the ordinary income tax transfer of asset rules and the rules as they apply to OIGs. I use the following terminology:

(1) "**OIG s.720**", the provisions of s.720 ITA which apply when a person abroad receives OIGs, deemed to be income within the scope of s.720.
(2) "**OIG s.731**", the provisions of s.731 ITA which apply when the person abroad receives OIGs which are deemed to be income and so relevant income, for the purposes of s.731; this may be contrasted with "**ordinary IT s.731**" which applies where the person abroad receives ordinary income which is relevant income.

Regulation 21(2) OFTR provides:

> Income treated as arising under that Chapter by virtue of paragraph (1) is regarded as "foreign" for the purposes of section 726, 730 or 735 of that Act.

This feeds into s.726 and 735 ITA which impose a remittance basis for OIG s.720 and OIG s.731. The motive defence may also apply.

There are only limited differences between the way that sections 720 and 731 work for OIGs and for ordinary income.

## 32.12 OIG s.87 charge

An OIG is not a chargeable gain, and so not a s.2(2) amount (trust gain), so in the absence of express provision it would not give rise to a charge under s.87 TCGA. Regulation 20(3) OFTR deals with this and applies the s.87 rules with modifications. Because there are modifications, there are significant differences between OIG s.87 and CGT s.87 rules.

### 32.12.1 *OIG s.87 charge*

Regulation 20(3) OFTR incorporates the s.87 TCGA rules in this manner:

> Sections 12, 87 to 90A and 96 to 98 of, and Schedule 4C to, TCGA 1992 apply in relation to OIG amounts as if—
> (a) references to section 2(2) amounts (except those in paragraph 7B(2)(b) and (4) of Schedule 4C) were to OIG amounts,
> (b) references to chargeable gains (except the one in paragraph 1(5) of Schedule 4C) were to offshore income gains,
> (c) references to anything accruing were to it arising[11] (and similar references, except the one in paragraph 1(5) of Schedule 4C, were read accordingly),
> (d) sections 87(4), 88(2) to (5) and 97(6) and paragraphs 1(3A), 3 to 7 and 12 of Schedule 4C were omitted, and
> (e) regulation 21 did not apply.

I do not set out all the these statutory provisions, as amended, because the

11 The terminology of the Taxes Acts is that CGT chargeable gains *accrue;* but OIGs *arise*. There is no difference in meaning so it seems somewhat pedantic to make the change of terminology when incorporating the CGT s.87 provisions for OIGs; but it does no harm.

text is far too long. The key provision is s.87(2)(3) TCGA which (amended as reg.20(3) directs) provides:

> [2][a] *Offshore income gains* are treated as *arising* in the relevant tax year to a beneficiary of the settlement
> [b] who has received a capital payment from the trustees in the relevant tax year or any earlier tax year
> [c] if all or part of the capital payment is matched (under s.87A as it applies for the relevant tax year) with the *OIG amount* for the relevant tax year or any earlier tax year.
> (3) The amount of *offshore income gains* treated as accruing is equal to—
> (a) the amount of the capital payment, or
> (b) if only part of the capital payment is matched, the amount of that part.

It is necessary to distinguish the CGT s.87 rules and the OIG s.87 rules because the rules are not identical. I use the following terminology:

(1) "**CGT s.87**", the provisions of s.87 TCGA which apply when the trust has a "**CGT s.2(2) amount**" (trust gains); if the section applies, a CGT chargeable gain accrues to a beneficiary which I call "**the s.87 deemed CGT gain**".
(2) "**OIG s.87**", the provisions of s.87 as amended, which apply when the trust has "**OIG amounts**"; if the section applies, an OIG accrues to a beneficiary which I call "**the s.87 deemed OIG**".

For a full discussion of CGT s.87, see 45.1 (Gains of Non-resident Trusts: section 87). I concentrate here on points where OIG s.13 is different from CGT s.13. But note one area where the two rules are the same. If a trust with OIG amounts makes a capital payment to a non-resident beneficiary, a s.87 deemed OIG is treated as accruing to the beneficiary under OIG s.87(2). But no income tax charge arises since the beneficiary qualifies for the OIG non-residence defence.[12] Thus capital payments to non-resident beneficiaries reduce (or "wash") OIG amounts, as they do for CGT s.2(2) amounts.

I deal with the 2008 transitional rules elsewhere because they are best

12 See 32.8 (OIG non-residence defence).

considered together with the CGT s.87 transitional rules.[13]

### 32.12.2 *"OIG amount"*

Regulation 20(2) OFTR defines the term "OIG amount":

> If—
> (a) offshore income gains arise to the trustees of a settlement in a tax year, and
> (b) section 87 of TCGA 1992 (gains of non-resident settlements) applies to the settlement for that year,
>
> the OIG amount for the settlement for that year is the amount of the offshore income gains.

"OIG amount" is the OIG equivalent of the CGT concept "s.2(2) amount" (formerly called trust gains) though the definition is not identically worded.[14]

It is necessary to have a different definition, since the definition of s.2(2) amounts (trust gains) caters for losses, and for CGT chargeable gains within s.86 TCGA; the definition of OIG amounts does not do this because there is no relief for OIG losses and s.86 does not apply.

One (I expect, unintended) consequence of the difference in drafting is that there is no double taxation relief where the OIGs are subject to a foreign capital gains tax.[15]

The drafter has correctly provided in reg. 20(3)(d) OFTR that s.87(4) TCGA does not apply for OIG s.87, because it has no role in that context.

---

13 See 45.22.1 (Pre-2008 OIG amounts); 45.23 (Pre-2008 inter-trust transfer); 45.32 (Rebasing - OIG amounts).

14 Section 87 TCGA provides:

"(4) The section 2(2) amount for a settlement for a tax year for which this section applies to the settlement is—

(a) the amount upon which the trustees of the settlement would be chargeable to tax under section 2(2) for that year if they were resident and ordinarily resident in the UK in that year, or

(b) if section 86 applies to the settlement for that year, the amount mentioned in para (a) minus the total amount of chargeable gains treated under that section as accruing in that year.

(5) The section 2(2) amount for a settlement for a tax year for which this section does not apply to the settlement is nil."

15 See 50.19 (DT reliefs: s.87 TCGA).

### 32.12.3 *"Capital payment"*

"Capital payment" is defined in s.97(1) TCGA. The OFTR does not amend this. It provides:

> In sections 86A to 96 and Schedule 4C and this section "capital payment"—
> (a) means
> [i] any payment which is not chargeable to income tax on the recipient
> [ii] or, in the case of a recipient who is neither resident nor ordinarily resident in the UK, any payment received otherwise than as income...

Suppose a trust within OIG s.87 makes a capital payment (or what appears to be a capital payment) to a UK resident beneficiary. The definition does not actually work for OIG s.87, since what would otherwise be a capital payment falling within OIG s.87 *is* chargeable to IT under OIG s.87! But for the purposes of OIG s.87 the definition must be taken to read that "capital payment" means:

> [i] any payment which is not chargeable to income tax on the recipient *[apart from OIG s.87]*
> [ii] or, in the case of a recipient who is neither resident nor ordinarily resident in the UK, any payment received otherwise than as income...

I refer to such a capital payment which is subject to income tax under OIG s.87 as an **"OIG capital payment"**.

### 32.12.4 *Deemed disposal*

If OIG s.87 applies, a beneficiary receives a s.87 deemed OIG. OIG s.87 does not directly impose a charge on that deemed OIG: the deeming feeds into reg.17 which imposes the charge when a gain accrues on the person making the disposal. A further deeming is needed, because the beneficiary to whom the s.87 deemed OIG accrues does not make a disposal. Therefore reg.20(5) OFTR provides for a deemed disposal, to bring the s.87 deemed OIG into charge under reg.17:

> If this regulation applies, the person to whom the offshore income gain arises is treated as the person making the disposal.

(The same rule applies for OIG s.13.)

### 32.12.5 *OIG s.87: miscellaneous points*

The deemed disposal rules of Schedule 4B TCGA do not apply to OIGs, but the harsh provisions of Schedule 4C TCGA may apply.

The interest supplement rule in s.91 TCGA applies only to CGT s.87 and not to OIG s.87.

A capital payment from a trust with OIG amounts does not give rise to an IHT exit charge as the exit charge income exemption applies.[16]

### 32.12.6 *OIG s.87 remittance basis*

If a remittance basis taxpayer receives a s.87 deemed OIG, s.87B TCGA applies to bring in a remittance basis just like the CGT s.87 remittance basis.

Reg.19(5) OFTR provides:

> This regulation does not apply for the purposes of regulation 20.

That disapplies the ordinary OIG remittance basis. That is needed because the OIG s.87B remittance basis applies instead.

### 32.12.7 *HMRC views*

HMRC agree with the above. The OFM provides:

> **OFM09315 Non-reporting funds: charge to tax on disposal of an interest: non-resident settlements: section 87 (and 87A) TCGA attribution rules: effect of residence and domicile status of beneficiary**
> **... Beneficiary is UK resident but non-UK domiciled**
> Where attributions are made to a beneficiary who is UK resident or ordinarily resident but non-UK domiciled then, under section 87 (and

16 See 27.11.5 (Interaction with IHT exit charge income exemption.)

87A) TCGA rules, the full amount attributed may not be chargeable to income tax for the following reasons

• such an individual will not be chargeable to income tax on offshore income gains attributed to them to the extent that in the matching process

- a capital payment received before 6 April 2008 is matched, or
- an OIG amount for the tax year 2007-08, or earlier, is matched (paragraph 100 Schedule 7 FA 2008).

• If the trustees have made a "rebasing" election under paragraph 126 Schedule 7 FA 2008 then such an individual will not be chargeable on the pre-6 April 2008 element of the offshore income gain attributed to them (paragraph 101 Schedule 7 FA 2008).

• If such an individual is a remittance basis user they can have the benefit of the remittance basis via the rules in section 87B TCGA.

The full amount of the offshore income gain attributed to the individual reduces the OIG amount of the non-resident settlement structure that is available to match with future capital payments. That is so even though less than the full amount may be chargeable to income tax on the individual.

**Beneficiary is non-UK resident**

Offshore income gains can still be attributed to a beneficiary who is not resident or ordinarily resident in the UK using the section 87 TCGA attribution rules. This applies even though they may not be chargeable to tax on such an individual. Any such attribution reduces the OIG amount of the non-resident settlement structure that is available to match with future capital payments.

## 32.13 OIG s.13 charge

An OIG is not a chargeable gain, so in the absence of express provision it would not fall within s.13 TCGA. Regulation 24(1) OFTR deals with this and applies s.13 TCGA to OIGs with modifications:

(1) Section 13 of TCGA 1992 (chargeable gains accruing to certain non-resident companies) applies for the purposes of this Part with the following modifications.

(2) The section applies as if—

(a) for any reference to a chargeable gain there were substituted a reference to an offshore income gain; and

(b) for any reference to anything accruing there were substituted a reference to it arising[17] (with similar references being read accordingly).

(3) The section applies as if, in subsection (5), paragraphs (b) and (c) were omitted.

(4) The section applies as if, in subsection (7), for the reference to capital gains tax there were substituted a reference to income tax or corporation tax.

(5) The section applies as if subsection (8) were omitted. ...

I refer to this as **"the OIG s.13 charge"**. It is necessary to distinguish the CGT s.13 rules and the OIG s.13 rules because the rules (though similar) are not identical. I refer below to:

(1) "**CGT s.13**", the provisions of s.13 TCGA which apply where CGT chargeable gains accrue to the non-resident company; if the section applies, a CGT chargeable gain accrues to a participator which I call "**the CGT s.13 deemed gain"**.

(2) "**OIG s.13**", the provisions of s.13 as amended, which apply where OIGs arise to the non-resident company; if the section applies, an OIG accrues to a participator which I call "**the OIG s.13 deemed OIG"**.

Amended as reg.24 directs, s.13 TCGA provides:

**Attribution of [OIGs] to members of non-resident companies**

(1) This section applies as respects *offshore income gains arising* 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 arises* to the company is resident or ordinarily resident in the UK, and who is a participator in the company, shall be treated for the purposes of this Act as if a part of the *offshore income gain* had *arisen* 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.

17 The terminology of the Taxes Acts is that CGT chargeable gains *accrue;* but OIGs *arise*. There is no difference in meaning so it seems somewhat pedantic to make the change of terminology when incorporating the CGT s.13 provisions for OIGs; but it does no harm.

(4) Subsection (2) above shall not apply in the case of any participator in the company to which the *offshore income gain arises* where the aggregate amount falling under that subsection to be apportioned to him and to persons connected with him does not exceed one tenth of the gain.
(5) This section shall not apply in relation to—
~~(b) *an offshore income gain* accruing on the disposal of an asset used, and used only—~~
~~(i) for the purposes of a trade carried on by the company wholly outside the UK, or~~
~~(ii) for the purposes of the part carried on outside the UK of a trade carried on by the company partly within and partly outside the UK, or~~
~~(c) *an offshore income gain* accruing on the disposal of currency or of a debt within section 252(1), where the currency or debt is or represents money in use for the purposes of a trade carried on by the company wholly outside the UK, or~~
(d) to *an offshore income gain* in respect of which the company is chargeable to tax by virtue of section 10B.
[*Subsections 5A to 7A relate to company distribution relief and company disposal relief and need not be printed here.*]
~~(8) So far as it would go to reduce or extinguish chargeable gains accruing by virtue of this section to a person in a year of assessment this section shall apply in relation to a loss accruing to the company on the disposal of an asset in that year of assessment as it would apply if a gain instead of a loss had accrued to the company on the disposal, but shall only so apply in relation to that person; and subject to the preceding provisions of this subsection this section shall not apply in relation to a loss accruing to the company.~~
(9) If a person who is a participator in the company at the time when the *offshore income gain arises* to the company is itself a company which is not resident in the UK but which would be a close company if it were resident in the UK, an amount equal to the amount apportioned under subsection (3) above out of the *offshore income gain* to the participating company's interest as a participator in the company to which the gain *arises* shall be further apportioned among the participators in the participating company according to the extent of their respective interests as participators, and subsection (2) above shall apply to them accordingly in relation to the amounts further apportioned, and so on through any number of companies.
(10) The persons treated by this section as if a part of an *offshore income gain arising* to a company had *arisen* to them shall include the trustees of a settlement who are participators in the company, or in any

company amongst the participators in which the gain is apportioned under subsection (9) above, if when the gain *arises* to the company the trustees are neither resident nor ordinarily resident in the UK.
(10B) [*This relates to pension schemes and need not be set out here*]
(11) [*This confers relief where tax is paid by the company and need not be set out here]*
(11A) For the purposes of this section the amount of the gain or loss[18] *arising* at any time to a company that is not resident in the UK shall be computed (where it is not the case) as if that company were within the charge to corporation tax on *offshore income gains*.
[*Section 13(12) to (15) contain definition and administrative provisions which need not be set out here*]

For a full discussion of CGT s.13, see 47.1 (Gains of Non-resident companies). I concentrate here on areas where OIG s.13 is different from CGT s.13.

The most important difference is that a CGT s.13 deemed gain is subject to CGT at CGT rates; an OIG s.13 deemed OIG is subject to IT at IT rates.

The deletions in s.13(5)(8) make sense as those CGT rules would not be appropriate for OIG s.13.

DTA relief may apply where a UK resident trustee holds a treaty non-resident company to which an OIG applies: s.79B TCGA disapplies the relief for CGT[19] but not for OIG. Offshore group relief does not apply to OIG s.13 because reg.24 does not incorporate s.14 TCGA.

## 32.13.1 *Deemed disposal*

If OIG s.13 applies, a participator receives an OIG s.13 deemed OIG. OIG s.13 does not directly impose a charge on that deemed OIG: the deeming feeds into reg.19 which imposes the charge when an OIG arises on the person making the disposal. A further deeming is needed, because the participator to whom the s.13 deemed OIG accrues does not make a disposal. Therefore reg.24(6) OFTR provides for a deemed disposal, to bring the deemed OIG into charge under reg.17:

18 The words "or loss" are otiose here. Presumably the drafter overlooked the need to delete them as the legislation takes the trouble to delete them elsewhere. But nothing turns on that.

19 See 50.14.4 (Disallowance of DT relief for trust participator).

> If this regulation applies, the person to whom the offshore income gain arises is treated as the person making the disposal.

(The same rule applies for OIG s.87.)

### 32.13.2 *OIG s.13 remittance basis*

Section 14A TCGA provides the CGT s.13 remittance basis, but this section does not apply for the purposes of OIG s.13. Instead reg.19 applies, but the end result is the same. This explains reg.19(3)(a) which provides:

> (3) For the purposes of Chapter A1 of Part 14 of ITA 2007(10) (remittance basis)—
> (a) any consideration obtained on the disposal of the asset is treated as deriving from the income. ...

This is the equivalent of s.14A(3)(a) TCGA which similarly provides:

> (3) For the purposes of Chapter A1 of Part 14 of ITA 2007 (remittance basis)—
> (a) treat any consideration obtained by the company on the disposal of the asset as deriving from the deemed chargeable gain. ...

## 32.14 OIGs and s.86 TCGA

A settlor of a non-resident trust is not subject to tax on OIGs under s.86 TCGA 1992; s.720 may apply in this case.

Suppose a non-resident trust where:
(1) the settlor and spouse are excluded, but
(2) s.86 applies (because the settlor is UK domiciled and the settlor's children are beneficiaries)

It may be attractive for a trust to invest in offshore funds (which give rise to OIGs outside s.86) rather than other assets (which give rise to CGT chargeable gains within s.86). Similarly, the trustees may invest for income and not capital growth. It may however be a balancing exercise, as to do so does increase the rate of tax on capital payments.

## 32.15 Interaction of anti-avoidance provisions

### 32.15.1 *Priority between OIG s.87 and CGT s.87*

Suppose a capital payment is made to a beneficiary from a trust with OIG amounts and CGT s.2(2) amounts. This would in principle give rise to a charge under OIG s.87 and CGT s.87, or at least it might not be clear which of the two applied.

It matters which applies because in one case the OIG is taxed at income tax rates and in the other the CGT chargeable gain is taxed at CGT rates.

Regulation 20(4) OFTR deals with this:

> Section 87A of TCGA 1992 applies for a tax year by virtue of paragraph (3) before it applies for that year otherwise than by virtue of that paragraph.

In short, OIG s.87 has priority to CGT s.87. Where OIG s.87 applies to a capital payment, there is no "capital payment" for the purposes of CGT s.87 as the payment is subject to income tax.

The OFM offers the following example:

> **OFM09320 Non-reporting funds: charge to tax on disposal of an interest: non-resident settlements: section 87 (and 87A) TCGA attribution rules: example**
>
> **Allocating capital payments between offshore income gains and chargeable gains arising in non-resident settlements – regulation 20(4)**
>
> **Example where both offshore income gains and capital gains received**
>
> A settlement with non-UK resident trustees has never been settlor interested and has never received any income. The following OIG amounts and capital gains have been received by the settlement:

| | OIG amount | Chargeable gains |
|---|---|---|
| 2008-09 | £30,000 | |
| 2009-10 | | £40,000 |
| 2010-11 | £50,000 | £60,000 |

> The first capital payment out of the settlement is made in 2010-11. That is a capital payment of £70,000 to a UK resident and domiciled beneficiary.

The HMRC analysis for 2010/11 is as follows:

> Regulation 20(4) tells you that you match any capital payments with OIG amounts arising in the non-resident settlement before matching with chargeable gains. This applies even if the OIG amount arose in an earlier year than the capital gain.
> Using the section 87A TCGA attribution rules the capital payment is matched first with the entire £50,000 OIG amount arising in 2010-11. Then the remaining £20,000 (£70,000 - £50,000) is matched with £20,000 of the £30,000 OIG amount arising in 2008-09.
> The beneficiary is treated as receiving £70,000 offshore income gains chargeable to income tax in 2010-11.

There are two errors here:

(1) The author has overlooked OIG s.731. In principle, the £30k OIG in 2008/09 is relevant income. The HMRC analysis is only correct if there are special circumstances which disapply OIG s.731, such as (1) the motive defence applies, or (2) if the beneficiary is resident but not ordinarily resident in the UK.

(2) The authors emphasises that the capital payment is matched with (1) the £50k OIG in 2010/11 and (2) £20k of the OIG in 2008/09. But it does not matter, as on the facts of the example, it makes no difference to which OIG the capital payment is matched. It matters for CGT chargeable gains, because of the interest surcharge, but that does not apply for OIG.

HMRC then turn to consider the position going forward:

> There are unmatched OIG amounts and chargeable gains in the settlement to carry forward at 5 April 2011 of:
> 2008-09 OIG amount £10,000 (£30,000 less £20,000 matched with capital payment)
> 2009-10 Capital gains £40,000
> 2010-11 Capital gains £60,000.

The HMRC example is an easier case as there was one capital payment which was less than the total OIGs. Suppose there was more than one, and the total amount exceeded the OIGs. For instance, on the facts of the above example, and assuming (as do HMRC) that s.731 is not applicable, suppose in the same year but on different days:
Capital payment (1): £80k

Capital payment (2): £20k.
Does one say:
(a) Capital payment (1) is matched with the OIG and capital payment (2) is matched with the CGT chargeable gains? or
(b) Each capital payment is matched with 80% of the OIG and 20% of the CGT chargeable gains?

It is considered that solution (b) is correct. That is consistent with the rule for s.2(2) amounts (trust gains).

### 32.15.2 *Priority between OIG s.13 & TAA provisions: company not held by trust*

Suppose an OIG accrues to a non-resident company (the company not being held by a trust). This could give rise to a charge under OIG s.720 (on the transferor) and under OIG s.13 (on the participators), or at least it might not be clear which of the two charges applies.

It may not matter which applies, as the OIG is taxed at income tax rates in either event, but it could matter eg if the transferor is not the sole participator or if some exemption to s.13 is in point.

Regulation 21(3) OFTR deals with this but it needs to be read with reg.21(1) to follow the sense:

> (1) Chapter 2 of Part 13 of ITA 2007 (transfer of assets abroad) applies in relation to an offshore income gain arising to a person resident or domiciled outside the UK as if the offshore income gain were income becoming payable to the person.
> (3) Paragraph (1) does not apply in relation to an offshore income gain if (and to the extent that) it is treated, by virtue of regulation 24 [OIG s.13], as arising to a person resident or ordinarily resident in the UK.

In short, a s.13 OIG charge has priority over the OIG TAA provisions. Regulation 24(7) OFTR provides:

> To the extent that an offshore income gain is treated, by virtue of this regulation, 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 (transfer of assets abroad).

### 32.15.3 *Priority between OIG s.13 and TAA provisions: company held by trust*

Suppose an OIG accrues to a company held by a settlor-interested trust. Suppose the company is within s.720. The trustees make a capital payment to a UK resident beneficiary. This could give rise to
(1) a charge under OIG s.720 on the transferor and
(2) under OIG s.87 on the beneficiary, on the basis that the OIGs accrue to the trustees under s.13 and constitute OIG amounts which are matched to the capital payments.
Is relief available under reg. 24(7) OFTR? That provides:

> To the extent that an offshore income gain is treated, by virtue of this regulation, 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 (transfer of assets abroad).

One would have to argue that the gain accruing to the individual is the same gain as that accruing to the company. It is suggested that this is the case, since otherwise there would be a strange anomaly between this case and the simple case where the OIG accrues to the trust directly (without a company). The purpose of s.13 is to put the taxpayer in the same position as if there were no company.

## 32.16 Priority between OIG s.87 and OIG TAA provisions

Suppose an OIG accrues to a non-resident trust which makes a capital payment to a beneficiary. This could give rise to a charge under OIG s.87 and the TAA provisions, or at least it might not be clear which of the two applies.

It matters which applies because:
(1) OIG s.87 qualifies for rebasing relief.
(2) OIG s.87 qualifies for 2008 transitional relief.
(3) Different mixed fund rules apply.
Regulation 21(5) deals with this but one first needs to read reg.21(4) OFTR which provides:

> The following provisions apply if regulation 20 applies in relation to an offshore income gain (the "relevant offshore income gain").

In short, the two provisions which follow – reg.21(5)(6) – apply where an OIG accrues to a non-resident trust.

Regulation 21(5) needs to be read with reg.21(1) to follow the sense:

> (1) Chapter 2 of Part 13 of ITA 2007 (transfer of assets abroad) applies in relation to an offshore income gain arising to a person resident or domiciled outside the UK as if the offshore income gain were income becoming payable to the person.
> (5) If—
> (a) by virtue of regulation 20 [OIG s.87] an offshore income gain is treated as arising in a tax year to a person resident or ordinarily resident in the UK, and
> (b) it is so treated by reason of the relevant offshore income gain (or part of it),
> for that and subsequent tax years paragraph (1) does not apply in relation to the relevant offshore income gain (or that part).

In short, the OIG s.87 charge has priority over the TAA provisions *if* the OIG amount is matched to a capital payment to a *UK resident*. I refer to this provision as "**OIG matching relief**". This applies even if the OIG s.87 charge is matched to a remittance basis taxpayer and (un)taxed on the OIG s.87 remittance basis, because an OIG is nevertheless treated as arising to a UK resident.

This rule applies for Chapter 2 of Part 13 of ITA 2007 but it is helpful to consider s.720 and s.731 separately.

### *32.17 Priority between OIG s.720 and OIG s.87*

The following examples are based on this situation:
(1) A non-resident settlor-interested trust is within s.720. The transferor/settlor (for the purposes of these examples the terms are interchangeable) is UK resident. The motive defence does not apply.
(2) The trust has realised an OIG in year 1 of £1m.
(3) The trust has no relevant income.

*Example 1*
*The trustees make no capital payment to any beneficiary in the year that*

*the OIG accrues.*
The settlor as transferor is taxed on the OIG under OIG s.720 (subject to the s.720 remittance basis if applicable).

Regulation 21(6) OFTR prevents a double charge to tax under OIG s.87, if there is a capital payment in a subsequent tax year. It provides:

> If, by virtue of paragraph (1) as it applies in relation to the relevant offshore income gain, income is treated under Chapter 2 of Part 13 of ITA 2007 as arising in a tax year, the OIG amount in question must be reduced (with effect from the following tax year) by the amount of the income.

*Example 2*
*The trustees make a capital payment of £1m to the settlor in year 1.*
The settlor is taxed on the capital payment under OIG s.87 (subject to the s.87 OIG remittance basis).
The TAA provisions are disapplied for the OIG because OIG matching relief applies.
It may make no difference whether it is OIG s.720 or OIGs.87 which is used to tax the settlor but it may matter for the following reasons:
(1) rebasing relief
(2) 2008 transitional relief
(3) mixed fund rules.

*Example 3*
*The trustees make a capital payment of £1m to a UK resident beneficiary (not the settlor) in year 1.*
The beneficiary is taxed on the capital payment under OIG s.87 (subject to the s.87 OIG remittance basis).
The TAA provisions are disapplied for the OIG.
So the result of the capital payment is to shift the tax charge from the settlor to the beneficiary. This would be particularly important if the beneficiary was a remittance basis taxpayer and the settlor was not. In such a case a capital payment to the beneficiary would save tax. The capital payment also affects the quantum of the charge if rebasing relief applies or 2008 transitional relief.

*Planning for trust within s.720 which realises an OIG*
In short, where an OIG arises to a trust within s.720, it is advantageous for

the trustees to make a capital payment matched to the OIG amount if:

(1) the settlor is not a remittance basis taxpayer and the a beneficiary is a remittance basis taxpayer; or
(2) if rebasing relief applies.

This planning point will often require a distribution to be made in the year that the OIG arises. The sum distributed need not be the proceeds representing the OIG. Other capital payments (eg the use of living accommodation) may suffice as that capital payment may be matched with the OIG.

If there is no time to make a payment in the form of a bank transfer, a resolution of the trustees to exercise their power to make a distribution will suffice. If the figures are not available, a resolution to distribute an amount equal to the offshore income gains will suffice. Inn order to make a distribution, it may be necessary to make a deed of appointment, or obtain consent of a protector: that depends of course on the terms of the trust.

### 32.17.1 *Priority between OIG s.731 and OIG s.87 over same OIG*

I turn to consider whether OIG s.87 TCGA 1992 takes precedence over OIG s.731.

Having regard to OIG matching relief:

(1) if the OIG amount is matched to a capital payment to a UK resident then an OIG is treated as arising in the year to that beneficiary and
(2) this disapplies OIG s.731.

In short, the OIG s.87 charge has priority over OIG s.731. This applies even if the OIG s.87 charge is (un)taxed on the OIG s.87 remittance basis because the s.87 deemed OIG is nevertheless treated as arising.

*Examples*

The following examples are based on this situation:

(1) A non-resident trust is within s.731 (UK resident beneficiaries) but not within s.720 (transferor has no power to enjoy or else is not UK resident.) The motive defence does not apply.
(2) The trust has realised an OIG in year 1 of £1m.
(3) The trust has no relevant income (leaving aside the OIG).

*Example 1*
*The trustees make a capital payment of £1m to a beneficiary in year 1.*
The beneficiary is taxed on the capital payment under OIG s.87 (subject to the s.87 OIG remittance basis).
The TAA provisions are disapplied, ie, the OIG does not become relevant income.

*Example 2*
*(1) The trustees make no capital payment to any beneficiary in the year that the OIG accrues*
No-one can be subject to tax in year 1 as OIG s.87 only applies if there is a capital payment and OIG s.731 only applies if there is a benefit (which for practical purposes means the same as a capital payment).
(2) *The trustees make a capital payment of £1m to a UK resident beneficiary in year 2.*
The beneficiary is taxed on the capital payment under OIG s.87 (subject to the s.87 OIG remittance basis).
I have considered regulation 21(6) OFTR which provides:

> If, by virtue of paragraph (1) as it applies in relation to the relevant offshore income gain, income is treated under Chapter 2 of Part 13 of ITA 2007 as arising in a tax year, the OIG amount in question must be reduced (with effect from the following tax year) by the amount of the income.

Does this apply in year 1? Only if *income is treated under Chapter 2 of Part 13 of ITA as arising* in year 1. Chapter 2 part 13 uses the expression *income is treated as arising* in s.731 (income treated as arising to a non-transferor) and in s.720 (income treated as arising to a transferor). However these sections do not apply in year 1. So reg.21(6) does not apply.

I have considered the argument that income is treated as arising in year 1 to the *person abroad* (the OIG) because of reg.21(1). But this is not correct, for such income is not treated as arising under Chapter 2 Part 13. This is confirmed, I think, by reg. 21(2) OFTR which uses the expression "treated as arising" where the reference is clearly to income treated as arising to the transferor under s.720 or to a beneficiary under s.731.

It follows that all capital payments are taxed under OIG s.87 and not OIG s.731. This is a fair and reasonable result.

## 32.17.2 *OFM example: OIG s.87 - 2008 transitional relief*

The OFM provides:

> **OFM09325 Non-reporting funds: charge to tax on disposal of an interest: non-resident settlements: attribution rules: example of non-UK domiciled beneficiary not chargeable on offshore income gain arising prior to 6 April 2008**
> **Example showing how a UK resident but non-UK domiciled beneficiary may not be chargeable to tax on an offshore income gain arising in a non-resident settlement prior to 6 April 2008 – paragraph 100 Schedule 7 FA 2008**
> **Example of effect of paragraph 100 Schedule 7 FA 2008**
> A settlement with non-UK resident trustees has never been settlor interested. The trustees own all the share capital of a non-UK resident company. Neither the trustees nor the company has received any income nor made any chargeable gains.
> The non-resident company held a material interest in an offshore fund. When that was disposed of in 2005-06 an OIG amount of £60,000 arose.
> The first capital payments to beneficiaries were made in 2010-11 which were:
> £40,000 to a UK resident and domiciled beneficiary
> £40,000 to a UK resident but non-UK domiciled beneficiary
> £40,000 to a non-UK resident beneficiary.
> There is a matching of £20,000 of each of these capital payments with the 2005-06 OIG amount. Each beneficiary has £20,000 of offshore income gain attributed to them via section 87 TCGA rules. There are no unmatched OIG amounts to carry forward within the non-resident settlement structure.
> The UK resident and domiciled beneficiary is chargeable to income tax in 2010-11 on the £20,000 offshore income gain attributed to them.
> The UK resident but non-UK domiciled beneficiary is not chargeable to income tax on any of the £20,000 offshore income gain attributed to them. This is because the OIG amount used in the section 87 matching process arose before 6 April 2008 - paragraph 100(2)(b) Schedule 7 FA 2008.
> The non-UK resident beneficiary is not chargeable to income tax on any of the £20,000 offshore income gain attributed to them.
> There are unmatched capital payments of £20,000 to each beneficiary to carry forward at 5 April 2011.

What is the position for s.731? Para 21(5) OFTR (OIG matching relief) provides:

> If—
> (a) by virtue of regulation 20 [OIG s.87] an offshore income gain is treated as arising in a tax year to a person *resident or ordinarily resident in the UK*, and
> (b) it is so treated by reason of the relevant offshore income gain (or part of it),
> for that and subsequent tax years paragraph (1) does not apply in relation to the relevant offshore income gain (or that part).

Of the £60k OIG, only £40k is treated as arising to persons resident in the UK, so one might think that £20k remained as relevant income, taxable on the UK resident beneficiaries. That is absurd, for contrast the situation where the same payments are made to the UK beneficiaries and no payment to the non resident. The UK domiciled resident is taxed on £30k and the foreign domiciled resident is not taxed. It seems strange if the tax should be more because of the payment to the non-resident. The author of the OFM presumably thought so.

The same point applies to the next example.

### 32.17.3 *OFM example: OIG s.87 - rebasing relief*

The OFM provides:

> **OFM09330 Non-reporting funds: charge to tax on disposal of an interest: non-resident settlements: attribution rules: example of effect of 'rebasing' election**
> **Example showing how a UK resident but non-UK domiciled beneficiary may benefit from a 'rebasing' election – paragraph 101 Schedule 7 FA 2008**
> **Example of effect of 'rebasing' election - paragraph 101 Schedule 7 FA 2008**
> A settlement with non-UK resident trustees is settlor interested because the settlor can benefit. The trustees own all the share capital of a non-UK resident company. Neither the trustees nor the company has received any income nor made any chargeable gains. The trustees have made a 'rebasing' election under paragraph 126 Schedule 7 FA 2008.

The non-resident company purchased a material interest in an offshore fund in 2000-01. This is disposed of in 2010-11 resulting in an OIG amount of £60,000. The post 5 April 2008 element of that OIG amount is £15,000.

The first capital payments made to beneficiaries were made in 2010-11. They were:

£40,000 to a UK resident and domiciled beneficiary

£40,000 to a UK resident but non-UK domiciled beneficiary

£40,000 to a non-UK resident beneficiary.

There is a matching of £20,000 of each of these capital payments with the 2010-11 OIG amount. Each beneficiary has £20,000 of offshore income gain attributed to them via section 87 TCGA rules. There are no unmatched OIG amounts to carry forward within the non-resident settlement structure.

The UK resident and domiciled beneficiary is chargeable to income tax in 2010-11 on the £20,000 offshore income gain attributed to them.

The UK resident but non-UK domiciled beneficiary (where the remittance basis is used) is only chargeable to income tax on £5,000 (£20,000×£15,000/£60,000) of the £20,000 offshore income gain attributed to them. That is the post 5 April 2008 element of the £20,000 offshore income gain attributed to them. This is by virtue of paragraph 101 Schedule 7 FA 2008.[20]

The non-UK resident beneficiary is not chargeable to income tax on any of the £20,000 offshore income gain attributed to them.

There are unmatched capital payments of £20,000 to each beneficiary to carry forward at 5 April 2011.

### 32.17.4 *OFM example: OIG s.720 - loss of rebasing relief*

The OFM provides:

**OFM09335 Non-reporting funds: charge to tax on disposal of an interest: non-resident settlements: attribution rules: example of ‘rebasing’ election having no effect**

**Example showing how a UK resident but non-UK domiciled beneficiary may not benefit from a ‘rebasing’ election – paragraph 101 Schedule 7 FA 2008**

**Example of ‘rebasing’ election having no effect - paragraph 101 Schedule 7 FA 2008**

20 [Author’s note:] it is assumed that the remittance basis does not apply.

> This example has similar facts as that in OFM09330 with the exception that capital payments are not made to beneficiaries until a year after that in which the OIG amount arises in the offshore trust structure. In such a case there may be no benefits of a 'rebasing' election to a non-UK domiciled beneficiary in respect of any offshore income gain attributed to them.
>
> A settlement with non-UK resident trustees is settlor interested because the UK resident and ordinarily resident, but non-domiciled, settlor can benefit. The trustees own all the share capital of a non-UK resident company. Neither the trustees nor the company has received any income nor made any capital gains. The trustees have made a 'rebasing' election under paragraph 126 Schedule 7 FA 2008.
>
> The non-resident company purchased a material interest in an offshore fund in 2000-01. This is disposed of in 2010-11 resulting in an OIG amount of £60,000. The post 5 April 2008 element of that OIG amount is £15,000.
>
> The first capital payments made to beneficiaries were made in 2011-12. They were:
>
> £40,000 to a UK resident and domiciled beneficiary
>
> £40,000 to a UK resident but non-UK domiciled beneficiary (who was also the settlor)
>
> £40,000 to a non-UK resident beneficiary.
>
> In 2010-11 there have been no capital payments in that year, or earlier years, to beneficiaries. So there can be no attribution of the OIG amount to beneficiaries under the section 87 attribution rules in regulation 20.
>
> We then have to consider if there can be an attribution under the transfer of assets rules in regulation 21 for 2010-11. The entire £60,000 OIG amount can be attributed to the settlor as an offshore income gain for that year. The non-UK domiciled settlor is chargeable to income tax in 2010-11 on the £60,000 offshore income gains attributed to them, subject to any remittance basis considerations. The 'rebasing' election has no effect on the amount chargeable to income tax as the attribution has not been made via the section 87 attribution rules.
>
> The OIG amount is reduced to Nil (regulation 21(6)). There are no unmatched OIG amounts to carry forward to 2011-12. There is nothing to match with the capital payments made in 2011-12 so the full amount of those payments are unmatched capital payments to carry forward at 5 April 2012.

Was this result intended in 2008? Since HMRC gave no indication of their thinking, it is hard to tell.

## 32.18 Interaction of OIG s.87 and OIG TAA provisions where motive defence applies

EN FB 2008 provides:

> 46. Offshore income gains that are not matched in that year [the year they arise] will be chargeable to tax by reason of the provisions relating to the transfer of assets abroad legislation in Chapter 2 of Part 13 of the Income Tax Act 2007. *There is an exception to this rule where the motive or purpose defence in sections 736 to 742 applies to the gain.*

The legislation has not however achieved this result. Regulation 21(6) disapplies OIG s.87:

> If, by virtue of paragraph (1) as it applies in relation to the relevant offshore income gain, income is treated under Chapter 2 of Part 13 of ITA 2007 as arising in a tax year,...

We must ask whether "income is treated under Chapter 2 of Part 13 of ITA 2007 as arising" if the motive defence applies. In fact even where the motive defence does apply, income is treated as arising *to the person abroad*. Regulation 21(1) OFTR provides:

> Chapter 2 of Part 13 of ITA 2007 (transfer of assets abroad) applies in relation to an offshore income gain arising to a person resident or domiciled outside the UK as if the offshore income gain were income becoming payable to the person.

But reg.21(6) is perhaps intending us to ask if income is treated as arising *to the transferor or to a non-transferor* under s.720 or s.731. Section 739(2) ITA provides the relief where the motive defence applies to pre-2006 transactions:

> An individual is not liable for income tax under this Chapter for the tax year by reference to the relevant transactions if the individual satisfies an officer of Revenue and Customs that condition A or B is met.

Section 737(2) ITA is identically worded for post-2006 transactions. Now, even though the individual is not liable for IT, the terms of reg.21(6) are still satisfied: "income is treated under Chapter 2 of Part 13 of ITA 2007 as arising in a tax year" even if the individual is not liable for income tax on that income. The result is not absurd, especially since the motive defence may be retrospectively lost by a tainted associated operation.

A court may find this too literal an approach. But as the legislation becomes more and more complex (and the OFTR is as complex as tax can get), it is less and less appropriate to apply anything but a literal interpretation to find what it means.

## 32.19 Computation of OIGs

Regulation 38 OFTR provides:

> (1) An offshore income gain arises to a person on the disposal of an asset if a basic gain arises on the disposal.
> (2) The disposal gives rise to an offshore income gain of an amount equal to the basic gain on the disposal.
> (3) The following provisions of this Chapter explain how the basic gain is computed.

So we move on to regulation 39:

> (1) In the case of a participant chargeable to income tax, the basic gain is a gain of the amount which would be the gain on that disposal for the purposes of TCGA 1992 if the gain were computed without regard to any charge to income tax arising under this Part.
> (2) In the case of a participant chargeable to corporation tax, the basic gain is a gain of the amount which would be the gain on that disposal for the purposes of TCGA 1992 if the gain were computed—
> (a) without regard to any charge to corporation tax arising under this Part, and
> (b) without regard to any indexation allowance on the disposal under TCGA 1992.

Following the abolition of CGT indexation and taper reliefs, the amount of an OIG accruing on a disposal by individuals or trustees is generally the same as the amount of a CGT chargeable gain would be had the asset not been an offshore fund. For UK companies, the gain is the same except that there is no indexation allowance.

There is no relief for tax credits or foreign tax paid by the offshore fund (except that such tax reduces the value of the fund and so reduces the

OIG). But this is also the case for CGT.

Regulation 39(3) flags up specific OIG rules:

> The computation of the basic gain is subject to—
> (a) regulation 34 (provisions applicable on death);
> (b) regulation 35 (application of section 135 of TCGA 1992);
> (c) regulation 36 (application of section 136 of TCGA 1992);
> (d) regulation 37 (exchange of interests of different classes);
> (e) regulation 40 (earlier disposal to which the no gain/no loss basis applies);
> (f) regulation 41 (modifications of TCGA 1992);
> (g) regulation 42 (losses);
> (h) regulation 43 (special rules for certain existing holdings).

I do not discuss regulations 35-39. Regulation 40 prevents indexation relief creeping in by the back door:

> **Earlier disposal to which the no gain/no loss basis applies**
> 40.—(1) This regulation applies if—
> (a) a participant is chargeable to corporation tax, and
> (b) the amount of any chargeable gain or allowable loss which would arise on the disposal would fall to be computed in a way which, in whole or in part, would take account of the indexation allowance on an earlier disposal to which section 56(2) of TCGA 1992 (disposals on a no gain/no loss basis) applies.
> (2) The basic gain on the disposal is computed as if—
> (a) no indexation allowance had been available on any such earlier disposal, and
> (b) subject to that, neither a gain nor a loss had arisen to the person making such an earlier disposal.

Regulation 41 disapplies rollover and holdover reliefs:

> (1) If the disposal forms part of a transfer to which section 162 of TCGA 1992 (roll-over relief on transfer of business) applies, the basic gain arising on the disposal is computed without regard to any deduction which falls to be made under that section in computing a chargeable gain.
> (2) If the disposal is made otherwise than under a bargain at arm's length and a claim for relief is made in respect of that disposal under section 165 or 260 of TCGA 1992 (relief for gifts), the claim does not affect the computation of the basic gain arising on the disposal.

## 32.20 Computation of CGT chargeable gain on disposal of offshore fund

A disposal for the offshore funds rules is generally also a disposal for CGT. The OFTR provides relief against a double charge. Regulation 44 sets the scene and provides terminology:

> (1) This Chapter applies if—
> (a) a material disposal[21] gives rise to an offshore income gain, and
> (b) that disposal also constitutes the disposal of the interest concerned for the purposes of TCGA 1992.
> (2) In this Chapter the disposal specified in paragraph (1)(b) is called the "TCGA disposal".

I adopt that terminology here. In practice a disposal of an offshore fund will generally be a TCGA disposal. Regulation 45 OFTR provides:

> (1) This regulation applies for the purposes of the computation of the chargeable gain arising on the TCGA disposal.
> (2) The provisions of this regulation have effect in relation to the TCGA disposal in substitution for section 37(1) of TCGA 1992 (deduction of consideration chargeable to tax on income).
> (3) In the computation of the gain arising on the TCGA 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.

Regulation 45(2) disapplies s.37(1) TCGA which normally governs the overlap between IT and CGT. It introduces instead its own rules in reg.45(3). I am not sure why, because s.37 would have had the same effect.[22]

This may apply to disposals on which no OIG charge arises. A TCGA disposal includes:

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21 Defined in reg.15: "In these Regulations a 'material disposal' means a disposal to which this Part applies." Since the expression "material disposal" is only used once in reg.44, it could have been more concisely expressed, but the meaning is clear.

22 Section 37(1) TCGA provides: "There shall be excluded from the consideration for a disposal of assets taken into account in the computation of the gain any money or money's worth charged to income tax as income of, or taken into account as a receipt in computing income or profits or gains or losses of, the person making the disposal for the purposes of the Income Tax Acts."

(1) A disposal by a non-resident individual, although the OIG non-residence defence applies.
(2) A disposal by a remittance basis taxpayer, although the OIG remittance basis applies.
(3) A disposal by a non-resident trust, although outside the scope of the OIG charge.
(4) A disposal by a non-resident company.

Regulation 45(5)(6) OFTR deals with part disposals:

> (5) Paragraph (6) applies if the TCGA disposal is of such a nature that, by virtue of section 42 of TCGA 1992 (part disposals), an apportionment falls to be made of certain expenditure.
> (6) No deduction is to be made by virtue of paragraph (3) in determining the amount or value of the consideration for the purposes of the fraction in section 42(2) of TCGA 1992.

The OFM provides:

> **OFM11100 Investors in non-reporting funds: deduction of offshore income gains in computing capital gains: treatment of the disposal - general – Regulation 45**
> Where there is a part-disposal so that section 42 of TCGA applies to determine the apportionment of acquisition costs to the disposal then the full amount of disposal consideration is taken into account for the purposes of the calculation required by that section – that is, the offshore income gain is not deducted from the disposal consideration for the purposes of calculating the part disposal fraction at section 42(2).

Why is that?

## 32.21 Losses

Regulation 42 OFTR provides:

> (1) If the effect of any computation under regulations 39 to 41 would be to produce a loss, the basic gain on the disposal is nil.
> (2) Paragraph (1) applies notwithstanding section 16 of TCGA 1992 (losses determined in like manner as gains).
> (3) Accordingly, for the purposes of these Regulations, no loss is to be treated as arising on the disposal.

An offshore income gain is charged to IT but where a loss arises on the disposal, there is no income tax relief.[23] The loss will be allowable for CGT if ordinary CGT principles permit. HMRC agree. The OFM provides:

> **OFM 09050 Investors in non-reporting funds: charge to tax on disposal of an interest: overview**
> ...Losses
> Where there is a loss on disposal then the gain for the purposes of tax on an offshore income gain is nil, that is there is no recognition of losses for the purposes of the regulations (regulation 42). Accordingly, in a case where there is also a disposal for the purposes of TCGA, any loss made (calculated in accordance with that Act) may be treated as a capital loss for the purposes of TCGA.

This means that remittance basis taxpayers and non-residents will generally have no loss relief.[24]

The loss (if allowable) is computed on CGT principles (not the OIG computation rules) but the amount is usually the same.

## 32.22 Exemptions

Chapter 3 part 2 OFTR set out 11 exemptions from the charge to tax on OIGs. The following are only mentioned here:

(1) UK companies owning offshore funds which are:
  (a) loan relationships (the loan relationship rules prevail)
  (b) derivative contracts (the derivative rules prevail)
  (c) intangible fixed assets (the intangible rules prevail)
(2) Excluded indexed securities
(3) Policies of insurance: the chargeable events regime prevails.
(4) Trading stock
(5) Exemption for insurance companies
(6) Offshore fund a loan other than a participating loan
(7) Transparent funds: see 32.22.1 (Exemption for transparent fund)
(8) Transitional relief; see 32.29 (2009 Transitional rules)
(9) Charities: see Kessler and Brown, *Taxation of Charities and Non-*

23 Section 152(8) ITA prevents miscellaneous losses being set against OIGs.
24 See 48.1 (Capital losses).

*Profit Organisations*, (8th ed, 2011), para 3.12.

### 32.22.1 *Exemption for transparent fund*

Regulation 29 OFTR provides an exemption:

> (1) No liability to tax arises under regulation 17 if—
> (a) the disposal is the disposal of an interest in an offshore fund falling within paragraph (b) or (c) of section 40A(2) of FA 2008, and
> (b) the fund is a transparent fund.
> This is subject to paragraphs (2) and (3).
> (2) But there is a charge to tax under regulation 17 if—
> (a) there is a disposal of an interest in a transparent fund, and
> (b) during a period beginning with the date the interest (or any part of it) was acquired and ending with the date of the disposal, the offshore fund has at any time held interests in other non-reporting funds which amounted in total to more than 5% by value of the offshore fund's assets.
> (3) And there is a charge to tax under regulation 17 if—
> (a) there is a disposal of an interest in a transparent fund,
> (b) the fund is a non-reporting fund, and
> (c) the fund fails to make sufficient information available to participants in the fund to enable those participants to meet their tax obligations in the UK with respect to their shares of the income of the fund.
> (4) If, on the disposal by an offshore fund of an interest in another non-reporting fund, no liability would arise under regulation 17 by virtue of this regulation, that interest is not taken into account for the purposes of paragraph (2)(b).

The OFM provides:

> **OFM10200 Investors in non-reporting funds: exceptions to the charge to tax: interests in certain transparent funds**
> ... Other types of arrangements that are transparent for income purposes but not transparent for capital gains purposes (Section 99 and 103A TCGA - see OFM03500 onwards) such as, for example, certain unit trusts (following the case of *Archer-Shee v. Baker*) or certain foreign contractual arrangements (such as Fonds Commun de Placement ("FCPs")) fall within the definition of an offshore fund. They are therefore subject to the Offshore Funds (Tax) Regulations 2009 (SI2009/3001) generally, with certain modifications as described below. The purpose of the offshore fund regime is to ensure that income cannot

be rolled up free of tax, with any subsequent gain on disposal being charged only as a capital gain. If a fund is transparent for income, such as would be the case for certain unit trusts and contractual funds, then any income arising to the fund is treated as arising to an investor in proportion to his rights. This means that income is charged to tax as it arises.

However, it might be the case that an income transparent fund that came within paragraph (b) or (c) of section 40A(2) of FA 2008 itself invested in a non-reporting fund, and if that were the case then income could be rolled up in the underlying fund, because income would only be credited to the top fund if it was distributed.

In order to counter potential roll-up of income by an income transparent fund in underlying non-reporting funds, whilst also preventing unnecessary administrative burdens for transparent arrangements coming within the definition of an offshore fund and for their investors, any gain on disposal of an interest in an income transparent offshore fund will not be taxed as an offshore income gain unless -

- during a period beginning on the date the interest (or any part of it) was acquired and ending on the date of the disposal, the offshore fund at any time held interests in other non-reporting funds (except for certain other transparent funds (see below) which amounted in total to more than 5% by value of the offshore fund's assets (Regulation 29(2)), or
- the transparent fund is a non-reporting fund, and the fund fails to make sufficient information available to participants in the fund to enable those participants to meet their tax obligations in the United Kingdom with respect to their shares of the income of the fund (Regulation 29(3)).

Whilst this does mean that transparent funds will have to monitor their underlying investments, it allows such funds to avoid the need to apply for reporting fund status (and for their UK investors to be charged only capital gains tax or corporation tax on an capital gain arising, rather than incurring an offshore income gain, provided the fund has complied with Regulation 29(2)).

It follows that if a transparent offshore fund is invested by more than 5% by value of its total investments in non-reporting non-transparent funds it may apply for reporting fund status in order to allow UK investors to be charged to tax on capital gains on disposal rather than to an offshore income gain. If reporting fund status is granted then the fund will be subject to the requirements of the regulations, including those relating to the calculation of income from non-reporting funds (see regulations 69 to 71).

Investments by transparent non-reporting funds in other transparent non-reporting funds - Regulation 29(4)

There is one important relaxation to the requirements of regulation 29(2). That is, if a transparent non-reporting fund ("TNRF1") invests in another TNRF (TRNF2) then, where a disposal of an interest in TNRF2 would not itself give rise to an offshore income gain (under regulation 17) for a UK investor, it is ignored in determining whether TNRF1 is invested in non-reporting funds by more than 5% of the value of its assets in total. This is because in such circumstances there can be no significant roll-up of income in the underlying fund(s).

This means that a TNRF's investments could, for example, consist wholly of interests in other underlying TNRFs that themselves held only, say, UK property. Or, a TNRF could be the top layer fund in a fund of funds structure with multiple layers of other TNRFs below the top fund, provided that each of those underlying TNRFs themselves did not hold more than 5% by value of their assets in total in other non-transparent, non-reporting funds.

In deciding whether the investee fund qualifies under this regulation this rule may be applied to the investee fund and to any funds in which it, in turn, holds investments.

**Provision of information to participants**

If a fund is unable to provide sufficient information to its UK investors to enable them to meet their UK tax obligations then an offshore income gain will be charged on any gains realised on subsequent disposals of relevant interests. The provision of "sufficient information" would include details of an investor¡|s proportionate share of both income arising to the fund and reported income or offshore income gains arising to it, as well as confirmation as to whether or not the fund has invested more than 5% by value of its assets in non-reporting funds. In practice, many existing income transparent funds with UK investors already provide vouchers to those clients detailing income arising to the fund, for example interest income, and foreign or UK dividends.

## 32.23 Distributed income of offshore fund

In the absence of express provision, the taxation of distributed income of reported funds would depend on the nature of the fund:

(1) Distributions from corporate funds would be taxed as dividends.

(2) Distributions from transparent funds would be taxed as the income of the underlying assets.

(3) Distributions from non-transparent non-corporate funds (ie non-

transparent unit trusts) would be taxed as annual payments.

In each case the income will be RFI and so can qualify for the remittance basis.

### 32.23.1 *Bond Funds*

The first dent in this position is s.378A ITTOIA which reclassifies some distributions as interest:

> (1) This section applies where—
> (a) a dividend[25] is paid by an offshore fund, and
> (b) the offshore fund fails to meet the qualifying investments test at any time in the relevant period.[26]
> (2) The dividend is treated as interest for income tax purposes.

Section 378A(3) defines the qualifying investments test:

> (3) For the purposes of this section, an offshore fund fails to meet the qualifying investments test if the market value of the fund's qualifying investments exceeds 60% of the market value of all of the assets of the fund (excluding cash awaiting investment)...
> "qualifying investments" has the meaning given in section 494 of CTA 2009.

I refer to offshore funds within s.378A as **"bond funds"**. EN FA 2009 explains:

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25 Defined in s378A(7):
"In this section—
"dividend" includes any distribution that (but for this section) would be treated as a dividend for income tax purposes".

26 Defined in s.378A(4)(5):
(4) "The relevant period" means—
(a) the relevant period of account of the offshore fund, or
(b) f longer, the period of 12 months ending on the last day of that period.
(5) "The relevant period of account" means—
(a) the last period of account ending before the dividend is paid, in a case in which the profits available for distribution at the end of that period (and not used since then by distribution or otherwise) equal or exceed the amount of the dividend (aggregated with any other distribution made by the offshore fund at the same time), and
(b) the period of account in which the dividend is paid, in any other case.

> Certain distributions from offshore funds are economically similar to payments of yearly interest. Clause 39, from 22 April 2009, charges distributions of this type to tax as if they were yearly interest.
> ... The test in subsection (3) is similar to that which applies to corporate investors for the purposes of the loan relationships legislation. (See sections 490 and 493 CTA 2009). A distribution is treated as interest if the offshore fund, at any time during the 'relevant period', holds more than 60 per cent of its assets in the form of qualifying investments. The definition of a qualifying investment is set out in section 494 CTA 2009 and, in summary, refers to interest bearing and economically similar investments.
> ... The purpose of the clause is to prevent a tax advantage being gained by holding interest bearing assets within an offshore fund structure....
> From 22 April 2009, where a distribution from an offshore fund takes the form of a dividend the rate will be the dividend tax rate after taking into account the dividend tax credit. However, where the offshore fund is substantially invested in interest bearing, or economically similar, assets as described in paragraph 4 above then any distribution will be treated as interest for income tax purposes.

## 32.24 Undistributed income of reporting funds (deemed RF income)

In the absence of express provision, undistributed income of offshore funds would not be subject to tax. However the OFTR alters that. The legislation distinguishes between three types of funds:

(1) Non-transparent funds:
    (a) corporate funds (corporate funds cannot be transparent)
    (a) non-corporate non-transparent funds
(2) Transparent funds.

### 32.24.1 *Meaning of "transparent"*

Regulation 11 OFTR provides:

> For the purposes of these Regulations a fund is a "transparent fund" if, in the case of holders of interests in the fund who are individuals resident in the UK, any sums which form part of the income of the fund are of such a nature that those holders—
> (a) are chargeable to tax under a provision specified in section 830(2) of ITTOIA 2005 in respect of such of those sums as are referable to their

> interests, or
> (b) if any of that income is derived from assets within the UK, would be so chargeable had the assets been outside the UK.

What is the purpose of (b)?

### 32.24.2 *Undistributed income of non-transparent funds*

Regulation 94(1) OFTR provides:

> In the case of a reporting fund which is not a transparent fund, the Tax Acts have effect as if the excess (if any) of the reported income of the fund in respect of a reporting period over the distributions made by the fund in respect of the reporting period were additional distributions made to the participants in the fund in proportion to their rights.

I refer to this as **"deemed RF income".** Reg.94(3) identifies the date and recipient of deemed RF income:

> The excess specified in paragraphs (1) and (2) is treated as made, on the fund distribution date,[27] to participants holding an interest in the fund at the end of the reporting period.

The OFM provides:

> **OFM15600 Reporting funds: tax treatment of participants in reporting funds: general provisions**
> ...Where an investor holds some interests that are grandfathered (as a result of regulation 30) and some that are not, the excess specified in regulation 94 is reduced proportionately.

### 32.24.3 *Corporate funds*

Regulation 95 OFTR provides:

> (1) This regulation applies if—

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27 This term is defined in reg.94(4) OFTR:
In these Regulations the "fund distribution date" for a reporting period of a reporting fund means the date six months following the last day of the reporting period.

> (a) a reporting fund makes a distribution to a participant chargeable to income tax in respect of a reporting period, and
> (b) the fund falls within section 40A(2)(a) of FA 2008.

That is, the regulation applies to corporate reporting funds.

> (2) This regulation also applies if some or all of the excess specified in regulation 94(1) is treated as made by such a fund to such a participant.
> (3) If section 378A of ITTOIA 2005 (offshore fund distributions) applies to any amount falling within paragraph (1) or (2), the amount is charged to income tax in accordance with that section.

This does not seem to need saying for distributed income, but it is necessary to classify deemed RF income as interest. So deemed RF income of bond funds is "treated as interest for income tax purposes." If the recipient is a remittance basis taxpayer, this type of income qualifies for the remittance basis, just like ordinary interest.

What about deemed RF income of corporate non-bond funds? This is treated as "distributions" so it is treated as a dividend. Reg.54, 95(4) assumes this and confers the right to tax credits as other dividends:

> (4) If paragraph (3) does not apply to any amount falling within paragraph (1) or (2), but the participant is entitled to a tax credit on receiving a distribution falling within paragraph (1), section 397A of ITTOIA 2005 (savings and investment income: dividends from non-UK resident companies) also applies to the excess falling within paragraph (2).

This income qualifies for the remittance basis just as ordinary dividends.

HMRC agree. The OFM provides:

> **OFM08400 Investors in non-reporting funds: income & distributions: the charge to tax: remittance basis**
> Where an investor in a (non-transparent) non-reporting offshore fund is taxed on the remittance basis then the remittance basis rules apply to income arising from the holding in that fund as they apply to other income from non-UK sources.
> Where the fund is transparent for tax-purposes, then the income will arise from the underlying assets and not from the fund. In such a case the income may sometimes arise in the UK (even though the fund itself is domiciled offshore). Where the income arises in the UK the

remittance basis does not apply. Where the income arises offshore then the remittance rules will apply.

### 32.24.4 *Non-corporate non-transparent funds*

Regulation 96 OFTR provides:

> (1) This regulation applies if—
> (a) a reporting fund makes a distribution to a participant chargeable to income tax in respect of a reporting period,
> (b) the fund falls within paragraph (b) or (c) of section 40A(2) of FA 2008, and
> (c) the fund is not a transparent fund.
> (2) This regulation also applies if some or all of the excess specified in regulation 94(1) is treated as made by such a fund to such a participant.
> (3) Any amount to which paragraph (1) or (2) applies is charged to income tax—
> (a) under section 378A of ITTOIA 2005 (offshore fund distributions), or
> (b) (if that section does not apply) under Chapter 8 of Part 5 of ITTOIA 2005 (miscellaneous income: income not otherwise charged) for the year of assessment in which the distribution is made ...

This does not apply to a non-resident participant as such a person is not chargeable to income tax.

Regulation 96(3) continues:

> but sections 688(1) and 689 of ITTOIA 2005 (income charged and person liable) do not apply.

The disapplied sections would have provided:

> ***688*** *(1) Tax is charged under this Chapter on the amount of the income arising in the tax year.*
> *(2) Subsection (1) is subject to—*
> *(a) Chapter 1 of Part 7 (which provides relief on income from the use of furnished accommodation in an individual's only or main residence: see, in particular, sections 794 and 798),*
> *(b) Chapter 2 of that Part (which provides relief on income from the provision by an individual of foster care: see, in particular, sections 814 and 817), and*

*(c) Part 8 (foreign income: special rules).*
*689 The person liable for any tax charged under this Chapter is the person receiving or entitled to the income.*

### 32.24.5 *HMRC views*

HMRC agree. The OFM provides:

**OFM15660 Reporting funds: tax treatment of participants in reporting funds: participants chargeable to income tax: corporate funds**
Where a reporting fund takes corporate form, any sums distributed together with any excess of reported income will be treated as foreign dividends (unless the fund is a 'bond fund' – see below). Until 22 April 2009, dividends received from offshore funds did not carry any entitlement to a dividend tax credit but from that date they will do so unless the distribution is from a bond fund (section 378A ITTOIA 2005). Any sums treated as an excess of reported income also carry an entitlement to a foreign tax credit, unless the fund is a bond fund (regulation 95(4)).
**Bond funds**
From 22 April 2009 there is a change to the way dividends from offshore funds which are substantially invested in interest-bearing assets (commonly known as 'bond funds') are treated for tax purposes. Where an offshore fund holds more than 60% of assets in interest-bearing (or economically similar) form, any distribution or excess of reported income is treated as a payment of yearly interest (section 378A ITTOIA 2005 / regulation 95(3)). Such sums do not qualify for a dividend tax credit and the tax rates that apply are those applying to interest. Fund managers should be able to tell UK investors if a fund is a bond fund.
**Remittance basis users**
Where individuals not domiciled in the United Kingdom are taxed on the remittance basis then the normal remittance basis rules will apply to income arising from the reporting fund.
In the case of income that is reported but is not distributed then that income has not been remitted to the UK.
**OFM15670 Reporting funds: tax treatment of participants in reporting funds: participants chargeable to income tax: other non-transparent funds**
Arrangements that are non-transparent for income purposes and that come within the definition of an offshore fund under section 40A(2)(b) FA 2008 (that is, funds that do not take corporate form) will be foreign

unit trusts. Foreign unit trusts that are not transparent for income purposes are sometimes referred to as 'Garland' unit trusts (following the case of *Garland v Archer-Shee* (15TC693)).

Non-transparent unit trusts

UK investors in foreign unit trusts that are non-transparent for income purposes are taxable on their proportionate share of income (as ascertained after the trustees have met the expenses of administering the trust) when it is indefeasibly allocated to them, regardless of whether the income is paid to them or accumulated. Unlike the position for transparent unit trusts, that income is taxable as miscellaneous foreign income (under Chapter 8 of Part 5 of ITTOIA 2005) and the tax rates applying will be those applying to such income.

If there is an excess of reported income over the amount allocated (for example if the unit trust has invested in another reporting fund and has itself received reports of income which was not actually distributed to it) then the excess must be treated by the participant in the same way as the allocated income (that is as miscellaneous foreign income (under Chapter 8 of Pat 5 of ITTOIA 2005).

**Remittance basis users**

Where individuals not domiciled in the United Kingdom are taxed on the remittance basis then the normal remittance basis rules will apply to income arising from the reporting fund.

In the case of income that is reported but is not distributed then that income has not been remitted to the UK.

**OFM15680 Reporting funds: tax treatment of participants in reporting funds: participants chargeable to income tax: transparent funds**

**...Income: UK tax treatment of investors**

No matter what the legal form of a transparent reporting fund, for UK tax purposes the income of an income transparent fund is treated as arising directly to its investors (UK investors are charged to tax on income arising net of a deduction for proper expenses of the management of the fund in question, and this is the case for both unit trusts and contractual arrangements). So, for example, if a fund receives interest income then UK investors are charged to tax on their proportionate share of that income as it arises, irrespective of whether or not it is actually distributed to them. Investors should receive a voucher from the fund to tell them what proportion of the fund's income they are entitled to, and the split between interest, dividends, property income, etc. Investors should ask their fund manager for a voucher if they do not receive one.

If a transparent reporting fund holds investments in other reporting funds then investors are also taxable on their proportionate share of any income reported but not actually distributed by the underlying fund (regulation 94(2)). This will become part of the excess to be reported by the transparent reporting fund. Such excess reported income is charged to tax as miscellaneous foreign income under Chapter 8 of Part 5 ITTOIA 2005 (regulation 97(4)), and it is chargeable at investors' highest tax rate.

**Remittance basis users**

In a case where the reporting fund is transparent for UK tax purposes then the income will arise from the underlying assets and not from the fund. In such a case the income may sometimes arise in the UK (even though the fund itself is domiciled offshore). Where the income arises in the UK the remittance basis does not apply. Where the income arises offshore then the remittance rules will apply.

**OFM15700 Reporting funds: tax treatment of participants in reporting funds: participants chargeable to corporation tax**

Corporate investors in offshore funds will be chargeable to corporation tax on any distributions received from reporting funds under general principles, and on any excess of reported income of the fund invested in under regulation 94(1) and (2). Where such investors are taxable under regulation 94(1) on excess reported income, that amount will be treated as exempt if it would be exempt had it been an actual distribution.

The bond fund rules in Chapter 3 of Part 6 CTA 2009 (relationships treated as loan relationships) may apply if a reporting fund held more that 60% by value of its investments in debt type assets at any time during an investing company's accounting period – see the Corporate Finance Manual ('CFM')).

### 32.24.6 *Can deemed RF income be remitted?*

Legislation frequently deems an individual to receive income or gains (eg deemed s.13 gains, deemed s.624 income, deemed s.720 income). In these cases the legislation always has a provision which deems some actual funds to be derived from the individual's deemed income. So if those actual income or gains are received by the individual (or a relevant person) there is a taxable remittance. In this case however there is no such provision. So it appears at first sight that the deemed RF income cannot be remitted. While the actual income in the hands of the offshore fund could be received in the UK, those funds do not derive from the deemed RF income. The deemed RF income perhaps derives from those funds.

This does lead to a result that might be thought too good to be true. So it is more than possible that a court might read in an implied provision that the actual income of the offshore fund is derived from the deemed RF income, though that verges on legislation rather than construction.

HMRC may not agree. The OFM provides:

> **OFM15950 Reporting funds: tax treatment of participants in reporting funds: remittance basis**
> Where individuals not domiciled in the United Kingdom are taxed on the remittance basis then the normal remittance basis rules will apply to income arising from the reporting fund.
> In the case of income that is reported but is not distributed then that income has not been remitted to the UK.
> **Transparent Funds**
> In a case where the reporting fund is transparent for UK tax purposes then the income will arise from the underlying assets and not from the fund. In such a case the income may sometimes arise in the UK (even though the fund itself is domiciled offshore). Where the income arises in the UK the remittance basis does not apply. Where the income arises offshore then the remittance rules will apply.
> **Disposals**
> The proceeds of a disposal of a reporting fund will normally constitute a 'mixed fund' for the purposes of the remittance basis rules. This is because the proceeds may have been funded by undistributed reported income as well as by the original investment and any capital growth.

## 32.25 Transparent funds

Regulation 97 OFTR provides:

> (1) This regulation applies if—
> (a) a reporting fund is a transparent fund, and
> (b) some or all of the excess specified in regulation 94(2) is treated as income of a participant by virtue of that provision.
> (2) Any amount to which paragraph (1) applies is charged to income tax under Chapter 8 of Part 5 of ITTOIA 2005 as relevant foreign income within the meaning given by section 830 of ITTOIA 2005 for the year of assessment in which the distribution is made, but sections 688(1) and 689 of ITTOIA 2005 do not apply.

## 32.26 Non-reporting fund with interest in reporting fund

Regulation 16 OFTR provides:

> (1) This regulation applies if a non-reporting fund which is a transparent fund has an interest in a reporting fund.
> (2) In the case of any excess specified in regulation 94(1) or (2) which is treated, under that regulation, as made to the non-reporting fund, the Tax Acts have effect as if the excess were additional income of the participants in the non-reporting fund in proportion to their rights.
> (3) The additional income is treated as arising on the same date as the excess is treated as made to the non-reporting fund.
> (4) If a participant in the non-reporting fund is chargeable to income tax, the additional income is charged as relevant foreign income within the meaning given by section 830 of ITTOIA 2005.

The OFM provides:

> OFM08200 Investors in non-reporting funds: distributions: the charge to tax: 'transparent' funds
> ... Transparent non-reporting funds with interests in reporting funds (regulation 16)
> There is a further point to consider with regard to transparent non-reporting funds that hold interests in reporting funds. That is, where the underlying reporting fund does not distribute all of its 'reportable income' (see OFM14000 and OFM15500 onwards) then the excess would, if a UK investor held a direct interest in the fund, be treated as income (regulation 94). To ensure that principle is maintained, regulation 16 provides that where the interest is held by a non-reporting fund which is transparent for income purposes then the reportable excess will be similarly treated as additional income in proportion to each investor's rights.

## 32.27 Fund transactions treated as non-trading

This topic is dealt with in chapter 6 part 3 OFTR. A full discussion needs a long chapter to itself. In short, reg.80 OFTR provides:

> (1) This regulation applies if a diversely owned fund carries out an investment transaction in an accounting period.
> (2) The investment transaction is treated as a non-trading transaction.

The consequence of non-trading status is that the profit of the transaction is not income and need not be distributed by reporting funds.

The definitions of diversely owned and investment transaction are not considered here. HMRC argue that reg.80 is not to be taken to mean what it says:

> HMRC is aware that there has been recent industry speculation as to whether regulations contained within Chapter 6 of Part 3 of The Offshore Funds (Tax) Regulations 2009 (the 'regulations'), setting out when transactions by certain offshore 'reporting' funds are not treated as trading transactions for the purposes of computing 'reportable income', has any relevance to matters relating to the taxation of such funds potentially trading in the UK through a permanent establishment or agent. HMRC is therefore confirming that there is no such relevance.
>
> Regulation 80(2) of the regulations, which confirms that certain transactions are treated as non-trading transactions, applies only for the purposes of Chapter 5 of the regulations; that is for the purposes of computing an offshore fund's reportable income in order to establish the UK tax position of participants in the fund.
>
> The regulations are made under powers enabling provision to be made about the tax treatment of participants in an offshore fund (section 41 FA 2008) and they should be read in that context. Specifically, the regulations do not make or purport to make rules that affect the taxation of any of the funds referred to therein as 'offshore funds'; only to regulate the taxation of the returns from those funds to persons taxable under UK legislation. Funds that are taxable in the UK are dealt with by other legislation.
>
> It is a question of fact whether or not, for the purposes of that other legislation, a non-resident fund is carrying on a trade in the UK. Where such a fund is carrying on a trade in the UK through an investment manager operating here, the protection of the Investment Manager Exemption may be available in relation to any 'investment transaction' specified in the Investment Manager (Specified Transaction) Regulations 2009.[28]

## 32.28 Conversion from non-reporting fund to reporting fund

Regulation 48 OFTR provides:

> (1) This regulation applies if an offshore fund ceases to be a non-reporting fund and becomes a reporting fund.
> (2) A participant in the fund may make an election to be treated—
> (a) as disposing of the interest owned by the participant in the

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28 Accessible *www.hmrc.gov.uk/ctsa/invest-man-exempt.htm* published 2 Feb 2010.

non-reporting fund at its market value on the disposal date, and
(b) as acquiring a holding in the reporting fund at the beginning of the reporting fund's first period of account.
This is subject to paragraph (5).
(3) Chapter 5 of this Part applies to determine the offshore income gain arising on the deemed disposal referred to in paragraph (2)(a).
(4) The deemed acquisition referred to in paragraph (2)(b) is treated as made for the same amount as the deemed disposal referred to in paragraph (2)(a).
(5) An election may not be made under paragraph (2) unless the offshore income gain arising on the deemed disposal referred to in paragraph (2)(a) (determined in accordance with paragraph (3)) is greater than zero.
(6) If the participant is chargeable to income tax, the election mentioned in paragraph (2) must be made by being included in a return made for the tax year which includes the disposal date.
(7) If the participant is chargeable to corporation tax, the election mentioned in paragraph (2) must be made by being included in the participant's company tax return for the accounting period which includes the disposal date.
(8) In this regulation—
"company tax return" has the same meaning as in Schedule 18 to the Finance Act 1998(a);
the "disposal date" means the final day of the last period of account before the fund becomes a reporting fund.

## 32.29 2009 Transitional rules

I do not attempt to discuss transitional rules in detail.[29]

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29 Note also the following HMRC statement: "HMRC regrets that ... the Statutory Instrument (SI 2009/3139) ... contained an error with respect to long periods of account.
The intention was that the transitional rules, which provide for an existing fund to apply for distributing status for periods ended on or after 1 December 2009, would not apply to any period ending after 31 May 2012 (not 2011 as provided for in the instrument).
The government intends to amend the cut-off date given in sub-paragraph 3(3B) of Schedule 1 to The Offshore Funds (Tax) Regulations (SI 2009/3001 as amended by SI 2009/3139) to read 31 May 2012.
This announcement therefore gives notice of the intended amendment, which will be made at the first convenient opportunity."

Reg.30 OFTR provides:

> (1) No liability to tax arises under regulation 17 in respect of any rights in an offshore fund to which this regulation applies if the rights are acquired by a person—
> (a) before 1st December 2009, or
> (b) in accordance with paragraph (2).
> (2) Rights are acquired in accordance with this paragraph if—
> (a) the rights are acquired by the participant in accordance with a legally enforceable agreement in writing that was entered into by the participant before 30th April 2009,
> (b) in the case of an agreement which was conditional, the conditions are met before that date, and
> (c) the agreement is not varied on or after that date.
> (3) Rights of a person in a fund are rights in an offshore fund to which this regulation applies if, on the date on which the person acquired the rights, those rights did not constitute a material interest in an offshore fund within the meaning of that expression given by section 759 of ICTA.

Reg.43 OFTR provides for the case where a person holds an offshore fund before 2009 and purchases more of the same fund:

> (1) This regulation applies if—
> (a) a person acquired rights (the "protected rights") in an offshore fund—
> (i) before 1st December 2009, or
> (ii) in accordance with paragraph (2),
> (b) immediately before 1st December 2009 those rights did not constitute a material interest in an offshore fund within the meaning of that expression given by section 759 of ICTA, and
> (c) on or after 1st December 2009 the person acquires additional rights in the offshore fund (the "non-protected rights").
> (2) Rights are acquired in accordance with this paragraph if—
> (a) the rights are acquired by the participant in accordance with a legally enforceable agreement in writing that was entered into by the participant before 30th April 2009,
> (b) in the case of an agreement which was conditional, the conditions are met before that date, and
> (c) the agreement is not varied on or after that date.
> (3) For the purposes of tax in respect of chargeable gains—
> (a) section 104 of TCGA 1992 (share pooling: general

interpretative provisions) applies as if the protected rights were assets of a different class from the non-protected rights, and

(b) all the protected rights must be treated as disposed of before any of the non-protected rights may be so treated.

CHAPTER THIRTY THREE

# ACCRUED INCOME PROFITS

## 33.1 Accrued income profits – Introduction

This subject needs a book to itself. It would be an unrewarding labour since the rules are "widely ignored by both taxpayers, their advisors and within HMRC".[1] This chapter focuses on the questions closest to the themes of this book, but one can only approach those questions after understanding how the provisions operate, at least in the standard case (I do not consider specialist topics such as variable rate securities or conversions of securities).

The provisions apply on a transfer of securities. The AIP provisions do not apply for corporation tax.

## 33.2 AIP securities

Section 619(1) ITA defines "securities":

> In this Chapter "securities" includes—
> (a) any loan stock or similar security other than an excluded security, and
> (b) shares in a building society which are qualifying shares for the purposes of section 117(4) of TCGA 1992 (qualifying corporate bonds),

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1 Responses to Consultation Exercise on Reform of the AIP, Inland Revenue, December 2004; consistent with that, several of the worked examples in the SAI manual are difficult to justify.
Reform was promised in 2006 but radical change was rejected and the matter was dropped.

but (subject to para (b)) it does not include any shares in a company.[2]

I refer to securities within this definition as "**AIP securities**". Section 619(3) ITA sets out seven categories of "Excluded securities":

(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))[3], and
- (g) a security that is a deeply discounted security within the meaning of Chapter 8 of Part 4 of ITTOIA 2005.[4]

Thus deeply discounted securities are not AIP securities: (subject to the 2003 transitional rule) the DDS rules take priority over the AIP rules.

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2 Section 619(2) ITA adds:
"(2) For the purposes of subsection (1)(a), it does not matter—
- (a) whether the security is of the government of the UK, any other government, any public or local authority in the UK or elsewhere, or any company or other body,
- (b) whether or not the security is secured,
- (c) whether or not the security carries a right to interest of a fixed amount or at a fixed rate percentage of the nominal value of the security, or
- (d) whether or not the security is in bearer form."

This can only be for the avoidance of doubt, because it only expresses the usual meaning of "security".

3 Defined s.619(5) ITA:
"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."

4 Section 619(4) ITA contains a transitional exception: " 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)."

### 33.2.1 *Securities "of the same kind"*

This expression is strictly understood. Section 619(6) ITA provides:

> Securities are treated as being of the same kind for the purposes of this Chapter if they—
> (a) are treated as being of the same kind by the practice of a recognised stock exchange, or
> (b) would be so treated if dealt in on such an exchange.

SAI Manual provides:

> **4040 Accrued Income Scheme: what are "securities"** [August 2008]
> ... For example, Treasury 5% 2004 is not the same kind as Treasury 5% 2012. This is similar to the capital gains tax concept of securities of a particular class.

## 33.3 "Transfer"

In outline, the definition is in s.620(1) ITA:

> References in this Chapter to the transfer of securities are—
> (a) to the transfer of securities by way of sale, exchange, gift or otherwise,
> (b) to the conversion of securities in any case where there is no transfer of the securities within para (a),
> (c) to the redemption of variable rate securities in any case where there has been a transfer of the securities at any time before redemption, 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).

Thus there are altogether eight types of transfer. In this book I consider only the first type, which are transfers in the normal sense of the word. Section 620(2) provides one exception:

But subsection (1)(a) does not include—
(a) the vesting of securities in personal representatives on death...[5]

## 33.4 Transfer "with accrued interest"

### 33.4.1 *The commercial background*

The Debt Management Office explains the terminology **"clean"** and **"dirty"** price:

> The following example is taken from the DMO website for 30 November 2004 and shows close of business data for 5% Treasury Stock 2014:

**5TY145 | Treasury 2014 | GB0031829509 | 103.17 | 104.344033 | 4.592604**

> The first three fields are all means of identifying the gilt. The first is the DMO's internal identifier code and the second a shortened form of the gilt's name. The third field is the ISIN number (the International Security Identification Number – an identifier number used by the London Stock Exchange).
> The next three fields give price and yield information. The two prices shown of £103.17 and £104.344033 are known as the 'clean' and 'dirty' price respectively. Clean prices do not include accrued interest whereas dirty prices do (see the section on accrued interest on page 15). The clean price is typically the price, which is quoted when agreeing a purchasing or selling price. However, the actual amount of money which will change hands is based on the dirty price and will reflect settlement on the business day after the transaction.
> So, on the basis of the reference price on 30 November 2004, every £1,000 nominal of 5% Treasury Stock 2014 was worth £1,043.44.[6]

Note that for tax purposes the consideration for a gilt is "the actual amount of money which will change hands" - the dirty price.
SAI Manual explains the terminology ex-dividend and cum-dividend::

> **4020. Transfers "with accrued interest" and "without accrued interest"**

5 Paragraph (b) is a transitional rule for pre-2003 DDS (not discussed here).
6 A Private Investor's Guide to Gilts, Dec 2004, accessible *www.dmo.gov.uk*.

**... Sales with accrued interest ("cum div")**
Most sales of marketable securities are "cum div". That is, the buyer is entitled to the next interest due. As an interest payment date on a security approaches, its market price increases to reflect the increase in value of the buyer's right to the interest. In other words, the price reflects accrued interest.
For example, £100,000 8% Treasury Stock 2002–06 is transferred cum div on 19 April. 14 days' interest has accrued since interest was last paid on 6 April. Accrued interest is £307 (14/365 × 8% × 100,000)...
**Sales without accrued interest ("ex div")**
Not all sales of securities are "cum div". This is because gilt-edged securities, and some corporate bonds, have an "ex div" or "ex coupon" date. The next interest coupon is paid to the person who is registered as the holder of the security at that date. So if the security is sold in the "ex div" period, the seller collects and keeps the next interest due after the sale. For gilts, the "ex div" period is 7 business days before the coupon date (except for 3 ½% War Loan stock, for which it is 10 business days). Other securities may have a similar, or shorter, "ex div" period.
Consequently the market price of a security sold "ex div" reflects the fact that the purchaser will own the security for a short period from the date of purchase to the next interest payment date. This is a period over which interest accrues but for which the interest is received not by him but by the seller. The interest accrued over such a period is known as rebate interest. It is treated in the opposite way to the more normal accrued interest associated with a "cum div" sale.
For example, £100,000 8% Treasury Stock 2002–06 is transferred ex div on 29 March. 7 days' interest has accrued from the day after the transfer to the next interest date, 6 April. Accrued interest is £153 (7/365 × 8% × 100,000). ...

### 33.4.2 *Definition of with/without accrued interest*

Section 623(1) ITA provides a commonsense definition:

The general rule is that securities are transferred with accrued interest for the purposes of this Chapter if they are transferred with the right to receive interest payable—
(a) in a case where the settlement day is an interest payment day, on the settlement day, and
(b) in any other case, on the first interest payment day after the settlement day.

Section 624(1) ITA provides the corresponding definition of a transfer "without accrued interest":

> The general rule is that securities are transferred without accrued interest for the purposes of this Chapter if they are transferred without the right to receive interest payable as mentioned in section 623(1)(a) or (b).

The definitions are comprehensive so every transfer must be either with or without accrued interest, and they are simply English paraphrases of the technical expressions *cum dividend* and *ex dividend* (or cum-div and ex-div).

The terms "interest" "settlement day" and "interest period" are defined but the definitions are not considered here.

Thus whether a market sale is with or without accrued interest depends only on the date of the sale, whether it is before or after the ex div date. Vendors and purchasers have no choice in the matter except by timing the sale. Whether an off-market sale is with or without accrued interest is a matter for the parties to agree.

## 33.5 Deemed interest payment, credit and debit

Section 632(1) ITA provides:

> 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.

It is useful to have some terminology to describe this. I refer to this payment as "**a deemed interest payment**". The transferor (deemed to receive the payment) has **"a deemed interest credit"**. The transferee (deemed to make the payment) has **"a deemed interest debit"**.

Section 632 then defines the amount of the deemed 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—

$I \times (A \div B)$

where—

I is the interest payable on the securities on the first interest payment day after the settlement day ("the payment day"),

A is the number of days in the period beginning with the first day on which that interest accrues and ending with the settlement day, and

B is the number of days in the period beginning with the first day on which that interest accrues and ending with the payment day.

Why are there two alternative methods of ascertaining the amount of the deemed interest payment, in subsections (3) and (4)(5)? SAI Manual provides:

**4140. Payments on transfers with accrued interest**

**...** The [deemed interest] payment is the amount of the gross interest accruing to the settlement day, which in most cases is shown separately from the consideration for the securities, under the arrangement (that is, the contract note) by which the transferee accounts to the transferor. This is commonly known as the "clean price" basis.

In exceptional cases – for example, sales off market, gifts, settlements, and deemed transfers – there will be no contract note and it will it be necessary to compute the amount of the [deemed interest] payment. Where this is done, the formula $I \times A/B$ is used...

The Manual offers a straightforward example of the two methods of computation on a single sale with accrued interest:

*Example*

Harriet sells corporate bonds to Howard on 15 March 2005. Interest is paid on the bonds on 31 March, 30 June, 30 September and 31 December. Howard will receive the interest coupon due on 31 March 2005, that is, the sale is cum div. The interest Howard receives is £200. If Harriet agrees to sell the bond to Howard for a "clean price" of £10,000 plus an additional £165 for accrued interest, she is taxable on accrued income profits of £165 in 2004–05. Howard will reduce his accrued income profits by £165.

Suppose that, instead, Harriet simply agrees to sell the bond to Howard for £10,165. The relevant interest period is 1 January to 31 March 2005, so B is 90 days. The number of days up to and including 15 March (A) is 74. So the "accrued amount" is £200 × 74/90 = £164.44. Again, Harriet's taxable accrued income will be £164, and Howard's reduced by £165 (following the principle of rounding in the taxpayer's favour).

In practice the two methods normally give the same result (as is the case in the HMRC example) though there could be cases where the parties account for accrued interest in some manner which is not the same as the formula I × A/B.

It is possible for the amount of the deemed interest payment to be nil, eg in the case of a transfer on the interest payment day.

Section 633 ITA contains corresponding rules on a transfer without accrued interest.

The SAI manual gives a straightforward example of a sale with accrued interest:

**4160. Examples of transfers with and without accrued interest**

*Example 1*

Anthony has a holding of £100,000 Treasury Stock 8¼% 2007, a British Government security which pays interest on 16 January and 16 July each year. He arranges for his holding to be sold on the Stock Exchange on 19 March 2006. The contract note from his stockbroker, dated 19 March 2006 contains the following information:

| | |
|---|---:|
| £100,000 Treasury Stock 8¼% 2007 sold @ 114 | £114,000 |
| Plus 56 days' accrued interest | £1,315 |
| Payable to you on 20 March 2006 | £115,315 |

The contract note contains all the information that is needed for the purposes of the AIS.

- Treasury Stock 8¼% 2007 falls within the definition of "securities" – Section 619 ITA 2007
- the securities have been transferred, and the transfer is treated as taking place on 19 March because there was a contract for their sale made on that date – Section 620 ITA 2007
- the settlement day for the transfer is 20 March because under Stock Exchange rules bargains in gilt-edged securities are settled on the next business day – Section 674 ITA 2007
- the transfer is with accrued interest because the purchaser gets the right to the interest payable on 16 July 2006, the next interest payment day to fall after 20 March 2006 – Section 623 ITA 2007

- under Stock Exchange rules, accrued interest on gilts is accounted for separately from the bargain price, so the accrued amount is £1,315 – Section 632 ITA 2007
- the interest period in which the settlement day falls is the period 17 January 2006–16 July 2006 – Section 673 ITA 2007.

Accordingly in this interest period Anthony (the transferor) is treated as having received a payment £1,315 and the transferee as having made a payment of £1,315 (Section 632 ITA 2007).

The manual then gives a straightforward example of a sale without accrued interest (ex-div):

*Example 2*

Facts as in Example 1, except that the sale takes place on 1 July 2006 which falls within the "ex-dividend" period for the stock.[7] The contract note from the stockbroker shows:

| | |
|---|---|
| £100,000 Treasury Stock 8¼% 2007 sold @ 114 | £114,000 |
| Minus 15 days' rebate interest | - £352 |
| Payable to you on 2 July 2006 | £113,648 |

The transfer of securities is treated as made on 1 July 2006. The settlement day is 2 July 2006. The transfer is without accrued interest because this is an "ex-div" sale where the seller retains the right to the interest payable on 16 July 2006 (Section 633 ITA 2007). The rebate amount is £352 and the relevant interest period is that from 17 January–16 July 2006

Accordingly in this interest period Anthony (the transferor) is treated as having made a payment of securities of £352 and the transferee as having received a payment of £352.

The manual then gives a straightforward example of an off-market sale with accrued interest (cum-div):

*Example 3*

Stuffed Dodos Ltd is a UK company which has issued unquoted unsecured loan stock paying interest each year on the Tuesday following Easter Day. Thus in 2005 interest is payable on 5 April and in 2006 interest is payable on 18 April. Joe Smith owns £10,000 nominal of this stock and agrees to sell £4,000 to his aunt Matilda. Under the agreement, which was made on 8 July 2005, Matilda is to pay £5,000 for the stock on 19 August. The interest payable on 18 April 2006 is at the rate of £5.50 per £100 nominal (5.5%).

Even though the loan stock is unsecured, it constitutes "securities" for the

7 This is not factually correct: a sale 15 days before the interest payment date would not be ex dividend. That does not spoil the illustrative force of the example but using correct figures would emphasise the triviality of the amounts involved, even in substantial transactions.

purpose of the scheme. The securities are treated as transferred on 8 July 2005 – Section 620(3) ITA 2007.
The settlement day is 19 August because that is the day Matilda has agreed to pay for the securities and it falls before the next interest payment day following the agreement – Section 674(3) ITA 2007. The transfer is with accrued interest (Section 623 ITA 2007).
Because the accrued interest is not accounted for separately, in calculating the accrued amount, the formula in Section 632(5) ITA 2007 is used. A is the period from 5 April 2005 to 19 August 2005. B is the period from 5 April 2005 to 18 April 2006. I is the interest applicable to the securities for the period (5.5% × £4,000 = £220). The accrued amount is thus 137/379 × £220 = 79.
The interest period in which the settlement day falls is that from 5 April 2005 to 4 April 2006. Accordingly in that interest period Joe is treated as receiving as payment of £79 and Matilda as having made a payment of £79.

## 33.6 Accrued income profits and losses

Tax is *not* charged on deemed interest credits. But armed with the concept of deemed interest payments, we can turn to the terms "accrued income profits" (and "accrued income losses") which are defined in ss.628 and 629 ITA:

**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).

Thus deemed interest debits are first set against deemed interest credits of the interest period for securities of the same kind. If or so far as they cannot be set against those interest credits, they constitute accrued income losses.

## 33.7 Charge on AIP income

I refer to the accrued income profits treated as made under s.628 ITA as "**AIP income**".

Section 616 ITA imposes the charge on AIP income:

> Income tax is charged on accrued income profits.

## 33.8 Relief for accrued income losses

Section 679 ITA allows accrued income losses to be set against interest from securities of the same kind:

> (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.

SAI Manual provides:

> **4120. Calculating accrued income profits and losses: relief for losses**
> **...** In other words, the losses always reduce the interest subsequently received on those securities, and cannot be used to offset accrued income profits for earlier interest periods or arising on securities which have different interest periods. Where the interest period spans the tax year, losses are therefore not allowed until the interest on the securities

is taxed in the following tax year.

For the interaction of loss relief and DTR, see 33.16 (Double taxation relief).

### 33.8.1 *HMRC examples*

SAI Manual provides 3 examples. The first example is a straightfoward sale and purchase of one kind of security with accrued interest, looking at the position of the seller:

**4130 Calculating accrued income profits and losses: examples**
Antoinette has £100,000 Treasury Stock 7¾ % 2006, which has interest dates of 8 March and 8 September. She makes the following transactions in the stock.

| Transaction | Profit/loss[8] |
|---|---|
| 19 March 2006 sells £100,000 | £2,107 |
| 21 March 2006 buys £50,000 | (£1,361) |
| 12 May 2006 sells £50,000 | (£131) |
| | **£615** |

The aggregate [accrued income] profit is £615, taxable for 2006–07, the tax year in which the interest period ended, even though two of the transactions occur in 2005–06.

The second example includes purchases and sales, with and without accrued interest, and involving two different kinds of security, looking at the position of the seller:

Jean made the following transactions in securities between 28 February 2005 and 5 April 2006:

| | |
|---|---|
| 19 Mar 2005 | bought £100,000 Treasury Stock 7½% 2006 (interest payment dates 7 June and 7 December) |
| 26 May 2005 | bought £50,000 Treasury Stock 7½% 2006 ex div |
| 15 Sept 2005 | sold £20,000 Treasury Stock 7½% 2006 |
| 22 Sept 2005 | bought £50,000 Treasury Stock 4½ % 2007 (interest payment dates 7 March and 7 September) |

The [accrued income] profits and losses arising on these transactions are:

8 This refers to deemed interest credits/debits, not the commercial profit/loss but I am unable to see how the figures of 2107, 1361 and 131 are derived: can any reader explain?

| Transaction date | Interest period | Profit/loss |
|---|---|---|
| 19 March 2005 | 08/12/04–07/06/05 | (£1,395) |
| 26 May 2005 | 08/12/04–07/06/05 | £82 |
| 15 Sept 2005 | 08/06/04–07/12/05 | £271 |
| 22 Sept 2005 | 08/09/04–07/03/05 | (£778) |

The profits and losses for 2005–06 are:

- Loss of £1,313 (1,395 minus 82) against interest of £3,750 (£100,000 × 7½% × ½) received on Treasury Stock 7½% 2006 on 7 June 2005.
- Profit of £271 (Treasury Stock 7½% 2006, interest period 8 June 2005–7 December 2005)
- Loss of £778 against interest of £2,250 received on Treasury Stock 4½ % 2007 on 7 March 2006.

The third example is a straightforward sale of a security with accrued interest, looking at the position of the purchaser:

*Example 3*
See Example 3 in SAIM4160 [set out below]. Joe Smith sells £4,000 unsecured loan stock in Stuffed Dodos Ltd to his Aunt Matilda on 19 August 2005. Interest is payable on 5 April 2005 and 18 April 2006. Neither Joe nor Matilda had any other transactions in securities.
The settlement day falls within the interest period 5 April 2005 to 4 April 2006.
Joe is taxable on £79 for 2005–06 in respect of this interest period.
Matilda's loss of £79 is carried forward to 2006–07 to be set against the interest receivable for the period 5 April 2005 to 18 April 2006 (Section 637 ITA 2007 – see SAIM4120).

## 33.9 AIP remittance basis

Section 670A ITA provides:

(1) This section applies if—
(a) accrued income profits are made by an individual as a result of a transfer of foreign securities, and
(b) section 809B, 809D or 809E (remittance basis) applies to the individual for the tax year in which the profits are made.
(2) Treat the accrued income profits as relevant foreign income of the individual. ...
(4) For the purposes of this section securities are "foreign" if income from them would be relevant foreign income.

This brings in the remittance basis. AIP income is fictional, deemed income, which could not be remitted. This is dealt with by s.670A(3) ITA which provides different rules depending on whether the individual receiving the AIP income is the transferor (the usual case of a sale with accrued interest) or the transferee. It is helpful to consider these two cases separately.

For the transferor, s.670A(3) ITA provides:

> For the purposes of Chapter A1 of Part 14 (remittance basis)—
> (a) if the individual[9] is the transferor—
> (i) treat any consideration for the transfer as deriving from the accrued income profits...

Thus the proceeds of sale of the securities are treated as containing the AIP income.

> (ii) if on the transfer the individual does not receive consideration of an amount equal to or exceeding the market value of the securities, treat the securities as deriving from the accrued income profits

Section 670A(3)(a)(ii) is the equivalent of the CGT rule for deemed gains on non-market value disposals.[10]

For the transferee, s.670A(3) ITA provides:

> (b) if the individual[11] is the transferee, treat the securities as deriving from the accrued income profits.

If the taxpayer is the transferee, the AIP securities in the hands of the transferee are deemed to contain the AIP income. It makes no difference whether or not the sale is for market value.

The SAI Manual provides:

> **4380 - Accrued Income Scheme: remittance basis** [December 2009]
> ... In some cases, a remittance basis taxpayer will make an accrued income profit on a transfer of securities, but will not receive consideration equal to the market value of the securities.
> [1] This may happen when the securities are transferred 'ex-div' and the taxpayer is the transferee.

9 That is, the individual who makes the accrued income profits.
10 See 10.24 (CGT disposal not for market value).
11 That is, the individual who makes the accrued income profits.

> [2] It may also happen where the taxpayer is the transferor, and makes a gift of the securities, or where the AIS rules treat an event as a transfer (for example, an appropriation of securities to trading stock).
> In such cases s.670A(3) ITA 2007 provides that the securities themselves are treated as deriving from the accrued income profits. This means that a charge will arise on the taxpayer when they, or some other 'relevant person', either bring the securities to the UK (if they are held in bearer form) or remit money or property deriving from the securities.

### 33.9.1 *Relief for losses*

What about accrued income losses accruing to a remittance basis taxpayer? The SAI Manual provides:

> **4380 - Accrued Income Scheme: remittance basis** [December 2009]
> ... Remittance basis taxpayers are able to obtain relief for accrued income losses. Losses arising on transfers of securities of a particular kind are set against interest received on securities of the same kind at the end of the relevant interest period, and will therefore reduce the amount of an individual's interest on those securities. There is an example of the interaction of the accrued income loss rules and the remittance basis rules at SAIM4390.

### 33.9.2 *Mixed funds and separating income/capital: sale with accrued interest*

The consideration received by the transferor (vendor) for the sale of AIP securities with accrued interest will be a mixed fund, consisting in part of AIP income, and the mixed fund rules will apply. In strict law one cannot separate the AIP income from the other proceeds of sale. There are three reasons for this.

First, assume that:

(1) P will pay a single sum for the security to V's broker (the total price).
(2) The broker will then divide the total price into two parts (accrued interest and clean price) and pay the two parts into two separate accounts of the vendor.

There is already a mixed fund on receipt of the payment by the broker on behalf of the client at stage (1), and the broker's act in transferring the single payment into two accounts is an offshore transfer under the mixed fund rules. In theory one might avoid this difficulty if P could pay two separate sums, one in respect of accrued interest and one in respect of the clean price; but in practice on a market sale that would not be possible.

Secondly, the AIP income is a fictional, notional amount which is distinct from the sum paid for the accrued interest. It is like the CFC income in *Brikom*.[12]

Even if that were wrong, however, there is a third obstacle in s.670A(3) ITA, which provides:

> For the purposes of Chapter A1 of Part 14 (remittance basis)
> (a) if the individual is the transferor –
> (i) treat *any* consideration for the transfer as deriving from the accrued income profits.

Thus even if (contrary to my view) the amount that V, the transferor, received for the accrued interest could in principle be separated and did in principle constitute the AIP income, the effect of s.670A(4) is that any consideration for the securities sold by V is treated as deriving from the AIP income.

However HMRC do not take that view. The RDR Manual provides:

> **33550 - Remittance Basis: Identifying Remittances: Specific Topics: Accrued Income Scheme** [July 2010]
> Where a security is sold with accrued income and the proceeds paid into an account, the part of the proceeds representing accrued income will be taxable as income and subject to income tax under the Accrued Income Scheme (AIS)....
> Where an individual is chargeable on the remittance basis, accrued income profits arising from on transfers of a ‘foreign security’ are treated as relevant foreign income...
> For consistency of treatment between the AIS and the remittance basis regime, HMRC will follow the tax treatment delivered by the AIS and accept that an ‘income amount’ can be transferred to a separate ‘income account’ immediately upon transfer, that is, the proceeds are ‘split’ into two separate accounts immediately upon receipt into the individual’s account. This ‘income’ could then be identified and taxed as such, without creating a mixed fund....
> To the extent that the remainder of the proceeds consist of capital or UK or non-taxable income (as opposed to, say, untaxed foreign income or gains) originally used in the purchase of the security ... the remainder of

12 See 50.9 (The characterisation issue).

the proceeds could therefore be separately identified and remitted as such.[13]

### 33.9.3 *Mixed funds & separating income/capital: sale without accrued interest*

The manual does not expressly consider the alternative situation where a security is sold without accrued interest and the transferee makes an accrued income profit. There is no difference between the two situations, so the purchaser (transferee) could divide up the purchased securities into an AIP income fraction and a clean capital fraction and hold the two in separate security accounts. However the amounts involved will generally be trivial.

### 33.9.4 *Mixed funds and separating income/capital: actual interest payment*

A similar problem arises on receipt of the interest payment after the sale. I refer to this as **"the actual interest payment"**. The recipient will be the purchaser (on a sale with accrued interest) or the seller (on a sale without accrued interest). Either way, the recipient will not normally be subject to income tax on the full amount of the interest as an deemed interest debit will normally generate an accrued income loss which can be set against the interest. The actual interest payment will therefore be a mixed fund. It is suggested that one can separate the actual interest payment on receipt into income and capital elements.

## 33.10 *HMRC examples*

The SAI Manual provides:

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13 Similarly SAI Manual:

> **4400. Remittance basis: Further examples** [December 2009]
> The disposal of a bond may be structured such that separate payment is made for the capital and the accrued income elements which may be paid into separate accounts. In this situation Section 632 ITA 2007 provides that the taxable amount shall be taken as the amount of gross interest accruing to the settlement day, which is separately identified as such.
> An individual who has received separate payments into two separate accounts in this way will not be regarded as having two mixed funds. In this situation a remittance of the capital element will not be regarded as a remittance of relevant foreign income."

**4390 - Accrued Income Scheme: remittance basis: examples**
[December 2009]
The application of the remittance basis to the AIS is not without complication.

The problem is identifying what is or represents the AIP income where there are deemed interest debits (in the statutory terminology, amount B's) to set against deemed income credits (amount A's.) There is no statutory solution.

The following examples set out line HMRC takes in particular circumstances.

*Example 1*

Ann holds foreign securities 'of the same kind' X and Y which are disposed of in an interest period. They realise the following A and B amounts.

| **Security** | **Proceeds** | **Amount A** | **Amount B** |
|---|---|---|---|
| X | 100,000 | 10,000 | |
| Y | 60,000 | | (5,000) |

There is an accrued income profit of £5,000 which will be treated as deriving from the proceeds of sale of security X. Assuming the proceeds are paid into a new bank account, there will be a mixed fund comprising capital of £95,000 and an accrued income profit of £5,000.

*Example 2*

Isabelle has 3 holdings of the same kind of foreign security, X, Y and Z. They are disposed of in an interest period and the proceeds are paid into separate accounts. They realise the following A and B amounts.

| **Security** | **Proceeds** | **Amount A** | **Amount B** |
|---|---|---|---|
| X | 100,000 | 7,000 | |
| Y | 200,000 | - | (10,000) |
| Z | 70,000 | 4,000 | |

In this situation there is an accrued income profit of £1,000. If the proceeds of disposal of all 3 bonds are paid into a single account there will be a mixed fund with capital of £369,000 and an accrued income profit of £1,000.

That is the easy case as there is only one possible answer.

If the proceeds were paid into separate accounts HMRC would expect the accrued income profit to be allocated pro rata in proportion to the Amount A of securities X and Z or, if this would create an unreasonable result, by any reasonable method.

Careful time of purchases and sales would avoid the problem. The last example is somewhat theoretical and I set it out for completeness only:

> **4400. Remittance basis: Further examples** [December 2009]
> It is unlikely that there are many situations where UK and foreign securities will be 'securities of the same kind' for the purposes of the AIS scheme. It may, however, happen in the case of bearer securities. The following example outlines such a situation.
> Sam has both overseas and UK bonds 'of the same kind' and they are disposed of in the same interest period with the following results.
> *Example 3*

| **Security** | **Proceeds** | **Amount A** | **Amount B** |
|---|---|---|---|
| X (overseas) | 100,000 | 7,000 | |
| Y (overseas) | 200,000 | - | (10,000) |
| Z (UK) | 70,000 | 4,000 | |

> In this case the accrued income profit of £1,000 does not arise as the result of a transfer of foreign securities. There is a net Amount B of £3,000 as the result of the transferred foreign securities. There is therefore no relevant foreign income which Sam might remit to the UK. There is a UK accrued income profit of £1,000 which is taxable on an arising basis.

There are several odd things in this example. First it is assumed that if the bearer security is in the UK, the interest is UK source. That is not the test of the location of a source of interest. Perhaps it is assumed that the income is received in the UK. Secondly, one would have expected the deemed interest debit (amount B) to be set against the deemed interest credits pro rata, not set against foreign income first. But since in practice the point will never arise, it is not necessary to pursue that further.

### 33.10.1 *Position before 2008 and transitional rules*

Until 2008/09 a foreign domiciled individual was wholly outside the scope of the AIP rules on foreign securities.

Para 160 Sch 7 FA 2008 provides:

> The amendments made by paras 156 to 159 have effect in relation to transfers of securities where the settlement day is on or after 6 April 2008.

The new rules therefore catch all AIP securities even if held before the law changed in 2008.

### 33.10.2 *Commentary*

When one contemplates the complications of the AIP remittance basis, one appreciates the wisdom of the rule, which applied from the inception of the accrued income scheme in 1985 until 2008, under which the accrued interest scheme did not apply to foreign securities of remittance basis taxpayers. CGT filled the gap. The problems were not discussed, and as far as is known were not even considered, when the law was changed in 2008.

Most if not all readers who have studied the text to this point will agree that the current rule does not give sufficient weight to the desiderata of simplicity and administrative workability. The pre-2008 rule ought to be restored.

## 33.11 Excluded persons

The AIP exemptions use the concept of excluded transferor/transferee.

Section 638 ITA provides:

> (1) This section applies if there is a transfer of securities in relation to which a person ("P") is an excluded transferor or excluded transferee.
> (2) In determining whether P has made accrued income profits or accrued income losses under section 628 (making accrued income profits and losses: general rule) and the amount of any such profits or losses, no account is to be taken of any payment treated as made by or to P on the transfer.

A person is not an excluded transferor/transferee in isolation. One is excluded in relation to a transfer of securities. An excluded person is broadly outside the AIP scheme.

## 33.12 AIP non-residence defence

Section 643 ITA provides:

> (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.[14] It also withholds the AIP relief. EN ITA explains the policy behind the rule:

> 1897. In practice it would be very difficult to apply the scheme to such non-residents consistently. While non-residents could take the benefit of relief for accrued income losses to get repayments of tax suffered if tax is deducted at source, it would be difficult to enforce the charge to tax on accrued income profits.

A person coming to or leaving the UK might time disposals to obtain AIP relief while UK resident, while making disposals on which a charge would apply while non-resident.

The temporary non-residence rules do not apply. However CGT may fill some of the gap left by the AIP non-residence defence. The gain on the disposal of AIP securities may be subject to CGT if the CGT temporary non-residence rules apply.

## 33.13 Trusts

### 33.13.1 *Application to trustees*

The TSE Manual provides:

> **3325. Do AIS provisions apply to trustee or beneficiary?** [August 2007]
> *Accrued Income Scheme charge*
> If trustees (other than bare trustee – TSEM3320) transfer securities, any Accrued Income Scheme charge is that of the trustees. The trustees are chargeable at the trust rate, under Sections 481 and 482 ITA.
> The transfer of securities does not form the income of any beneficiary. The trustee must not include it on the Trust and Estate Return as the income of a beneficiary.

14 Section 1015 ITA (if needed) could also restrict the territorial scope of the AIP charge, but the rules discussed here leave it no room to operate.

*Accrued Income Scheme allowance*
The treatment of the allowance depends on who received the income against which relief is due. If the trustees received the income, they are entitled to the relief. There are instructions at AP4910.
The trustees may have mandated the income to a beneficiary. The beneficiary should claim the allowance against the income.

### 33.13.2 *Transfer to trust*

The TSE Manual provides:

**3330.Securities go into trust: Accrued Income Scheme** [August 2007]
When securities go into trust there is a transfer, for Accrued Income Scheme purposes. The transfer is from the settlor to the trustee.
This includes
• a settlor creates a new trust by transferring securities to the trustee
• a person who holds securities for his own benefit declares he will in future hold them as trustee
• at the end of an administration period, a personal representative starts to hold securities as trustee of a will trust. There are instructions at AP4928.

### 33.13.3 *Transfer from trustees*

The TSE Manual provides:

**3335. Beneficial interest in trust changes: Accrued Income Scheme** [August 2007]
*Change results from the terms of the trust*
The terms of a trust may often result in changes in beneficial interests. For example, on the death of a life tenant the trust assets may pass absolutely to another beneficiary. Such changes in beneficial interest have no accrued income scheme consequences. Either there is no actual transfer, or the transfer simply produces self-cancelling deemed sums and reliefs.

SAI Manual makes the same point:

**4050. What is a transfer?** [August 2007]
... The AIS is based on transfers of the legal ownership of securities, not the transfer of the underlying beneficial ownership. Thus, for example,

there is no transfer for the purposes of the AIS if a beneficiary under a trust becomes absolutely entitled as against the trustees to securities forming part of the trust fund.

Returning to the TSE Manual:

**3335. Beneficial interest in trust changes: Accrued Income Scheme**
[August 2007] ...
*Change follows an action by the trustees*
Sometimes a change is not a direct result of the terms of the deed. Trustees can use their powers to advance interests or appoint property. The exercise of these powers can amount to a transfer.

That seems inconsistent with what was said above..

*'Stranded' Accrued Income Scheme Allowance*
A change in beneficial owner can result in an Accrued Income scheme allowance being 'stranded'. It is no longer available to set against the interest. For example, the trustee could have bought securities 'cum dividend' (with a right to the dividend). Shortly afterwards a beneficiary could become absolutely entitled to the trust assets following a contingency. The contingency does not involve any transfer for Accrued Income Scheme purposes. This means the trustee's Accrued Income Scheme allowance is lost. The beneficiary was never entitled to the allowance, so cannot set it against subsequent interest.

### 33.13.4 *Appointment of new trustees*

The TSE Manual provides:

**3340. Accrued income scheme: change of trustees**
*Trustees remain resident in the UK*
There are no accrued income scheme consequences when trustees change, but remain resident in the UK. The change simply produces self-cancelling deemed sums and reliefs.
*Trustees change from resident to non-resident*
As the new trustees are not resident, they do not satisfy the 'residence requirement' of the accrued income scheme. The appointment of non-resident trustees is a transfer of the securities by the resident trustees. ...

> *Trustees change from non-resident to resident*
> As the old trustees were not resident, they do not satisfy the 'residence requirement' of the accrued income scheme. The change of trustees is a transfer of securities to the resident trustees.

This may have been right before 2006, but now that trustees are treated as a single person (distinct from the actual trustees) it is considered that the appointment of new trustees (wherever resident) is not a transfer for AIS purposes.

## 33.14 Settlor-interested trusts

### 33.14.1 *UK resident settlor-interested trusts*

Section 667(1) ITA provides:

> If the trustees[15] of a settlement are treated as making qualifying accrued income profits,[16] those profits are to be taken to be income arising under the settlement for the purposes of Chapter 5 of Part 5 of ITTOIA 2005 (settlements: amounts treated as income of settlor).

I am not sure if this is necessary, but perhaps it could have been argued that although "tax is charged on accrued income profits" (s.616) such profits are nevertheless not "income arising under a settlement". Perhaps the provision is just for symmetry with the provision which follows for non-resident trusts.

The rate of tax in the absence of s.624 is 50%, so s.624 can only reduce the tax rate (or make no difference).

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15 Defined in s.667(4)(b) ITA.

16 Defined in s.667(4)(a) ITA:

> "'qualifying accrued income profits' means accrued income profits which are treated as made—
> (i) under section 628(5), or
> (ii) under section 630(2) in respect of a transfer of variable rate securities."

The drafting is misleading: as far as I can see, all accrued income profits are "qualifying" accrued income profits.

### 33.14.2 *Non-resident trusts*

In the absence of express provision, AIP income of non-resident trustees would not fall within the settlement provisions because the trustees would qualify for the AIP non-residence defence. Section 667 ITA provides:

> (2) Subsection (3) applies if the trustees of a settlement—
> (a) are non-UK resident or domiciled outside the UK throughout a tax year in which an interest period or part of an interest period falls, and
> (b) would have been treated as making an amount or an additional amount of qualifying accrued income profits in the interest period if the trustees had been UK resident or domiciled in the UK during a part of each such tax year.
> (3) The amount or additional amount of qualifying accrued income profits that the trustees would have been treated as making is to be taken to be income arising under the settlement for the purposes of Chapter 5 of Part 5 of ITTOIA 2005.

Thus the AIP income of a settlor-interested trust is within the scope of s.624 ITTOIA. However, the s.624 remittance basis can apply.

Non-resident trustees would not qualify for AIP loss relief,[17] so s.680 ITA extends the relief:

> (1) This section applies if—
> (a) the trustees of a settlement are non-UK resident or domiciled outside the UK throughout a tax year in which an interest period or part of an interest period of securities falls,
> (b) the trustees' income is or includes interest from those securities,
> (c) the interest falls due at the end of that interest period, and
> (d) had the trustees been UK resident, or domiciled in the UK, during a part of each such tax year the interest would have been wholly or partly exempt from income tax under section 679.
> (2) No liability to income tax arises as a result of Chapter 5 of Part 5 of ITTOIA 2005 (settlements: amounts treated as income of settlor) in respect of so much of the interest as would have been exempt from income tax under section 679.

The references to domicile in ss.667 and 680 ITA is otiose because after

17 See 33.8 (Relief for accrued income losses).

the 2008 reforms domicile of trustees is irrelevant. The reference to "an additional amount" is also otiose. But no harm is done by these infelicities.

## 33.15 Transfer of assets abroad

In the absence of express provision, AIP income would not fall within the TAA provisions because the person abroad would qualify for the AIP non-residence defence (assuming the person abroad is non-resident). However, s.747 ITA deals with this:

> (1) This subsection applies if a person—
> (a) would have been treated as—
> (i) making qualifying accrued income profits, or
> (ii) making qualifying accrued income profits of a greater amount, in an interest period, but
> (b) is not so treated because of being resident or domiciled outside the UK throughout any tax year in which the interest period (or part of it) falls.
> (2) If subsection (1) applies, this Chapter applies as if the amount which the person would be treated as making or, as the case may be, the additional amount were income becoming payable to the person.
> (3) Accordingly, any reference in this Chapter to income of (or payable or arising to) a person abroad must be read as including a reference to such an amount.

It has been suggested that this leaves a gap where AIP securities are held by a non-resident company. Section 747(1) ITA applies only if the company would have fallen within the AIP rules but did not do so "because of being resident outside the UK". But if the company had been UK resident, it would be within the charge to corporation tax and outside the scope of AIP. That is correct on a literal construction. However, the context shows that the deeming is not intended to be applied that way, and a comparable argument in a CGT context was resoundingly dismissed in *de Rothschild v Lawrenson* 67 TC 300 ("I do not believe that our processes of statutory construction are so wanting in technique and imagination ...").

The reference to domicile is otiose from 2008 but it does no harm.

The person abroad (if non-resident) would not qualify for AIP loss relief, so s.747(4)(5) ITA extends the relief:

(4) This subsection applies if income consisting of interest which falls due at the end of an interest period—
(a) would have been income as respects which a person is entitled to an exemption, or an exemption of a greater amount, from liability to income tax under section 679 (interest on securities involving accrued income losses: general), but
(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.

## 33.15.1 *Definitions*

Section 747 ITA provides definitions for s.747:

(6) In this section—
(a) expressions which are also used in Chapter 2 of Part 12 (accrued income profits) have the same meaning as in that Chapter (but see subsection (7)), and
(b) "qualifying accrued income profits" means accrued income profits which are treated as made—
(i) under section 628(5), or
(ii) under section 630(2) in respect of a transfer of variable rate securities.
(7) In the case of qualifying accrued income profits within sub-paragraph (ii) of the definition of that expression in subsection (6)(b)—
(a) references in subsection (1)(a) to making qualifying accrued income profits in an interest period are to be read as making them in the tax year in which the settlement day falls, and
(b) the reference in subsection (1)(b) to the interest period is to the period—
(i) beginning with the day after the last day of the only or last interest period of the securities, and
(ii) ending with the settlement day.

The expression "qualifying" accrued income profits is misleading: as far as I can see, all accrued income profits are qualifying.

For the interaction with s.731, see 27.15.2 (Stock dividends and accrued income profits).

## 33.16 Double taxation relief

In the absence of express provision there would be no double taxation relief, as the AIP income is not taxable in the other state.

Section 10 TIOPA provides relief:

> (1) Subsection (2) applies if—
> (a) a person is treated under section 628(5) of ITA 2007 as making accrued income profits in an interest period,
> (b) the person would, were the person to become entitled in the relevant tax year[18] to any interest on the securities concerned, be liable in respect of the interest to tax chargeable under ITTOIA 2005 on relevant foreign income, and
> (c) the person is liable under the law of the territory to tax in respect of interest payable on the securities at the end of the interest period or the person would be so liable if the person were entitled to that interest.

I cannot see the need for (b) as it will be satisfied whenever (a) is satisfied. Section 10(2) provides the relief:

> (2) Credit is to be allowed against income tax calculated by reference to the accrued income profits.
> (3) The amount of the credit allowed under subsection (2) is given by—
> AIP × FTR
> where—
> AIP is the amount of the accrued income profits, and
> FTR is the rate of tax to which the person is or would be liable as mentioned in subsection (1)(c)...

Section 39 TIOPA restricts DTA relief where there is relief for accrued income losses.[19]

The SAI Manual provides:

> **4370. Double taxation relief** [December 2009]
> Where an AIS charge arises on a foreign stock on which the interest

18 Defined subsection (5): "In subsection (1)(b) 'the relevant tax year' means the tax year in which, under section 617(2) of ITA 2007, the accrued income profits are treated as made."

19 See 33.8 (Relief for accrued income losses).

would have suffered foreign tax eligible for credit relief if interest had been received, credit for foreign tax is allowable for the lower of

- the rate of UK tax charged on the accrued income profit, and
- the rate of foreign tax suffered on the interest payable at the end of the interest period for which the charge arises.

If there is an accrued income loss to be set against foreign interest, reduce the credit for foreign tax in the proportion which the allowance bears to the interest.

*Example*

Taxpayer holds foreign stock on which the interest suffers tax eligible for credit at 15%. Interest paid on 30 June and 31 December.

In the interest period to 30 June 2005, the taxpayer makes transactions resulting in an AIS loss of £200. He receives interest (gross) of £1,000 less £150 foreign tax.

In August 2006 he sells the entire holding and there is an AIS profit of £300. He is liable to UK tax at 22%. His double taxation relief is as follows

| | | | |
|---|---|---|---|
| Foreign interest | | £1,000 | |
| Less Accrued Income relief | | - £200 | |
| | | £800 | |
| Foreign tax deducted | £150 | | |
| Credit restricted to | £1000–£200 × £150/£1000 | | = £120 |
| Accrued income profit | | | £300 |
| Allow credit for foreign tax | | | |
| on AIS charge £300 @ 15% | | | = £45 |
| Total double taxation relief £120 + £45 | | | = £165 |

The double taxation relief given can exceed the foreign tax suffered (£165 exceeds the £150 suffered).

## 33.17 Interaction with CGT

Section 119(1) TCGA disapplies the normal CGT rules in ss.37 and 39 TCGA:

(1) Where there is a transfer of securities within the meaning of Chapter 2 of Part 12 of ITA 2007 (accrued income profits)—

(a) if a payment is treated as made to the transferor under section 632 of that Act or by the transferor under section 633 of that Act, section 37 shall be disregarded in computing the gain accruing on the disposal concerned;

(b) if a payment is treated as made by the transferee under section 632 of that Act or to the transferee under section 633 of that Act, section

> 39 shall be disregarded in computing the gain accruing to the transferee if he disposes of the securities;
>
> but subsections (2) and (3) below shall apply.

Section 119 TCGA goes on to set out its own rules:

> (2) Where the securities are transferred with accrued interest (within the meaning of that Chapter)—
>
> (a) if a payment is treated as made to the transferor under section 632 of ITA 2007, an amount equal to the amount of that payment shall be excluded from the consideration mentioned in subsection (8) below;
>
> (b) if a payment is treated as made by the transferee under that section, an amount equal to the amount of that payment shall be excluded from the sums mentioned in subsection (9) below. ...
>
> (8) The consideration is the consideration for the disposal of the securities transferred which is taken into account in the computation of the gain accruing on the disposal.

Section 119(3)(9) contains corresponding rules for a transfer without accrued interest:

> (3) Where the securities are transferred without accrued interest (within the meaning of that Chapter)—
>
> (a) if a payment is treated as made by the transferor under section 633 of ITA 2007, an amount equal to the amount of that payment shall be added to the consideration mentioned in subsection (8) below;
>
> (b) if a payment is treated as made to the transferee under that section, an amount equal to the amount of that payment shall be added to the sums mentioned in subsection (9) below...
>
> (9) The sums are the sums allowable to the transferee as a deduction from the consideration in the computation of the gain accruing to him if he disposes of the securities.

## 33.18 Foreign currency securities

SAIM provides:

> **4310. Special calculations: Foreign currency securities**
>
> Foreign securities: Translation into sterling
>
> Section 664 ITA 2007 provides rules for translation into sterling of the

payments made on the transfer of securities where the interest on securities is payable in a currency other than sterling.

If the interest is accounted for separately between transferor and transferee, and the parties specify in their contact what the sterling equivalent of the accrued or rebate interest is, the sterling amount so specified is to be used in the AIS calculations. Otherwise, the amount is to be determined in the foreign currency according to the usual rules, and then translated into sterling at the rate of exchange prevailing on the settlement day for the transfer, calculated by reference to the London closing rate of exchange for the day concerned.

The nominal value of foreign securities is also determined (under Section 677 ITA 2007) as the sterling equivalent of that value on any day, calculated by reference to the London closing rate for that day.

Where unrealised interest is payable in a foreign currency, Section 665 ITA 2007 provides that the amount the accrued income profits under Section 631 ITA 2007 is the sterling equivalent on the settlement day, or in the case of interest in default (SAIM4290), the value on the day of receipt.

Although the London closing rate should in strictness be used in all the above cases, figures of rates of exchange supplied by taxpayers or their agents should normally be accepted, provided that they come from a reputable source (for example, an exchange rate quoted by the taxpayer's bank for the day in question) and the basis is used consistently.

CHAPTER THIRTY FOUR

# DEEPLY DISCOUNTED SECURITIES

## 34.1 DDS – Introduction

A full discussion would need a half a book. The following is a general outline with a focus on the issues closest to the themes of this work. In particular, the following aspects are not discussed:
- securities issued in tranches
- earn-out rights
- strips
- exchanges and conversions

In outline, the effect of the rule is that profits arising on the disposal of a deeply discounted security ("DDS") are subject to income tax rather than CGT. The rules only apply to a holder of a DDS who is subject to income tax. They do not apply to the issuer and they do not apply for the purposes of corporation tax.

## 34.2 Meaning of "deeply discounted security"

### 34.2.1 *"Security"*

SAI Manual states:

> **3010 Introduction** [August 2008]
> The term 'security' is not defined in the legislation. It may be taken to have a broad meaning comparable to the definition in TCGA Section 132(3)(b) (CG53420) ...

### *34.2.2 "Deeply discounted"*

In outline, the definition is in s.430 ITTOIA:

**430 Meaning of "deeply discounted security"**
(1) The general rule is that a security is a "deeply discounted security" for the purposes of this Chapter if, as at the time it is issued, the amount payable on maturity or any other possible occasion of redemption ("A") exceeds or may exceed the issue price by more than A×0.5%×Y,
where Y is the number of years in the redemption period or 30, whichever is the lower.
(2) If the redemption period is not a number of complete years, for the purposes of subsection (1) the incomplete year is expressed as twelfths, treating each complete month and any remaining part of a month as one-twelfth.
(3) In this section "redemption period" means the period between the date of issue and the date of the occasion of redemption in question.
(4) Interest payable on an occasion of redemption is ignored in determining for the purposes of this section the amount payable on that occasion.

SAI Manual gives three examples:

**3020 Meaning of deeply discounted security**
*Example 1*
Company A issues securities for £1,000 which are redeemable in 10 years time for the subscription amount increased by the percentage movement in the Retail Price Index over the same period. As the linkage to the RPI may give more than a 5% increase in value (10 years × 0.5%) over that period, the securities are deeply discounted securities.
*Example 2*
Company B issues a 12-month security for £950. It is redeemable for £950 at maturity or, depending on events, for £1,000 after 6 months. The occasion of early redemption is not disregarded under Section 431 ITTOIA 2005 (SAIM3030). The difference between the issue and early redemption prices is more than £2.50 (£1,000 × 0.5% × 6/12). The security is therefore a DDS.
*Example 3*
Bank C issues a 5-year security that is linked to the FTSE 100 share index. Each security has a nominal value to £100. If the index rises, the investor receives on redemption £100 multiplied by the percentage rise in the index. For example, the index has risen to 150% of its starting value, the investor receives £150. If the index falls, the investor is guaranteed to receive back his or her £100, so the security is not an excluded indexed security (SAIM3050). Since the security may give more than a 2.5% increase in value over the period (5 years × 0.5%), it

is a DDS, even though there is no certainty as to the redemption amount.

### 34.2.3 *Securities dealt with under other regimes*

Section 432(1) ITTOIA provides:

> 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.[1]

### 34.2.4 *Securitised derivatives*

The SAI Manual provides:

> **3040. Securities which are not deeply discounted securities** [October 2010]
> ... In practice, therefore, most deeply discounted securities will be securities in the nature of debts, that is, where the issuer has an obligation to make some form of return to the investor.
> **Securitised derivatives**
> Securitised derivatives present particular problems. These are investment products where the amount which the investor gets back at the end depends on the performance of a share index, or a particular share or shares, or (less commonly) some other asset. The capital initially subscribed by the investor may be completely or partly protected, or it may be possible for the investors to lose the whole of their money.
> Some such products, properly analysed, are options, for which the investor pays a premium (these are often described as 'warrants'). Others may be contracts for differences, or other derivatives. These will not be deeply discounted securities; disposal of an option, or of a financial future within Section 143 TCGA 1992, will give rise to a capital gain or allowable loss. See also SAIM7000 on the tax treatment of derivatives that generate an interest-like return.
> Other securitised derivatives, however, create a debt (in technical terms, they are structured as a debt security plus one or more options or other

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1 Section 432(3) ITTOIA provides:
"In this section 'capital redemption policies' has the same meaning as in Chapter 9 of this Part (see section 473(2))."

> derivatives). These will be deeply discounted securities, unless they fulfil the stringent conditions to be 'excluded indexed securities' (SAIM3050). You should seek advice from CT & VAT (Financial Products and Services Team) if it is unclear whether or not a particular instrument is a deeply discounted security.

There are some deep conceptual issues here.

## 34.3 Securities denominated in foreign currency

In the following discussion **"a foreign currency denominated security"** is one issued for a foreign currency and redeemable in that currency.

### 34.3.1 *Is a foreign currency denominated security necessarily a DDS?*

Consider for instance a US Treasury Note issued for $1,000 and redeemable on maturity at $1,000 and carrying interest at a market rate. Is a security of that kind deeply discounted? The question (in short) is whether:

> the amount payable on maturity may exceed the issue price

This raises a currency translation issue. If:
(1) "issue price" means the sterling equivalent of the issue price at the time of issue; and
(2) "the amount payable on maturity" means the sterling equivalent at the time of maturity

then a foreign currency denominated security is a DDS since currency fluctuations could lead to a gain measured by £sterling. If "issue price" means the dollar price and "the amount payable on maturity" means the dollar amount, then the two are equal and the security is not a DDS.

The statutory words could be understood either way, so the context must resolve the issue. The context shows that the second view is correct. This is for several reasons. First, the object of the DDS rules is to tax discounts, which are commercially similar to interest. It is not to tax currency fluctuations. The absence of relief on losses would operate very unfairly. Secondly, if that were not the case, all foreign currency denominated securities would be within the DDS regime.[2] That would be surprising (and indeed contrary to EU law).[3]

HMRC agree. SAI Manual provides:

> **3020 Meaning of deeply discounted security**
> The test for deep discount is carried out in the currency of issue.

### 34.3.2 *Foreign currency denominated DDS*

The above paragraph is considering a security whose dollar issue price equals its dollar maturity price. Of course, a foreign currency denominated security would in principle be a DDS if the redemption price may sufficiently exceed the issue price. It is understood that US treasury bills (which do not carry interest) are normally DDSs. I refer to such a security as **"a foreign currency denominated DDS".**

How does one compute the profit on the disposal of a foreign denominated DDS? The profit is:

> the amount by which the amount payable on the disposal exceeds the amount paid by the person to acquire the security.

This raises another currency translation issue. Suppose a person acquires a security on issue for dollars and redeems it for dollars. Is the amount paid to acquire the security:

(1) The sterling equivalent of the purchase price at the time of issue? Or
(2) The dollar amount? If so, it is deducted from the dollar amount payable on disposal, to give a dollar profit, translated into sterling at the time of disposal.

The statutory words could be understood either way, so the context must resolve the issue. The context shows that the second view is correct. This is consistent with the approach to the definition of a DDS: see above. The same point applies: the object of the DDS rules is to tax discounts, which are commercially similar to interest. It is not to tax currency fluctuations.

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2 Unless they contained a cap to limit the gain to a sterling amount, which would not normally be the case.

3 The arguments are more fully set out in Ghosh, "Corporate Bonds: If The Cap Does Not Fit" *Taxation*, 7 Feb 2002 p.439 but since HMRC have accepted this view since the publication of Tax Bulletin 9, it is not necessary to consider that here.

The solution to the same problem for CGT is different.[4] The reason for this is explained in *Capcount Trading v Evans* 65 TC 545. One important factor in that decision was the provision in the CGT legislation that currency other than sterling is an asset for CGT. There is no similar provision for IT.

## 34.4 Excluded occasions of redemption

Section 431(1) ITTOIA provides:

> An occasion of redemption of a security other than maturity is ignored for the purposes of section 430(1) if the third-party option conditions or the commercial protection conditions are met.

### 34.4.1 *The third-party option conditions*

> (2) The third-party option conditions are that—
> (a) the security may be redeemed on the occasion at the option of a person other than its holder,
> (b) the security is issued to a person who is not connected with the issuer, and
> (c) the obtaining of a tax advantage by any person is not the main benefit, or one of the main benefits, that might have been expected to accrue from the provision in accordance with which the security may be redeemed on the occasion.

### 34.4.2 *The commercial protection conditions*

> (3) The commercial protection conditions are that—
> (a) the security may be redeemed on the occasion as the result of an exercise of an option that is exercisable only on the occurrence of—
> (i) an event adversely affecting the holder (see subsection (8))[5], or
> (ii) a default by any person, and
> (b) as at the time of the security's issue it appears unlikely that the option will be exercisable on the occasion.

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4 See 49.2 (CGT: currency conversion date).

5 "(8) In this section "event adversely affecting the holder", in relation to a security, means an event the occurrence of which appears, as at the time of the security's issue, likely to have an adverse effect on the interests of its holder at the time of the event if there were no provision for redemption on its occurrence."

### 34.4.3 *Restrictions on conditions*

(4) Subsection (1) does not apply to an occasion just because the occasion coincides or may coincide with an occasion meeting the third-party option conditions or the commercial protection conditions.
(5) If—
(a) the only reason that a security is not a deeply discounted security is that an occasion on which it may be redeemed is ignored because the third-party option conditions are met, and
(b) at some time after its issue the security is acquired by, or its holder becomes, a person connected with the issuer,
in relation to that time and later this Chapter applies as if the security were a deeply discounted security.
(6) If a person ("P") who is not connected with the issuer acquires—
(a) a security which is only a deeply discounted security because it was issued to a person connected with the issuer and so fails to meet the condition specified in subsection (2)(b), or
(b) a security within subsection (5),
this Chapter applies in relation to P as if the security ceased to be a deeply discounted security on the acquisition.
(7) For the purposes of the application of this section to a security, the question whether persons are connected is determined without regard to the security or any other security issued under the same prospectus.

## 34.5 Meaning of "disposal"

Section 437(1) ITTOIA provides:

References in this Chapter to the disposal of a deeply discounted security are—
(a) to its redemption,
(b) to its transfer by sale, exchange, gift or otherwise, including a transfer treated as made by subsection (3), and
(c) so far as not covered by para (a) or (b), to its conversion under its terms into shares in a company or other securities (including other deeply discounted securities).

### 34.5.1 *"Person making a disposal"*

Section 437(2) ITTOIA provides:

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.

### 34.5.2 *Death of holder*

Section 437(3) ITTOIA provides:

A person who dies while entitled to a deeply discounted security is treated as transferring it immediately before death to the personal representatives.

## 34.6 Meaning of "profit"

Section 439 ITTOIA provides:

(1) A person's profit on a disposal is the amount by which the amount payable on the disposal exceeds the amount paid by the person to acquire the security.
(2) No account is to be taken of any incidental expenses incurred in connection with the disposal or acquisition.

I refer to this as the DDS profit. The DDS profit is greater than a chargeable gain on a disposal because expenses are disallowed.

### 34.6.1 *Deemed DDS profit*

Section 440 ITTOIA provides:

(1) On the disposal of a deeply discounted security by a transfer of a kind specified in subsection (2), for the purposes of this Chapter an amount equal to the market value at the time of the disposal is treated as payable.
(2) The transfers are—
(a) a transfer made otherwise than by a bargain at arm's length,
(b) a transfer between connected persons,
(c) a transfer for a consideration which is not wholly in money or

money's worth,
(d) a transfer treated as made by section 437(3) (death), and
(e) a transfer by personal representatives to a legatee. ...

I refer to the profit on a disposal within this section as "**deemed DDS profit**".

## 34.7 Charge to tax on disposal of DDS

Sections 427 and 428 ITTOIA impose the charge:

> **427 Charge to tax on profits from deeply discounted securities**
> (1) Income tax is charged on profits on the disposal of deeply discounted securities.
> (2) The profits are treated as income for income tax purposes if they would not otherwise be income.
> **428 Income charged**
> (1) Tax is charged under this Chapter on the full amount of profits arising in the tax year.
> (2) The profits on a disposal are to be taken to arise when the disposal occurs.
> **429 Person liable**
> (1) The person liable for any tax charged under this Chapter is the person making the disposal.

## 34.8 DDS remittance basis

Section 428(3) ITTOIA provides:

> 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).

This brings in the ITA remittance basis for a DDS that is outside the UK.
The section uses the words "treated as" because DDS income does not have a source, at least in the traditional sense.[6]

6 See 16.4.2 (Location of source of income when there is no source).

How does one decide whether a security is "outside the UK"? In the HMRC view the test is the residence of the issuer. The former Inspectors Manual para 1541 provided:

> Where the security was issued by a UK resident any profit is assessable under Case III of Schedule D. Where the security was issued by a non-UK resident, any profit is assessable under Case IV of Schedule D.

This is not obviously right, but it is as good a test as any other and (in relation to a non-resident issuer) at least we should know where we stand.[7] This passage is omitted in the SAIM but there is no indication that HMRC practice has changed.

An alternative approach is to say that a security is in the UK if income from it has a UK source and outside the UK if income from it has a non-UK source.[8] This will usually come to the same thing[9] and I doubt if the point will ever need to be decided.[10]

For completeness: another possible approach is that "outside the UK" means situated outside the UK applying common law situs rules. This too would usually come to the same thing, but it would allow some scope for tax planning. This view is less attractive since (1) common law situs is not generally relevant for IT; (2) one would have expected the drafter to use the word "situate" if it was intended to incorporate a situs rule.

Strictly, one cannot segregate income from capital (for no identifiable part of the proceeds represents the income). But since HMRC do not apply that rule for the accrued income scheme,[11] they should logically not

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7 The position if the issuer changes residence is less clear, but perhaps this does not arise in practice.

8 This would be consistent with the AIP scheme, where the test is whether income from the security has a foreign source: see 33.9 (AIP remittance basis). However, the two cases are not the same, because a DDS may not yield any income, so the question whether income from the DDS has a foreign source could be a hypothetical question.

9 See 17.4.6 (Interest from securities). Because the rules concerning the location of the source of interest are so unclear, it is impossible to say in what (if any) circumstances the source of the income might be different from the residence of the issuer.

10 If it mattered, the view that income source was the test should be rejected, for if the drafter intended to apply an income-source test, one would have expected the wording to match that used elsewhere for income-source tests. The wording is not very far from the former case IV in s.18 ICTA 1988 ("income arising from securities out of the UK") but there the words "out of the UK" govern "arising" and not "securities".

11 See 33.9 (AIP remittance basis).

take the point in this context either. There is however no discussion in the RDR Manual.

A deemed DDS profit (eg on a gift) cannot be remitted and so is tax free.[12]

## 34.9 UK resident trust

### 34.9.1 *UK resident trust (not settlor-interested)*

A UK resident trust is in principle subject to income tax on its DDS profits. Tax is charged at the trust rate, 50%: s.482 ITA.

### 34.9.2 *UK resident settlor-interested trust*

A DDS profit accruing to UK trustees is not "income" in the general sense and in the absence of express provision it would not fall within s.624 ITTOIA which only applies to income. However s.427(2) ITTOIA directs that the profits are "treated as income for income tax purposes" so it does fall within s.624 ITTOIA. For good measure, s.457 ITTOIA provides:

> (1) This section applies if profits are taken to arise on a disposal of a deeply discounted security by trustees.
> (2) For the purposes of Chapter 5 of Part 5 (settlements: amounts treated as income of settlor), the profits are to be taken to be income arising under the settlement from the security. ...

Thus DDS profits do fall within the settlement provisions.

If the settlor is a remittance basis taxpayer the s.624 remittance basis is available, ie the settlor is not taxed on an unremitted foreign DDS profit.[13]

The rate of tax in the absence of s.624 is 50%, so s.624 can only reduce the tax rate (or make no difference).

## 34.10 Non-resident individual

Section 368 ITTOIA provides the necessary exemption for non-residents.[14]

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12 The CGT rule does not apply here; see 10.26 (CGT disposal not for market value).
13 See 24.5 (Section 624 remittance basis).
14 See 16.4 (Why does location of source matter?).

In short non-resident individuals are not chargeable if the security is out of the UK. They are theoretically chargeable if the security is in the UK but non-residents IT relief is usually available.[15]

The temporary non-residence rules do not apply for DDS purposes because (1) these rules do not apply for IT (in particular, DDS) purposes and (2) the rules do apply for CGT purposes but no chargeable gain arises on the disposal of a DDS.[16]

## 34.11 Non resident trust

In the absence of express provision, non-resident trustees would not be charged on foreign DDS profits but could be charged on UK DDS profits. However s.458(1) ITTOIA provides:

> Tax is not charged under this Chapter if the disposal is made by the trustees of a settlement[17] and they are non-UK resident.

So non-resident trusts are not subject to tax on DDS, whether UK or foreign.

It is considered that s.624 applies to non-resident settlor-interested trusts as it applies to UK resident trusts. Section 458 does not provide relief since the charge on settlor-interested trusts is not a charge "under this chapter".

## 34.12 Transfers of assets abroad

A DDS profit accruing to a non-resident is not "income" so in the absence of express provision it would not fall within the TAA provisions even if it accrued to a person abroad within s.720 or 731. However s.427(2) ITTOIA directs that the profits are "treated as income for income tax purposes" so it does fall within the TAA provisions. For good measure, s.459 ITTOIA provides:

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15 See 37.1 (Non-residents IT relief).

16 See 34.14 (Interaction with CGT).

17 "Settlement" here means settlement-arrangement: see s.458(3) which provides:
"In this section 'settlement' has the same meaning as in Chapter 5 of Part 5 (see section 620)."

> (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).

Thus DDS profits do fall within the scope of the TAA provisions.

### 34.12.1 *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[18] 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 arose when a UK resident foreign domiciled beneficiary sold a non-UK situate asset and realised a chargeable gain. Prior to the 2008 mixed fund rule, if the individual remitted (say) one-half of the proceeds of sale, their were regarded as remitting one-half of the gain.

Inspectors Manual para 1567 explained:

> This is because, whilst the income content of any fund is a separate and distinguishable part of that fund, a capital gain is merely part of the whole proceeds of a disposal transaction that has no separate identifiable existence within those proceeds.

The same reasoning would apply here. Thus the only way to avoid relevant income by distribution would be to distribute the entire proceeds of an arm's length disposal. It is conceivable that HMRC will not apply the law on this point strictly, but do not rely on this without clearance.

If there are only fictional profits, because the market value rule applies[19]

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18 See 27.22 (Relevant income of trust distributed as income in year it arises) to 27.26 (Distributed income: HMRC view).

19 See 34.6 (Meaning of "profit").

then s.731 does not apply because fictional income cannot be used to benefit a beneficiary, so it cannot be relevant income.

## 34.13 Non-resident company

Section 368 ITTOIA provides the necessary exemption for non-residents.[20] In short, they are not chargeable if the security is outside the UK. They are theoretically chargeable if the security is in the UK, but see 37.1 (Limit of liability for non-residents). The company DDS income is within the scope of the TAA provisions. There is no group relief so an inter-group transfer may give rise to a charge.

## 34.14 Interaction with CGT

Section 117(1) TCGA provides the usual definition of corporate bond. Section 117(2AA) provides:

> For the purposes of this section "corporate bond" also includes any asset which is not included in the definition in subsection (1) above and which is a deeply discounted security for the purposes of Chapter 8 of Part 4 of ITTOIA 2005 (see section 430).

Section 117(7) TCGA defines qualifying corporate bond as (in short) any corporate bond issued after 13 March 1984. (The rules for pre-1984 bonds are not considered here.) Thus any DDS is in principle a qualifying corporate bond ("QCB"). Section 115(1) TCGA provides exemption for QCBs:

> A gain which accrues on the disposal by any person of—
> (a) gilt-edged securities or qualifying corporate bonds, or
> (b) any option or contract to acquire or dispose of gilt-edged securities or qualifying corporate bonds,
> shall not be a chargeable gain.

Thus a DDS is entirely outside the scope of CGT.

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20 See 16.4 (Why does location of source matter?).

CHAPTER THIRTY FIVE

# UNIT TRUSTS

## 35.1 Unit Trusts - Introduction

This chapter considers unit trusts and Luxembourg Fonds Commun de Placement (which are treated in a similar way).

The taxation of unit trusts needs a book to itself. This chapter focuses on the matters closest to the themes of this book.

### *35.1.1 Definition(s) of "unit trust"*

The High Court of Australia rightly say:

> "unit trust" ... in the absence of an applicable statutory meaning, does not have a constant, fixed, normative meaning ... [1]

However for most tax contexts there is a statutory definition. Section 1007 ITA provides:

> (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, in relation to a unit trust scheme within the meaning given by section 237 of FISMA 2000 whose trustees are UK resident, by regulations provide that the scheme is not to be a unit trust scheme for the purposes of the definition in section 989 of "unauthorised unit trust" if it is within a specified description. ...

1 *CPT Custodian Pty Ltd v State Revenue* (2005) 221 ALR 196 at [15] accessible *www.austlii.org*.

CGT is effectively the same. Section 99 TCGA 1992 provides:

> (2) Subject to subsection (3) and sections 99A and 151W(a) 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 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(1) FISMA, which is pleasingly short:

> 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" needs a book to itself and is not discussed here.

## 35.2 Income accruing to unit trust

### 35.2.1 *Authorised unit trusts*

Section 617(1) CTA 2010 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 UK resident company; 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.

### 35.2.2 *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 and 496B 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.

## 35.3 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 considered that ordinary interest in possession trust rules apply. Depending on the drafting and proper law, a unit trust may be a transparent, *Baker* style trust or non-transparent.[2] HMRC agree. The Life

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2 See 23.1 (IP trusts: income tax). 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.

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" 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]

The Offshore Funds Manual discusses *Baker* unit trusts::

> **OFM08200 Investors in non-reporting funds: distributions: the charge to tax: 'transparent' funds**
> ... Income: UK tax treatment of investors
> For UK tax purposes the income of an income transparent fund is treated as arising directly to its investors (UK investors are charged to tax on income arising net of a deduction for proper expenses of the management of the fund in question, and this is the case for both unit trusts and contractual arrangements[4]). So, for example, if a fund receives interest income then UK investors are charged to tax on their proportionate share of that income as it arises, irrespective of whether or not it is actually distributed to them. Investors should receive a voucher from the fund to tell them what proportion of the fund's income they are entitled to, and the split between interest, dividends or property income. Investors should ask their fund manager for a voucher if they do not receive one.

The OFM also discusses *Garland* unit trusts:

> OFM08300 Investors in non-reporting funds: distributions: the charge to tax: 'non-transparent' funds
> ... Foreign unit trusts that are not transparent for income purposes are sometimes referred to as 'Garland' unit trusts (following the case of Garland v Archer-Shee (15TC693))...
> Non-transparent unit trusts

3 The same point is made at 4C.401.

4 Author's note: the reference is to Fonds Commun de Placement.

> UK investors in foreign unit trusts that are non-transparent for income purposes are taxable on their proportionate share of income (as ascertained after the trustees have met the expenses of administering the trust) when it is indefeasibly allocated to them, regardless of whether the income is paid to them or accumulated. Unlike the position for transparent unit trusts (see OFM08200), that income is taxable as miscellaneous foreign income (under Chapter 8 of Part 5 of ITTOIA 2005, or Chapter 8 of Part 10 CTA 2009) and the tax rates applying will be those applying to such income. Corporation tax payers are subject to the rules in Chapter 3 of Part 6 of CTA 2009 if the fund is a bond fund.

Inspectors Manual provided:

> **1617 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

5 This assumes the unit trust is a non-transparent *Garland*-style trust; or else that it holds only foreign investments.

> 18 ICTA 1988. A fund with automatic reinvestment of "accumulation" shares may not be able to meet this criterion as there may be doubt about whether it has "paid" a distribution that is capable of being construed as income for UK tax purposes.
>
> Where such a fund nevertheless wishes to benefit from having distributing fund status it can reach agreement with HMRC that it will apply "reinvestment mechanics". The important point here is that the mechanics of reinvestment establish in principle the chargeability to UK tax of the distribution.
>
> We take the view that, it would satisfy "paid" for the purposes of the test, provided the distribution
>
> - passes out of the fund's control and
> - into the hands of a third party, who can **clearly be seen** to receive the distribution and
> - to reinvest it in further shares/units or increase in capital value of the existing shares/units on behalf of the relevant participator.
>
> This does require a physical separation of the distribution from the fund and its subsequent reinvestment, not just a paper transaction.
>
> (Emphasis original)

Everything depends on the documentation concerned.

### 35.3.1 *Baker or Garland?*

This depends on the applicable law[6] and the drafting. A standard unit trust form provides:

> On each Distribution Date the Trustee shall calculate and distribute among the Holders rateably in accordance with the number of Units held or deemed to be held by them respectively on the Distribution Date such amount as shall in the opinion of the Trustee represent the amount of income available for distribution and accordingly such income shall not form part of the Trust Fund. No amount payable to the Holder in respect of any distribution or redemption shall bear interest. Upon the expiry of the period of ten years after any such amount first becomes payable the Holder and any person claiming through, under or in trust for him shall forfeit any right thereto, and such amount shall be retained as part of the Trust Fund or otherwise dealt with in accordance with the provisions of this Instrument.

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6 See 23.4 (Baker or Garland trust jurisdiction?).

It is suggested that this creates a *Garland*-style trust even in a *Baker* jurisdiction.

### 35.3.2 *Residence of trustees of unit trust*

The residence of the trustees of a unit trust is important for IT purposes, because the rules set out above depend on whether or not the trustees are UK resident. However, there is no definition of residence for this purpose. The common IT/CGT definition of residence of "trustees of a settlement"[7] does not apply, because a unit trust is not a "settlement".[8] Ordinary rules of residence apply to determine the residence of the trustees in their private capacities.

## 35.4 Gains accruing to unit trust

Section 99(1) TCGA provides:

> (1) This Act shall apply in relation to any unit trust scheme as if—
> (a) the scheme were a company,
> (b) the rights of the unit holders were shares in the company, and
> (c) in the case of an authorised unit trust, the company were resident and ordinarily resident in the UK,
> except that nothing in this section shall be taken to bring a unit trust scheme within the charge to corporation tax on chargeable gains.

Thus a UK resident unit trust is subject to CGT, but a non-resident one is not (unless carrying a trade in the UK through a branch or agency). The residence of a unit trust is important for CGT purposes. Statute states that authorised unit trusts are UK resident but does not define the test of residence for unauthorised unit trusts. Since a unit trust is treated as a company, it is considered that the test of residence for CGT is the corporate test, ie, central management and control.

Gains accruing to a non-resident close unit trust fall in principle within the scope of s.13 TCGA, and may be attributed to UK resident unit

7 See 4.1 (Residence of trustees).

8 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).

holders.[9]

## 35.5 Situs of unit

### 35.5.1 *Situs for IHT*

The situs of a unit in an authorised unit trust is not normally relevant for IHT.[10] 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.[11] One should not apply rules governing other kinds of equitable interests without considering this.

It is considered that share/security situs rules should normally be applied, so that the place of the register is normally the determining factor. HMRC accept this.[12]

Another possible view is that situs depends on the residence of the trustees. In practice a situation where the place of residence of the trustees is different from the place of the register would be rare so the priority between the two tests may never need to be decided. Trustee residence determines whether a unit trust is treated as a company or offshore fund for IT and CGT purposes.[13] 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 based on private

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9 Julian Ghosh QC agrees: "When is a company not a company?" PTPR Vol 7 p. 241.

10 See 53.3 (Non-settled property: authorised unit trusts and OEICs).

11 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.

12 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).

13 See 31.3 (Meaning of "offshore fund") and 35.2.2 (Unauthorised unit trust: UK trustees).

international law, not tax law, 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.[14]

(2) The proposal to look to the situs of the underlying assets is unworkable because the unit holder will not normally be able to ascertain what the underlying assets are at any particular moment. (Accounts of the unit trust may disclose the position at the end of an accounting period but that will not help as assets are normally bought and sold constantly by the trustees of the unit trust. The unit holder normally has no further right to information.)

Although the consequence is that one can alter situs by interposition of a unit trust, that is not so surprising: one can do the same with an OEIC.

### 35.5.2 *Situs of unit for CGT*

If the unit trust is governed by a foreign proper law, registered units are situate where they are registered, because that is the rule for shares[15] and the unit is deemed to be a share. This is the same as the private international law rule.

If the unit trust is governed by a UK proper law, a unit is probably UK situate under the UK law rule,[16] or under CGT situs rules for shares in UK incorporated companies.[17] However, a UK law unit trust will in practice

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14 A similar argument applies in relation to the situs of an equitable interest under a substantive trust.

15 See 71.6 (Registered securities: non-UK company).

16 See 71.13.2 (The UK law rule).

17 See 71.5 (Securities of UK incorporated company). This assumes that a unit trust with a UK proper law should be regarded for CGT as a company incorporated in the UK. That seems the better view, though the contrary is arguable.

have a register here, so the question of priority between the place-of-register rule and the UK law rule will not arise.

The situs of the underlying assets is not relevant. Section 99 clearly overrides s.60 TCGA. A unit is an asset for CGT purposes, rather than an interest in an asset, so that the co-ownership rule is not relevant.[18]

### 35.5.3 *Residence of trustees and situs*

The residence of the trustees is not relevant for situs, though non-resident trustees are required if it is desired that the units are not to be chargeable securities for SDRT purposes.[19]

## 35.6 Gain accruing on disposal of unit

An offshore unit trust will be an offshore fund. It may qualify as a reporting fund. If it does not, a gain accruing on a disposal of a unit will be an offshore income gain.[20]

## 35.7 Luxembourg Fonds Commun de Placement

Section 103A TCGA provides:

> (1) This Act applies in relation to a relevant offshore fund as if—
> (a) the fund were a company, and
> (b) the rights of the participants in the fund were shares in the company.
> (2) An offshore fund is a relevant offshore fund if—
> (a) it is not constituted by a company or by two or more persons carrying on a trade or business in partnership, and
> (b) it is not a unit trust scheme (see section 99).
> (3) In this section and section 103B "offshore fund" has the meaning given in section 355 of TIOPA 2010; "participant", in relation to a fund, have the meanings given in section 362(1) of that Act.

Offshore Funds Manual provides:

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18 See 71.3 (Co-ownership).
19 See s.99(5A) FA 1986.
20 See 31.1 (Offshore funds).

**OFM03550 Application of Taxation of Chargeable Gains Act (TCGA) 1992 to interests in arrangements that create rights in the nature of co-ownership – Section 103A TCGA 1992**

Certain contractual arrangements have historically been treated as transparent for both income and capital gains purposes (for example, Luxembourg Fonds Commun de placement ('FCPs')). But whilst such funds came within the previous definition of an offshore fund, the offshore funds regime for taxing offshore income gains was not applicable as investors were treated as holding, for capital gains purposes, interests in the underlying assets rather than in the fund itself. This led to considerable difficulties for investors when they disposed of their interests, or when new investors were admitted to the fund, as capital gains computations could become very complex. This is not the case for interests in offshore unit trusts which were and are subject to section 99 TCGA 1992, so that for the purposes of tax on chargeable gains a unit trust is treated as if the fund was a company, and the rights of the participants in the fund were shares in that company.

Section 103A TCGA 1992 was introduced by Part 2 of Schedule 22 Finance Act 2009 to align the treatment of interests in arrangements that create rights in the nature of co-ownership with that of interests in unit trusts. That is, those arrangements are treated as opaque for capital gains purposes from the operative date (see below), so that Section 103A shifts the taxation of gains arising to UK residents to the time when they dispose of their interest in a fund.

Section 103A does not change the tax treatment of such arrangements for income purposes – they remain fiscally transparent. Therefore, investors are entitled to income as it arises (from whatever source or country) and UK investors are taxable on such income as it arises, regardless of whether income is actually distributed. Income arising retains its character where arrangements are fiscally transparent, so for example if a fund receives income from property situated in the UK then UK investors would be chargeable to tax as if they had received that income directly. ...

CHAPTER THIRTY SIX

# PARTNERSHIPS

## 36.1 Partnerships - Introduction

A full discussion of partnership taxation would require a book to itself and in this chapter I focus on aspects relevant to the themes of this book.

I do not consider the position of corporate partners within the scope of corporation tax.

### 36.1.1 *Cross references*

This chapter considers aspects of partnerships which are more conveniently addressed in isolation. I have generally preferred to deal with partnership issues as they arise in the context of other topics.

For IHT, see 70.28 (Situs of partnership share). For POA issues see 66.22 (Partnerships). For categorisation, see 72.16 (Jersey general and limited partnerships) and 72.17 (Foreign limited liability partnership). For remittance issues, see 10.37 (Partnerships).

## 36.2 "Partnership" "person" "trade" and "firm"

### 36.2.1 *Partnership*

"Partnership" is not defined[1] in tax legislation so it has its general (partnership law) meaning.

### 36.2.2 *Is a partnership a "person"*?

The use of the word "person" requires some care when partnerships are

1 Except in relation to LLPs; see 36.7 (Limited liability partnership).

concerned.

A Scottish partnership is a legal person.

An English[2] partnership is not a legal person, that is, it is not a legal entity distinct from the partners and it is not a person in the ordinary sense of the word.

The rule that English partnerships are not legal persons could have been more or less undone by sch.1 Interpretation Act 1978 which provides that:

> "Person" includes a body of persons corporate or unincorporate.

A partnership is a "body of persons" in the ordinary sense of that phrase,[3] and is "unincorporate" and so an English partnership is a person in the Interpretation Act sense. Although the position strictly is that references to person in statutes prima facie include even an English partnership, the rule that English partnerships are not legal persons is very deeply ingrained and in practice only limited attention is given to the Interpretation Act definition; a judge may regard its application as more or less optional since it does not apply "where the context otherwise requires." I suspect that this definition is more important in the area of unincorporated associations than partnerships.

The difference between England and Scotland is not in practice as important as it might appear at first sight:

> In order that the Rule may be applicable there must first of all be "a person charged". The word "person" is in the singular but it includes the plural and also any body of persons corporate or unincorporate (Interpretation Act, 1889 [now Interpretation Act 1978]). In considering whether a partnership or a group of persons associated in partnership constitutes "a person charged" within the meaning of the Rule, I think it right to lay aside any preconceptions derived either from the law of England or from the law of Scotland as to the technical legal nature of a partnership. In Scotland a firm is "a legal person distinct from the partners of whom it is composed" (Partnership Act, 1890, Section 4 (2)),

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2 The same applies to a Northern Ireland partnership. For the purposes of this chapter, I use the expression "English partnership" to include a general partnership and a limited partnership, as no difference is to be drawn between them.

3 "A partnership is, as a matter of the ordinary use of English, plainly a body of persons"; *Padmore v IRC* 62 TC 352 at p.377. However it appears that a partnership is not a "body of persons" within the definition in s.989 ITA: see at p.377.

> but this is not so under English law. For the present purpose this distinction should, in my opinion, be disregarded. The Income Tax Acts are Imperial Statutes equally applicable on both sides of the border and the language which they employ ought to be construed so as to have, as far as possible, uniform effect in England and in Scotland alike.[4]

Fundamentally, the context governs the sense and may show that the word person is used in a way which does or does not include a partnership.

In practice the starting point for the tax status of partnerships is to be found in s.848 ITTOIA and s.59 TCGA from which the principle of transparency can be deduced.

A LLP is a legal person and a body corporate but for tax purposes that is subject to similar principles: see 36.7.3 (Income tax treatment of LLP).

As to whether a partnership is a person for the purposes of the OECD model treaty, see 5.13.1 (Is a partnership a "person" for treaty purposes?).

### 36.2.3 *"Trade"*

Before discussing "firm" we need to consider ITTOIA's idiosyncratic definitions of "trade". Section 847 ITTOIA provides:

> (2) The provisions of this Part which are expressed to apply to trades also apply, unless otherwise indicated (whether expressly or by implication)—
> (a) to professions, and
> (b) in the case of this section and sections 849, 850, 857 and 858 to businesses that are not trades or professions.
> (3) In those sections as applied by subsection (2)(b)—
> (a) references to a trade are references to a business, and
> (b) references to the profits of a trade are references to the income arising from a business.

Thus the word "trade" in part 9 ITTOIA always includes profession (it would be appropriate to simplify the law by abolishing all distinctions between professions and trades). The word "trade" sometimes includes "business". Since it is not convenient to use the same word in two different senses, when trade is used in the wider sense, I refer to it as

4 *R v General Commissioners of Income Tax for The City of London ex p. Gibbs* 24 TC 221 at p.247; the point is also made at p.244.

“**trade (including business)**”.

### 36.2.4 *“Firm”*

We can now turn to the definition of “firm”. Section 847(1) ITTOIA provides:

> In this Act persons carrying on a trade [including business] in partnership are referred to collectively as a “firm”.

This is the same as the definition of “firm” in the Partnership Act 1890.[5] In practice “partnership” and “firm” are used interchangeably.

## 36.3 Transparency of partnership for IT

After a (somewhat unnecessary) overview in accordance with the principles of Plain English Drafting,[6] s.848 ITTOIA provides:

> **848 Assessment of partnerships**
> Unless otherwise indicated (whether expressly or by implication), a firm is not to be regarded for income tax purposes as an entity separate and distinct from the partners.

ITTOIA EN provides:

> 1711. This section makes it clear that, for income tax purposes, a firm is not an entity distinct from the partners in the firm. It is based on section 111(1) of ICTA.
> 1712. In the case of firms established under English law this provision merely confirms their position under that law. But Scottish firms, for example, are legal entities. This provision ensures that all firms are treated in the same way.

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5 The Partnership Act 1890 provides:
“1(1) Partnership is the relation which subsists between persons carrying on a business in common with a view of profit. ...
4(1) Persons who have entered into partnership with one another are for the purposes of this Act called collectively a firm ...”

6 Section 846 ITTOIA provides: “This Part contains some special rules about partnerships.”

So partnerships are transparent for IT ie partnership income is regarded as income of the partners and not of the partnership as such.

IT transparency follows from basic principles, not from this statutory provision.[7] In England this is clearly the case. IT transparency is a necessary consequence of the partnership law rule that the partners are joint owners of the partnership assets, and that an English law partnership does not have legal personality, ie it is itself not a person. For unless partnership income accrued to the partners, it would not accrue to anyone, and the partnership income must accrue to some person or persons if it is to be taxed.

In Scotland too, IT transparency follows from basic principles and not from the statutory provision. The Law Commission Report on Partnership Law provides:[8]

> The Inland Revenue justify their approach to UK partnerships[9] by reference to the following three characteristics:
> (1) the partners carry on the business of the partnership with a view to profit;
> (2) every partner is liable jointly or jointly and severally with the other partners for all the debts and obligations of the partnership; and
> (3) the partners own the business, each having at least an indirect share in the net assets of the partnership.[10]

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7 This provision only dates from the FA 1995. Yet the IT transparency of partnerships has been settled tax law since early times: *Dreyfus v IRC* 14 TC 560 The predecessor provision, s.111 ICTA 1988, perhaps assumed but did not prescribe IT transparency. ("Where a trade or profession is carried on by two or more persons jointly, income tax in respect thereof shall be computed and stated jointly, and in one sum, and shall be separate and distinct from any other tax chargeable on those persons or any of them, and a joint assessment shall be made in the partnership name.")

8 Law Com 283 (2003) para 4.18.

9 [Footnote original] This covers both the English law partnership and the Scots law partnership notwithstanding that the former has no separate legal personality and the latter has separate legal personality.

10 [Footnote original] See *Memec plc v IRC* 71 TC 77 and in particular Peter Gibson LJ at pp. 111-113. Neither the separate personality of the Scottish partnership nor the absence of mutual agency in Scots law prevented the conclusion that in substance the position of the partners in a Scottish partnership in relation to the profits was the same as in an English partnership (p. 113B–C).

That is, the fact that a Scots partnership does have legal personality does not necessarily require the conclusion that income accrues to the partners and not to the partnership. Underlying this issue is some vagueness or ambiguity in what the concept of legal personality means or entails. Of course, the Courts' natural inclination to minimise taxation differences between English and Scots partnerships has been an influence in reaching this legal analysis.

The practical reader might ask impatiently whether it matters that IT transparency follows from basic nature of a partnership or from the statutory provision. It does not matter so far as the settled rule is that partnership income or gains accrue to the partners, but identifying the nature of a partnership is the first step when any questions arise relating to partnerships, so the question often does matter.[11]

## 36.4 Partnership income: remittance basis

Section 857 ITTOIA provides:

> (1) This section applies if—
> (a) a firm carries on a trade [including business] wholly or partly outside the UK,[12]
> (b) the control and management of the trade [including business] is outside the UK, and
> (c) section 809B, 809D or 809E of ITA 2007 (remittance basis) applies to a partner for a tax year.
> (2) The partner's share of the profits of the trade [including business] arising in the UK is determined in accordance with sections 849 to 856.
> (3) The partner's share of the profits of the trade [including business] arising outside the UK is treated as relevant foreign income.

The significance of s.857(3) – treating partnership income as RFI – is that the income can qualify for the remittance basis.

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11 See 10.37 (Partnerships).

12 Section 857(1)(a) appears to be otiose because if the condition in s.857(1)(b) is met the condition in s.857(1)(a) must be met. But it does not matter.

### 36.4.1 *Segregating partnership profits*

Suppose:

(1) profits of a partnership trade arise partly in and partly outside the UK; and

(2) a partner receives a share of those profits.

There is an apportionment to determine the profits arising in/outside the UK.[13] The profits that the partner receives constitute a mixed fund, partly RFI (mixed fund category (d)) and partly other income (mixed fund category (I)). A remittance from such a fund follows the mixed fund rule; later years before earlier, and RFI of a year before the other income of the year.

On the other hand, suppose:

(1) profits of a partnership trade arise partly in and partly outside the UK; and

(2) a partner receives a share of profits arising outside the UK only.

In that case all the income that the partner receives is RFI. If a partnership includes partners who are remittance basis taxpayers, it may therefore be important for a partnership, if it can, to segregate the two parts of its trade so it can identify which parts of its profits arise in and which parts arise outside the UK. The same point arises if a partnership includes non-resident partners.

### 36.4.2 *Control and management*

The test is control and management of the trade, not control and management of the partnership, but that will make not usually make any difference.

Normally a remittance basis taxpayer will want to argue that the trade 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: UK partners may argue for control in the UK, to obtain more generous loss relief.

The expression "control and management" is of course from the company residence test, and it is considered that it should be given the same meaning here. Thus the company residence case law gives

13 See 13.19 (Trade partly in UK: apportionment).

guidance.[14] The former ITH provided at para 1612:

> Generally speaking we follow the thinking on companies and look at the place of the highest level of management rather than day-to-day management. Outside textbooks follow the same line.
> In deciding the location of the control and management of a firm with both UK and overseas partners, we would usually regard as significant such factors as the comparative seniority of the partners in age and experience (a simple head count will not do of course), the extent of their interests in the firm, the source and control of the finance, the places of decision on policy and major transactions, the places and locations of partners' meetings and what was done at those meetings. The place of meetings incidentally is not a conclusive factor any more than it is – or ought to be – for companies. So the nature of the business done at the meeting is important. Is it really about control and management or just part of a facade to mislead us about the place of actual control and management?

The former ITH continued with another interesting point at para 1613:

> [Section 857 ITTOIA] refers simply to control and management being abroad and the view which we have, in general, adopted in determining whether the Section applies is that this means control etc must be wholly abroad. The strength of this view has never been tested in the Courts and the word 'wholly' does not appear in the Act. It is sometimes put to us that where control and management is partly abroad then [section 857] applies. On the other hand, we have argued that because the Section says 'is situated abroad' it means just that and if control is partly here then it is not abroad.

The Commissioners would normally adopt a broad approach, looking at the whole picture in order to identify one overall place of control where possible, and situations where control was located in the UK and abroad would be rare. If it did arise, the HMRC view seems sound.

In *Mark Higgins Rallying v HMRC* [2011] UJFTT 340 the First Tier Tribunal said:

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14 There was a discussion in the former ITH at para 1614 as to whether "control and management" are two distinct tests with distinct meanings, or a composite phrase. If my approach is right, the words are a single composite phrase.

51. We consider the appropriate test for the location of control and management of the business of a partnership is that adopted by the courts in relation to residence of companies. We note the same conclusion was reached by HMRC and stated in their Manual; also that it was the one argued for before us by the Partnership.

52. We have found helpful the summary put forward by the Special Commissioners in *Untelrab*[15] (at [74]):

"From these authorities we have identified the following principles: that the residence of a company is where the directors meet and transact their business and exercise the powers conferred upon them; that if the directors meet in two places then the company's residence is where its real business is carried on and the real business is carried on where the central management and control actually abides; that a determination as to whether a case falls within that rule is a pure question of fact to be determined by a scrutiny of the course of business and trading; that the actual place of management, and not the place where a company ought to be managed, fixes the place of residence of a company; … and that when deciding the issue of residence one should stand back from the detail and make up one's mind from the picture which the whole of the evidence presents."

53. Also, the views of the Tribunal in *Laerstate*[16] (at [27]-[29]):

"There is no assumption that [central control and management] must be found where the directors meet. It is entirely a question of fact where it is found. Where a company is managed by its directors in board meetings it will normally be where the board meetings are held. But if the management is carried out outside board meetings one needs to ask who was managing the company by making high level decisions and where, even where this is contrary to the company's constitution.

It is significant, we think, that Lord Loreburn (in *De Beers*[17]) referred to the test as being where central management and control 'abides'. This is a test that does not confine itself to a consideration of particular actions of the company, such as the signing of documents or the making of certain board resolutions outside the UK if, in a given case, a more general overview of the course of business and trading demonstrates that as a matter of fact central management and control abides in the UK. As Lord Loreburn said (at 212-213), the factual question must be considered 'upon a scrutiny of the course of business and trading'.

This is consistent with the analogy with individual residence which was

15 *Untelrab Ltd v McGregor* [1996] STC (SCD) 1.

16 *Laerstate BV v HMRC* [2009] SFTD 551.

17 *De Beers Consolidated Mines Ltd v Howe* 5 TC 198.

the basis on which Lord Loreburn propounded the central management and control test. Just as for an individual, for example, where a temporary departure from the UK would not of itself give rise to a change of residence, the residence of a company will not fluctuate merely by reason of individual acts of management and control taking place in different territories. The whole picture must be considered in each case."...

55. The position must be considered for each tax year under appeal but, as per *Laerstate,* the place of residence of the Partnership will not fluctuate from year to year merely by reason of individual acts of management and control taking place in different territories....

62. We find that the place where certain contracts – even important ones such as the manufacturers' works team agreements – were signed is not in itself a determining factor. It is evidence towards where decisions were being made but it is the location of the decision-making, rather than where the contracts were signed, which is important.

### 36.4.3 *HMRC practice*

The former ITH provided:

**1622. Normal professional partnership: foreign partnership treatment**
In the *Frost* case[18] we tried to argue before the Commissioners that control and management was not abroad. That is our approach to any case where partnerships appear to have been set up for the purpose of avoidance and Case V is of advantage, which, as ITH1630 indicates, it may yet be though to a much lesser extent than in earlier years.

**1623. Foreign partnership treatment: artificial arrangements**
But a common situation in professions such as engineers and accountants is one where there is a UK partnership and a separate partnership formed abroad with one or more non-UK resident partners in which some or all of the UK partnership partners are members. Generally speaking where the non-resident partners are professionally qualified and the overseas partnership takes on work which is reasonably local to the place where the partnership is based, it is possible to take a fairly relaxed view and accept a claim to Section [857] treatment. That was so even when Case V was on the remittance basis. If, however, the prima facie evidence against this view were very strong, we would look much more closely.

It seems obvious that in these cases there will be some control in the UK – although proving that that is so is a different matter – but usually the UK resident partners will make visits to the overseas office and there is a case for saying that

18 *Newstead v Frost* 53 TC 525.

the management of the partnership is abroad. (This harks back to the Solicitor's Opinion considered in ITH1614.) It may be that some of the overseas partnership work is done in the UK by the UK partnership but this normally happens – or is said to happen – through the UK partnership acting as subcontractor for the overseas partnership.

**1624. Foreign partnership treatment: income that of partnership?**

If, however, one reaches the position that the ultimate control is in the UK and the bulk of the work is actually done here – albeit under subcontract – then that would be a case for a possible challenge. Cases have been seen where the arrangements were plainly offensive and amounted to no more than attempts to park UK-earned profits in a Section [857] partnership with the admitted intention of avoiding UK tax.

We would certainly want to attack these devices and argue, for example, that the work done in the UK by partners who were also members of the overseas firm was done in their capacity as members of that overseas firm. We could then establish that the profits from those activities could be assessed under Case II. Our Solicitor, on particular cases, has not been discouraging about the chances that we may succeed and in the days of the remittance basis there was some success in settling cases on Case II lines rather than Case V. However, these cases turn crucially on questions of fact and degree and there is the usual difficulty of obtaining information.

**1625. Foreign partnership treatment: income that of partnership?**

Sometimes we have had to consider whether there is in fact an overseas partnership and/or whether amounts claimed to be receipts of an overseas partnership are in fact receipts of the UK partnership which is seeking to avoid tax. We have had some success with the latter line under circumstances which gave grounds for quiet satisfaction. A firm of UK solicitors which had profited from its fees for advice about the setting up of a well-known tax avoidance scheme, sought to avoid tax on those fees by arranging to park them in a Channel Islands finance and brokerage partnership to which Section [857] was said to apply. This was insult added to injury with vengeance.

Our Solicitor's advice was that we could not challenge the view that control and management was abroad. However, there was considerable artificiality in the arrangements which led ultimately to the fees landing in the accounts of the Jersey partnership. We argued that the amounts were in fact receipts of the UK solicitor's practice and we were aided in this by the fact that it was probably improper for a UK solicitor to enter into a partnership with a non-solicitor to do what they claimed to do in Jersey. This line was eventually conceded and we got tax on the Channel Island profits accruing to the UK partners.

## 36.5 Partnership with resident and non-resident partners

Section 849 ITTOIA provides:

(1) If—

(a) a firm carries on a trade, and

(b) any partner in the firm is chargeable to income tax,
the profits or losses of the trade are calculated on the basis set out in subsection (2) or (3), as the case may require.
(2) For any period of account in which the partner is a UK resident individual, the profits or losses of the trade are calculated as if the firm were a UK resident individual.
(3) For any period of account in which the partner is non-UK resident, the profits or losses of the trade are calculated as if the firm were a non-UK resident individual.
(4) In calculating under subsection (2) or (3) the profits of a trade for any period of account no account is taken of any losses for another period of account.

ITTOIA EN explains:

1714. If some of a firm's partners are resident in the UK and some are not, the profits of the firm's trade must be calculated on different bases. For the resident partners, the calculation includes profits arising outside the UK; for the non-resident partners, the calculation is restricted to profits arising in the UK.
1715. Section 111 of ICTA is not explicit that the profits may have to be calculated on more than one basis. This section brings together the rules for resident and non-resident partners. Subsection (1) introduces the idea that more than one calculation may be needed.
1716. The source legislation refers to the computation of the profits from the actual trade "for any period". Profits are calculated for a period of account. So subsections (2) and (3) make it clear that the section applies to a period of account. It is possible for a partner to be both resident (for one tax year) and non-resident (for another) within a single period of account. In such a case, the firm's profit has to be calculated twice to arrive at the partner's share of the profits.
1717. Subsection (2) sets out the normal basis for calculating the profits, for an individual resident in the UK. The profits are calculated as if the firm were an individual resident in the UK.
1718. Subsection (3) sets out an additional basis for calculating the profits. If the partner (who may be a non-resident company liable to income tax) is not resident in the UK the profits of the firm are calculated as if the firm were an individual not resident in the UK.

## 36.6 Transparency of partnership for CGT

Section 59(1) TCGA provides:

> Where 2 or more persons carry on a trade or business in partnership—
> (a) tax in respect of chargeable gains accruing to them on the disposal of any partnership assets shall, in Scotland as well as elsewhere in the UK, be assessed and charged on them separately, and
> (b) any partnership dealings shall be treated as dealings by the partners and not by the firm as such.

This is somewhat scanty foundation for the CGT treatment of partnerships.[19] It is expanded by SP D12:

> **Disposals of assets by a partnership**
> Where an asset is disposed of by a partnership to an outside party each of the partners will be treated as disposing of his fractional share of the asset.

So partnerships are transparent for CGT and gains on disposals of partnership assets accrue to the partners (not to the partnership). For reasons similar to those discussed above for IT,[20] it is considered that this result follows from first principles, and not from the statutory provision.

In determining whether gains are foreign chargeable gains (which may qualify for the remittance basis) one has regard to the situs of the partnership assets; the situs of the partnership share is irrelevant.

The question then is to identify the fractional share of each partner, and that is more tricky as partners do not always have easily identifiable fractional shares. SP D12 continues:

> In computing gains or losses the proceeds of disposal will be allocated between the partners in the ratio of their share in asset surpluses at the time of disposal. Where this is not specifically laid down the allocation will follow the actual destination of the surplus as shown in the partnership accounts; regard will of course have to be paid to any agreement outside the accounts. If the surplus is not allocated among the partners but, for example, put to a common reserve, regard will be had to the ordinary profit sharing ratio in the absence of a specified asset-

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19 The Law Commission put the point more tactfully: "The working out of this concept in practice has not been easy, and has had to be regulated by extra-statutory guidance;" Law Com 283, *Partnership Law* (2009) para 3.51.

20 See 36.3 (Transparency of partnership for IT).

surplus-sharing ratio. Expenditure on the acquisition of assets by a partnership will be allocated between the partners in the same way at the time of the acquisition. This allocation may require adjustment, however, if there is a subsequent change in the partnership sharing ratios (see para 4).

## 36.7 Limited liability partnership

### 36.7.1 *Definition of LLP*

Section 1 Limited Liability Partnerships Act provides the definition:

> (1) There shall be a new form of legal entity to be known as a limited liability partnership.
> (2) A limited liability partnership is a body corporate (with legal personality separate from that of its members) which is formed by being incorporated under this Act; and—
> (a) in the following provisions of this Act (except in the phrase "oversea limited liability partnership"), and
> (b) in any other enactment (except where provision is made to the contrary or the context otherwise requires),
> references to a limited liability partnership are to such a body corporate.

Thus LLP (in tax legislation in particular) in principle means a LLP incorporated under the LLPA 2000, and does not include a foreign LLP.[21]

### 36.7.2 *Nature of LLP*

A LLP is (as a matter of LLP law) a body corporate. A LLP (despite its name) is not a partnership in the strict sense of the word.[22] So a LLP is in principle classified as a company for tax purposes.[23] However this default position is subject to such wide exceptions that it hardly ever applies.

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21 See 72.17 (Foreign limited liability partnership).

22 The drafter assumed this in s.863(2) ITTOIA. This view is also supported by s.1(5) Limited Liability Partnerships Act 2000 ("Accordingly, except as far as otherwise provided by this Act or any other enactment, the law relating to partnerships does not apply to a limited liability partnership.")

23 See 72.3 (Meaning of "company").

### 36.7.3 *Income tax treatment of LLP*

Section 863 ITTOIA provides:

> (1) For income tax purposes, if a limited liability partnership carries on a trade, profession or business with a view to profit—
> (a) all the activities of the limited liability partnership are treated as carried on in partnership by its members (and not by the limited liability partnership as such),
> (b) anything done by, to or in relation to the limited liability partnership for the purposes of, or in connection with, any of its activities is treated as done by, to or in relation to the members as partners, and
> (c) the property of the limited liability partnership is treated as held by the members as partnership property.
> References in this subsection to the activities of the limited liability partnership are to anything that it does, whether or not in the course of carrying on a trade, profession or business with a view to profit.
> (2) For all purposes, except as otherwise provided, in the Income Tax Acts—
> (a) references to a firm or partnership include a limited liability partnership in relation to which subsection (1) applies,
> (b) references to members or partners of a firm or partnership include members of such a limited liability partnership,
> (c) references to a company do not include such a limited liability partnership, and
> (d) references to members of a company do not include members of such a limited liability partnership.

Thus a LLP is treated like a general partnership (provided it is carrying on a business with a view to profit). Section 863 then deals with the position where the LLP ceases to do that:

> (3) Subsection (1) continues to apply in relation to a limited liability partnership which no longer carries on any trade, profession or business with a view to profit—
> (a) if the cessation is only temporary, or
> (b) during a period of winding up following a permanent cessation, provided—
> (i) the winding up is not for reasons connected in whole or in part with the avoidance of tax, and
> (ii) the period of winding up is not unreasonably prolonged.

> This is subject to subsection (4).
> (4) Subsection (1) ceases to apply in relation to a limited liability partnership—
> (a) on the appointment of a liquidator or (if earlier) the making of a winding-up order by the court, or
> (b) on the occurrence of any event under the law of a territory outside the UK corresponding to an event specified in paragraph (a).

### 36.7.4 *CGT treatment of LLP*

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.[24]

This puts a LLP in the same position as a general partnership. Section 59A(3)–(5) deal with the position where a limited liability partnership ceases to carry on a business with a view to profit, or is wound up; they are equivalent to s.863(3)(4) ITTOIA.

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24 Section 59A(2) TCGA is the equivalent of s.863(2) ITTOIA:
"(2) For all purposes, except as otherwise provided, in the enactments relating to tax in respect of chargeable gains—
(a) references to a partnership include a limited liability partnership in relation to which subsection (1) above applies,
(b) references to members of a partnership include members of such a limited liability partnership,
(c) references to a company do not include such a limited liability partnership, and
(d) references to members of a company do not include members of such a limited liability partnership."

### 36.7.5 *HMRC practice*

SP D12 provides:

> The enactment of the Limited Liability Partnership Act 2000, has created, from April 2001, the concept of limited liability partnerships (as bodies corporate) in UK law. In conjunction with this, new capital gains tax provisions dealing with such partnerships have been introduced through s.59A TCGA. Section 59A(1) TCGA mirrors s.59 TCGA in treating any dealings in chargeable assets by a limited liability partnership as dealings by the individual members, as partners, for capital gains tax purposes. Each member of a limited liability partnership to which s 59A(1) applies has therefore to be regarded, like a partner in any other (non-corporate) partnership, as owning a fractional share of each of the partnership assets and not an interest in the partnership itself. This statement of practice has therefore been extended to limited liability partnerships which meet the requirements of s.59A(1) TCGA, such that capital gains of a partnership fall to charged on its members as partners. Accordingly, in the text of the statement of practice, all references to a "partnership" or "firm" include reference to limited liability partnerships to which s.59A(1) TCGA applies, and all references to "partner" include reference to a member of a limited liability partnership to which s.59A(1) TCGA applies.
>
> For the avoidance of doubt, this statement of practice does not apply to the members of a limited liability partnership which ceases to be "fiscally transparent" by reason of its not being, or its no longer being, within ss.59 and 59A(1) TCGA.

## 36.8 Residence of partnership

The residence of a partnership is not often important for tax, but it matters occasionally:

(1) The provision relating to the disallowance of partnership DTR refers to a firm which resides outside the UK.[25]

(2) In order to be a "foreign employer" (and so have chargeable overseas earnings) a partnership must be resident outside the UK and not resident in the UK.[26]

25 See 36.9 (DTA Relief for partnership).

26 See 12.12 (Foreign employer).

(3) One needs to identify domestic-law residence of a partnership in order to determine its treaty-residence.[27]

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 ...*

This was absent-mindedly repealed, and now there is no statutory definition, but it is considered that the test of partnership residence is still control and management. This is consistent with the general scheme of UK taxation of partnerships. ITTOIA EN agrees, in the passage set out above ("For UK tax purposes, if it is necessary to consider where a firm is resident, the question is likely to be decided by the place where the firm's business is controlled and managed. ...").[28] HMRC agree. The former ITH provided:

> **1609. Residence**
> In English law a partnership is not a person and it has long been assumed that it cannot in fact have a residence. Although Scottish partnerships are persons we have not made any distinction. ... But there has been some nibbling away of the principle that a partnership does not have a residence. The concept of residence and partnerships appears in other Sections of the Taxes Acts. For example in [the definition of chargeable overseas earnings] there is the concept of a partnership, 'resident outside and not resident in the UK'. The transfer pricing provisions ... apply to partnerships but their effect may depend on whether or not the buyer or seller is resident in the UK. It is probable that if residence of a partnership in these contexts ever had to be put to the test the criterion of control and management would be used.
> More important is the case of *Padmore v IRC* 62 TC 352. This concerned the effect of the Double Taxation Agreement with Jersey on the liability of UK resident partners of a partnership controlled and managed in Jersey. Jersey law has a provision very similar to Section 112. Both the High Court and the Court of Appeal considered that it must be deduced from the respective Sections that both Jersey and UK

27 See 5.13 (Treaty residence: Partnerships). This is no longer relevant for UK tax because of the treaty override, but may be relevant for foreign tax.

28 See 36.9 (DTA relief for partnership).

law attach tax consequences to the residence of partnerships and that residence is determined by control and management.

## 36.9 DTA relief for partnership

For the question whether a partnership can be a treaty-resident for DTA purposes, see 5.13 (Partnerships).

Section 858 ITTOIA disapplies DTA relief on partnership income of UK residents. Section 858(1) provides:

> This section applies if—
> (a) a UK resident ("the partner") is a member of a firm which—
> (i) resides outside the UK, or
> (ii) carries on a trade [including business] the control and management of which is outside the UK, and
> (b) by virtue of any arrangements having effect under section 2(1) of TIOPA 2010 ("the arrangements") any of the income of the firm is relieved from income tax in the UK.

ITTOIA EN explains the need for s.858(1)(a)(ii):

> 1777. For UK tax purposes, if it is necessary to consider where a firm is resident, the question is likely to be decided by the place where the firm's business is controlled and managed. But it is possible that, under foreign law, a firm may be considered to be resident elsewhere, for example, by reference to where the firm was established. So the section uses both the "control and management" test and the "resides" test.

Section 858(2) ITTOIA provides:

> The partner is liable to income tax on the partner's share of the income of the firm despite the arrangements.

This disapplies treaty relief. It survived an attack in *Padmore v IRC (No 2)* [2001] STC 280.

ITTOIA EN provides:

> 1774. This section ensures that a UK resident partner's share of the income of a foreign firm remains liable to UK tax even though the income of the firm as a whole is exempt from UK tax in accordance with a double taxation agreement. It is based on section 112(4) and (5)

> of ICTA.
> 1775. The business profits article of the UK/Jersey double taxation arrangement exempts the profits of a Jersey firm from UK tax. In the case of *Padmore v IRC* 62 TC 352, the Court of Appeal decided that the exemption extended to the share of the profits arising to a UK resident individual. The rules in section 112(4) and (5) of ICTA were enacted in 1987 to remove the exemption.
> 1776. Subsection (1) sets out the type of individual and firm with which the section is concerned. It goes on to identify the sort of exemption from tax that was considered in the Padmore case. ...
> 1778. Subsection (2) makes it clear that the section does no more than remove any exemption under a double taxation arrangement. It does not deny other reliefs, such as tax credit relief. See Change 145 in Annex 1.[29]

This provision dates back to 1987. Interestingly, in those days retrospective legislation and breach of treaty obligations were thought to require special justification.[30]

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29 Change 145 is as follows:
"This change enacts the Inland Revenue practice of giving a narrow interpretation to the word 'affect' in section 112(4) of ICTA.
The business profits article of the UK/Jersey double taxation agreement exempts the profits of a Jersey firm from UK tax. In the case of *Padmore v IRC* 62 TC 352 the Court of Appeal decided that the exemption covered the share of the profits arising to a UK resident partner. The rules in section 112(4) and (5) of ICTA were enacted in 1987 to remove the exemption.
It was intended, in the case of income tax, that the 1987 legislation should do no more than remove the exemption claimed in the *Padmore* case. The words used in section 112(4) of ICTA are 'shall not affect any liability to tax'. On the face of it, these words could deny the partner any relief, including tax credit relief, under a double taxation treaty. Section 858(2) of this Act makes it clear that it is only the partner's chargeability to tax that is preserved, overriding any provision to the contrary in a double taxation treaty. No other effect of the treaty is overridden.
This change is in principle in taxpayers' favour but is expected to have no practical effect as it is in line with current practice."

30 The former ITH para 1660 provided:
"The retrospective nature of the legislation [in 1987] provoked comment in the professional press and in Parliament. The Government, and later the House, were persuaded as to the propriety of this action because the Section does no more than restore the general understanding of the law and retrospection prevents third parties suddenly deriving a substantial windfall benefit for six years. Although the Section protects from retrospection only those taxpayers who gained a Commissioners' or

Section 858(3) ITTOIA provides:

> If the partner's share of the income of the firm consists of or includes a share in a qualifying distribution—
> (a) made by a UK resident company, and
> (b) chargeable to tax under Chapter 3 of Part 4,
> the partner (and not the firm) is, despite the arrangements, entitled to the share of the tax credit which corresponds to the partner's share of the distribution.

ITTOIA EN provides:

> 1779. Subsection (3) deals with UK tax credits. A double taxation arrangement may give a non-resident person an entitlement to payment of a tax credit on a distribution by a UK company. The entitlement is restricted to the share of the distribution that arises to a UK resident partner.

### 36.9.1 *"Members of a firm"*

Section 858(4) defines "members of a firm":

> For the purposes of this section, the members of a firm include any person entitled to a share of income of the firm.

Section 58(4) FA 2008 provides:

> The amendments made by subsections (1) to (3) are treated as always having had effect.

Retrospective legislation without limit of time! This is aimed at a tax avoidance scheme which involved trustees of 2 IP trusts trading in

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Court decision before 17 March 1987, similar treatment was allowed to a small number of other taxpayers who were told by the Revenue that their cases would follow the Padmore decision. Criticism was also made because the legislation is intended to override the effect of the Jersey Arrangement and any other treaty which the Courts might have found to have similar effect. This 'treaty override' was defended on similar grounds – that it merely puts into effect what was generally understood to be the position. It has not met with any objection from treaty partners."

partnership.[31] The EN to the draft clause provided:

> 11. The users of the scheme claim that, under the terms of the relevant Double Taxation Treaty, the UK is not entitled to tax the partnership income of the foreign trustees. As that income is precisely the same income as that received by the UK individuals as beneficiaries of the trust, they argue that the UK is not entitled to tax the UK individuals on it.
> 12. Legislation was introduced in Finance (No 2) Act 1987, which provided that (as had almost universally been assumed to be the case until a High Court decision to the contrary,) a Double Taxation Treaty did not affect UK residents' liability to UK tax on their share of income or gains from a foreign partnership.
> This new avoidance scheme purports to get round that legislation by claiming that the foreign trustees are the partners rather than the UK individuals.
> 13. The Government believes that a partner for the purposes of that legislation has always included all those persons entitled to a share of income or capital gains of the partnership. As such, the UK individuals remain liable to UK tax despite the elaborate, artificial structure designed to exempt them. This clause will put it beyond doubt that the legislation has always had that effect.

This justification of the retrospective nature of the 2008 amendment raises questions of law, fact, policy, practice and human rights.

As a matter of law, was it the case (before the retrospective legislation) that "member of a firm" for the purposes of that legislation has always included all those persons entitled to a share of income or capital gains of

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31 The EN to the draft clause published 12 March 2008 provides a somewhat untechnical explanation:

"8. An avoidance scheme purports to exempt from UK tax income received by UK resident individuals by using certain provisions in the UK's bilateral Double Taxation Treaties.

9.This scheme involves the establishment of offshore trusts, (of which the UK individuals are both settlors and beneficiaries) and partnerships (of which the foreign trustees of those trusts are partners).

10. The partnerships acquire the rights to receive the UK individuals' income but the terms of the trusts are such that, as beneficiaries of the trust, the UK individuals retain beneficial entitlement to the income – with the trustees obliged to remit the income to the UK individuals as it arises."

the partnership? The answer is, no.[32]

As a matter of fact, did the Government believe that to be the case? I think it is a safe bet that if HMRC received expert and impartial advice on the point, it would have been hedged with caveats such that the terms of EN para 13 would not represent a fair and accurate summary of the position.[33]

The question of policy is whether the reasons given justify retrospective legislation.[34] One might discern two reasons from the EN. The first is that the scheme will fail (or so the Government believe). If that is true, the 2008 change is unnecessary; if false (and it is certainly debatable) it is not a good reason. The only reason worth considering is that the scheme is "elaborate and artificial", or, HMRC might fairly have said, abusive (however that flexible term may be defined). Whether that justifies retrospective legislation is ultimately a political question on which views differ depending on how one values the rule of law. It is arbitrary and unfair in that this scheme was retrospectively stopped and others – no less elaborate, artificial and abusive – were not. Pragmatists (to whom constitutional proprieties such as the rule of law are of little interest) should bear in mind that retrospective legislation increases the "legal risk", a measure under which the UK falls low on international surveys, and the lowering of the UK's reputation in that regard has a significant albeit intangible cost. I suspect a major factor in picking on this arrangement, not mentioned in the EN, was the amount of money involved.

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32 Partner is a term of partnership law, and in the partnership law sense a person who is entitled to income or gains of a partnership is not as such a partner. HMRC would have to argue that "partner" in s.858 was not used in its partnership law sense, which is a difficult line to take even in these times of purposive interpretation, though in a tax avoidance case nothing is impossible. This is confirmed in *R on the application of Huitson v HMRC* [2010] EWHC 97 (Admin) at [71]; the point will need review when the case is final.

33 In Parliament the statement was described as "disingenuous": Public Bill Cttee debate on Finance Bill, 22 May 2008 Hansard col 371. In *R on the application of Huitson v HMRC* [2010] EWHC 97 (Admin) HMRC wisely claimed legal professional privilege: at [71].

34 For an illuminating discussion of the policy issues in a US context, see Daniel Shaviro, *When Rules Change*, University of Chicago Press (2000). Taxpayers may on this point look with envy to the USA, where a norm opposing retrospective legislation is "strongly rooted in popular sentiment, legislative practice, and perhaps even the Constitution as the Courts are likely to interpret it" (p.104).

The question of practice is how often retrospective legislation will be used in the future. What advice can anyone give to clients seeking to know their position? The answer of course is that one cannot give a clear answer. Much depends on the politics of the day, but I guess that retrospective legislation will continue to be a rare response; a popular scheme carried out by many taxpayers and involving larger sums is certainly more at risk than others.

Lastly, does the retrospective legislation breach the Human Rights Act and (regardless of retrospectivity) is it EU law compliant? It will take years before a final decision is reached on these points. HMRC have won the first round, though in a case in which tax counsel was not instructed.[35]

### 36.9.2 *DT relief for partnership gains*

Section 59 TCGA sets out the same rules for CGT:

> (2) Subsection (3) applies if—
> (a) a person resident in the UK ("the resident partner") is a member of a partnership which resides outside the UK or which carries on any trade, profession or business the control and management of which is situated outside the UK, and
> (b) by virtue of any arrangements that have effect under section 2(1) of TIOPA 2010 ("the arrangements") any of the capital gains of the partnership are relieved from capital gains tax or corporation tax in the UK.
> (3) The arrangements (so far as providing for that relief) do not affect any liability to capital gains tax or corporation tax in respect of the resident partner's share of any capital gains of the partnership.
> (4) For the purposes of subsections (2) and (3) the members of a partnership include any person entitled to a share of capital gains of the partnership.

## 36.10 SD and SDLT position of partnerships

SD and SDLT are outside the scope of this book, but the HMRC statement

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35 *R on the application of Huitson v HMRC* [2010] EWHC 97 (Admin) raises the HR point and *R on the application of Shiner v HMRC* [2010] EWCA Civ 558 will raise the EU law point which is based on free movement of capital.

published 11 October 2010 is of wider importance as it discusses the nature of partnerships which is relevant for many tax purposes.

### 36.10.1 *LLPs*

**Group relief for SDLT and Stamp Duty: partnerships**
**Stamp Duty Land Tax - a change in HMRC's view of the law**
Where land transactions take place between members of a group, relief for Stamp Duty Land Tax (SDLT) is available (Part 1 Schedule 7 Finance Act 2003). Companies are members of the same group for the purposes of the relief if one body corporate is a 75% subsidiary of another or if both are 75% subsidiaries of a third body corporate. Broadly, the 75% relationship refers to the beneficial ownership of the subsidiary company's issued ordinary share capital.
A 'company' for group relief purposes is defined in Schedule 7 FA 2003 as a 'body corporate'. HMRC did not consider that a 'body corporate' for the purposes of Part 1 Schedule 7 FA 2003 included a Limited Liability Partnership incorporated under the Limited Liability Partnership Act 2000 (LLP), so that LLPs were disregarded ('looked through') when considering whether a group relationship existed, the members of the LLP being treated as the beneficial owners of the LLP assets.
This view has recently been challenged. Following legal advice, HMRC now accepts that, for the purposes of SDLT group relief, a 'body corporate' does include an LLP. An LLP can therefore be the parent in a group structure. However, as an LLP does not itself have issued ordinary share capital it cannot be the subsidiary of other companies. This also means that any subsidiaries of the LLP cannot be grouped with the companies that are the corporate members of the LLP.
This revised view does not affect which party can claim group relief, but does affect which entities are regarded as forming part of a group. An LLP cannot claim group relief itself because its chargeable interests in land are treated as held by or on behalf of the individual members (Paragraph 2 Schedule 15 FA 2003), and this position is unchanged. As such, in broad terms, an LLP continues to be disregarded if it is the vendor or purchaser in a transaction. In such a transaction group relief may be, in part at least, available if some or all of its members (which are incorporated companies) are themselves grouped. It also follows that if an LLP transfers land to a company that it owns, and that is within the LLP headed group, no group relief will be available as the land is deemed to be owned by the members of the LLP, and those members are not within the same group as the company owned by the LLP.

If SDLT group relief has been incorrectly claimed solely as a result of an LLP in the group structure being disregarded or looked through for the purposes of establishing group relationships then HMRC will not seek to revisit the claim.

**Stamp Duty**
Group relief for Stamp Duty is available to bodies corporate that are associated (Section 42 FA 1930). Bodies corporate are associated if one is a 75% subsidiary of another or if both are 75% subsidiaries of a third body corporate. Broadly, the 75% relationship refers to the beneficial ownership of the subsidiary company's issued ordinary share capital. In general, HMRC has taken the view that an LLP, as a body corporate, can be the ultimate parent of a group for the purposes of Section 42 FA 1930. Furthermore, as an LLP does not itself have issued ordinary share capital it cannot be the subsidiary of another company.
Transfers of stock and marketable securities may be made to the parent LLP from a subsidiary body corporate in the same group and qualify for group relief and vice versa. Group relief cannot be claimed on the transfer of stock and marketable securities from a body corporate parent of an LLP to the LLP or to a body corporate subsidiary of the LLP.

### 36.10.2 *English partnerships*

**English partnerships**
As English limited and general partnerships do not have legal personalities separate from the persons who are the partners they must be 'looked through' when establishing bodies corporate that form a group for Stamp Duty Land Tax and Stamp Duty purposes. As such the companies that are the partners of an English general or limited partnership can, depending upon the facts, be grouped with those companies that are below the partnership in the group structure.

### 36.10.3 *Scottish partnerships*

**Scottish partnerships**
Both Scottish limited and general partnerships have legal personalities separate from the persons who are the partners. They cannot therefore be 'looked through' when establishing bodies corporate that form a group. But they are not bodies corporate and so cannot be the parent of a group of companies.

## 36.10.4 *Foreign partnerships*

**Non-UK partnerships**

The principles set out in the earlier section on UK partnerships will be applied case by case to non-UK partnerships.

CHAPTER THIRTY SEVEN

# NON-RESIDENTS INCOME TAX RELIEF

## 37.1 Non-residents IT relief – Introduction

This chapter considers the IT relief for UK source income of non-residents. The legislation is twice as long as it needs to be as it distinguishes unnecessarily between:
(1) non-resident individuals and trustees
(2) non-resident companies.

The two reliefs operate in more or less the same way. I refer to them together as "**non-residents IT relief**".

In short, the relief is that UK source interest, dividend and pension income of non-residents is not subject to UK tax beyond withholding tax (where applicable).

## 37.2 Relief for non-resident individuals and trustees

In the absence of relief, non-resident individuals and trustees are subject to tax on UK source income at the same rates as UK residents. Thus non-resident individuals are subject to income tax at the higher rate, and non-resident trustees are subject to tax at the trust rate. Section 811 ITA provides relief.

Section 811(1) ITA provides:

> This section applies to income tax to which—
> (a) a non-UK resident, other than a company, is liable, or
> (b) a non-UK resident company is liable as a trustee.[1]

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1 Section 811(1)(b) is otiose since a trustee is a separate person for tax.

Section 811(3) ITA sets out the relief:

> The non-UK resident's liability to income tax for a tax year is limited to the sum of amounts A and B.

An individual must be non-resident throughout the year: the split year concession does not apply.[2]

There is no equivalent CGT relief but that is not needed as a non-resident is not usually subject to CGT. It is not difficult to envisage a case where a non-resident would be subject to CGT on gains made through an investment manager, though it is not common, in practice no-one would expect compliance, and HMRC would probably turn a blind eye. The former ITH stated at para 970:

> it would be very rare to find a situation where a non-resident would be liable on capital gains made through an investment manager.

## 37.3 Amount A (tax deducted at source)

Section 811(4) ITA defines amount A:

> Amount A is the sum of—
> (a) any sums representing income tax deducted from the non-UK resident's disregarded income for the tax year (see section 813),
> (b) any sums representing income tax that are treated as deducted from or paid in respect of that income, and
> (c) any tax credits in respect of that income.

In short, amount A is tax deducted at source or its equivalent.

## 37.4 Amount B (disregarded income and reliefs)

Section 811(5) ITA defines amount B:

> Amount B is the amount that, apart from this section, would be the non-UK resident's liability to income tax for the tax year, if the following were left out of account—
> (a) the non-UK resident's disregarded income for the tax year, and

2 See 6.10 (UK source investment income).

(b) any relief mentioned in subsection (6) to which the non-UK resident is entitled for the tax year as a result of—
   (i) section 56(3) or 460(3) of this Act (residence etc of claimants), or
   (ii) double taxation arrangements.

I refer to the reliefs within (b) as "**disregarded reliefs**". These reliefs are not disapplied. The individual can in theory claim them. But that increases amount B, so reduces the benefit of s.811 relief. A higher rate taxpayer will often be no better off, particularly after taking professional costs into account.

Section 811(6) ITA sets out the full list of disregarded reliefs:

> The reliefs referred to in subsection (5) are—
> (a) an allowance under Chapter 2 of Part 3 of this Act (personal allowance and blind person's allowance),
> (b) a tax reduction under Chapter 3 of Part 3 of this Act (tax reductions for married couples and civil partners),
> (c) relief under section 457 or 458 of this Act (payments to trade unions and police organisations),
> (d) a tax reduction under section 459 of this Act (payments for benefit of family members), and
> (e) relief under section 266 of ICTA (life assurance premiums).

The effect of "amount B" is that the UK retains tax on (1) non-disregarded income (eg UK property income) and (2) disallows disregarded reliefs.

## 37.5 Trusts: UK beneficiary rule

Section 812(1) ITA provides:

> Section 811 does not apply to income tax to which non-UK resident trustees are liable for a tax year, if there is a beneficiary of the trust who is—
> (a) an individual who is ordinarily UK resident, or
> (b) a UK resident company.

One UK beneficiary may disqualify the entire trust from the relief.

Section 624 saves the relief if the trust is settlor-interested and the settlor is non-UK resident.[3]

### 37.5.1 "*Beneficiary*"

Section 812 ITA defines "beneficiary":

> (2) For the purposes of subsection (1) a person is a beneficiary of the trust if—
> (a) the person is an actual or potential beneficiary of the trust, and
> (b) condition A or B is met in relation to the person.
> (3) Condition A is that the person is, or will or may become, entitled under the trust to receive some or all of any income[4] under the trust.
> (4) Condition B is that some or all of any income under the trust may be paid to or used for the benefit of the person in the exercise of a discretion conferred by the trust.

The definition is the same as 17.13.3 (Non-resident discretionary trust).
At first sight it appears that a trust with power to add beneficiaries would not qualify for relief, since residents of the UK are potential beneficiaries. But such powers are standard form in offshore trusts, so if that were right, offshore trusts would not normally qualify. In practice I understand that HMRC do not take that point.

## 37.6 Disregarded income

The definition of "disregarded income" is crucial. In practice, the most important categories are dividends and interest.
The full definition is complex. There are six categories of disregarded income. Section 813(1) ITA provides:

> For the purposes of this Chapter income arising to a non-UK resident is "disregarded income" if it is—
> (a) disregarded savings and investment income (see section 825),
> (b) disregarded annual payments (see section 826),

3 See 24.7.2 (Non-resident trust, non-resident settlor).

4 Income is in turn defined in s. 812(5) ITA:
"The references in subsections (3) and (4) to any income under the trust include a reference to any capital under the trust so far as it represents amounts originally received by the trustees as income."

> (c) disregarded pension income,
> (d) disregarded social security income,
> (e) disregarded transaction income (see section 814), or
> (f) income of such other description as the Treasury may by regulations designate for the purposes of this section.

Thus we have to turn to another five definitions. But first, s.813(2) ITA brings in an important exception:

> But income in relation to which the non-UK resident has a UK representative for the purposes of Chapter 2B is not disregarded income.

See 38.3 (UK representative).

## 37.7 Disregarded savings and investment income

Section 825 ITA provides the definition:

> (1) For the purposes of this Chapter income is "disregarded savings and investment income" if—
> (a) it is chargeable under Chapter 3 or 5 of Part 4 of ITTOIA 2005 (dividends etc from UK resident companies and stock dividends from UK resident companies), or
> (b) it is within subsection (2) and is not relevant foreign income.
> (2) Income is within this subsection if it is chargeable under—
> (a) Chapter 2 of Part 4 of ITTOIA 2005 (interest),
> (b) Chapter 7 of that Part (purchased life annuity payments),
> (c) Chapter 8 of that Part (profits from deeply discounted securities),
> (d) Chapter 10 of that Part (distributions from unauthorised unit trusts), or
> (e) Chapter 11 of that Part (transactions in deposits).

## 37.8 Disregarded annual payments

Section 826 ITA provides the definition:

> For the purposes of this Chapter income is "disregarded annual payments" if it is not relevant foreign income and is chargeable under—
> (a) section 579 of ITTOIA 2005, so far as it relates to annual payments (royalties etc from intellectual property),
> (b) Chapter 4 of Part 5 of that Act, so far as it relates to annual

payments (certain telecommunication rights: non-trading income), or

(c) Chapter 7 of Part 5 of that Act (annual payments not otherwise charged).

There are two types of royalty income:
(1) royalties which are annual payments ("AP royalties");
(2) royalties which are not annual payments ("non-AP royalties").
AP royalties are disregarded income (but they do not qualify for deductible expenses). Non-AP royalties are not disregarded income, but they do qualify for deduction for allowable expenses: s.582 ITTOIA. In practice DTA relief will often apply in which case the distinction will not matter.

## 37.9 Disregarded pension/social security income

Section 813 ITA provides:

> (3) Income is "disregarded pension income" if it is chargeable under Part 9 of ITEPA 2003 (pension income) because any of the following provisions of that Act applies to it—
> section 577 (UK social security pensions),
> section 579A (pensions under registered pension schemes) (but see subsection (4) below),
> section 609 (annuities for the benefit of dependants),
> section 610 (annuities under non-registered occupational pension schemes), or
> section 611 (annuities in recognition of another's services).[5]
>
> (5) Income is "disregarded social security income" if—
> (a) it is a taxable benefit listed in Table A in section 660 of ITEPA 2003, other than income support or jobseeker's allowance, and
> (b) it is chargeable under Part 10 of that Act (social security income).

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5 Section 813(4) ITA provides:
"Income chargeable under Part 9 of ITEPA 2003 because section 579A of that Act applies to it is disregarded pension income only if the registered pension scheme in question—
(a) falls within para 1(1)(f) of Schedule 36 to FA 2004, and
(b) was, immediately before 6 April 2006, a retirement annuity contract to which section 605 of ITEPA 2003 applied."

## 37.10 Limit on liability: companies

### 37.10.1 *Income tax limit*

Non-resident companies are in principle subject to income tax on UK source income at the basic rate. Section 815 ITA provides relief:

> (1) This section applies to income tax to which a non-UK resident company is liable, otherwise than as a trustee.
> (2) The non-UK resident company's liability to income tax for a tax year is limited to the sum of amounts A and B.
> (3) Amount A is the sum of—
> (a) any amounts representing income tax deducted from the non-UK resident company's disregarded company income for the tax year,
> (b) any amounts representing income tax that are treated as deducted from or paid in respect of that income, and
> (c) any tax credits in respect of that income.
> (4) Amount B is the amount that, apart from this section, would be the non-UK resident company's liability to income tax for the tax year if the non-UK resident company's disregarded company income for the tax year were left out of account.

### 37.10.2 *Disregarded company income*

There are five categories of disregarded company income. Section 816 ITA provides:

> (1) For the purposes of this Chapter income arising to a non-UK resident company is "disregarded company income" if it is—
> (a) disregarded savings and investment income (see section 825),
> (b) disregarded annual payments (see section 826),
> [(c) and (d) relate to the IME, see 39.1 (Investment manager exemptions - Introduction).]
> (e) income of such other description as the Treasury may by regulations designate for the purposes of this section.

This is effectively the same as the definition of "disregarded income" which applies for s.811 relief (individuals and trusts). There are two apparent differences:
(1) It omits references to pension or social security income (which do not

apply to companies).

(2) There are differences in the wording of s.816(1)(c)(d) which are the equivalent of the individual's exemption for "transaction income" but I cannot see they are of any significance.

## 37.11 Commentary

Non-residents income tax relief originated in a long standing concession, put on a statutory basis in 1995. As far as I know, no thorough consideration of the reasons for non-residents IT relief has ever been published. However several reasons can be identified.

First of all is the practical difficulty in seeking to collect tax in excess of tax deducted at source (**"progressive rate tax"**). The rule that the person claiming the relief effectively loses the benefit of DTA relief, personal allowances and other minor reliefs ensures that the full amount deducted at source is retained, and simplifies administration for HMRC and for taxpayers. Nowadays the existence of tax collection treaties would make tax collection practical in most jurisdictions, so some other justification for the relief is needed.

Secondly there is the tax competition consideration that non-resident investors would not invest in UK securities if they had to pay progressive IT rates.

Thirdly, some policy considerations tend to suggest that progressive rates of UK tax are not appropriate for non-resident individuals:

(1) Progressive rates of UK tax would not be applied to all non-residents income (most of their income may be foreign source income and not subject to UK tax).
(2) Non-residents are likely to be taxed in their country of residence, with credit for UK tax.
(3) If every country applied its own progressive rates, wealthy taxpayers would have to fill in tax returns in as many countries as they held investments, which would be an enormously difficult exercise for a worldwide portfolio.

These considerations form the basis for a general international acceptance that progressive rates are mainly a matter for the country of residence.[6]

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6 This view is expressed in "A Platform for Consultation" (Australia) para 30.61 December 2010 accessible *www.rbt.treasury.gov.au/publications/paper3/index.htm*.

The exclusion of UK employment income from the relief is understandable since PAYE makes collection of tax a practicality; also disparity compared to other employees might be regarded as unacceptable.

The exclusion of UK property income from the relief is strange. Deduction at source on rent is limited to the basic rate, though enforcement of progressive rates would normally be possible because of the situation of assets in the UK (not to mention international tax collection treaties). In the past, the Inland Revenue did not attempt to collect progressive rates on UK property income of non-residents.[7] This is not the current practice, at least officially. However one wonders how much tax notionally due is actually collected. Of course well advised non-residents will normally invest via non-resident companies so there may not often be much progressive rate tax even notionally due.

Logically:

(1) the collection of tax at source rules ought to extend to progressive rates, where land is vested in an individual or a trust; (though this may be difficult for agents) or

(2) non-residents income tax relief should be extended to property income.

On this point non-residents income tax relief reflects a lack of consistent thinking or a somewhat unhappy compromise between different policy considerations.

7 The point arose in *Burns v HMRC* [2009] STC (SCD) 165 where HMRC argued that transfers of land from (supposedly) non-resident individuals to non-resident companies in 1980 and 1982 were made to avoid higher rate income tax on UK property income. The taxpayers responded that that could not be correct since the Inland Revenue did not collect that tax. The Special Commissioner did not have to decide the issue but did accept that in the 1980's there was "a certain level of expectation" that HMRC did not seek to collect higher rate tax on UK source rental income of non-residents. The practice was perhaps one of HMRC routinely turning a blind eye, rather than anything more formal or express; though a thorough review of old Inland Revenue files would be needed to know the answer.

CHAPTER THIRTY EIGHT

# COLLECTION OF TAX FROM UK REPRESENTATIVES

## 38.1 Collection of tax directly from non-residents

The former ITH provided:

**903. Machinery of assessment: direct charge on non-residents**
It always was and still is possible to assess a non-resident directly if, in the words of the Courts, he can be reached. A simple example of such a situation arose in the case of *Tischler v Apthorpe* [2 TC 89]. Mr Tischler was not resident. He was a partner in a French wine firm who spent four months or so a year in England. He lived then in a London hotel and sold wine to English customers. His firm also employed London agents and the question was whether the English profits could be assessed directly on Mr Tischler or whether such assessments should, Mr Tischler being non-resident, be made only on the English agents. The High Court held that an assessment made directly on the firm was good and that Mr Tischler was obliged to make a return served on him. In the words of Mathew J 'If the principal can be got at there is no need to have recourse to Section 41 (of the 1842 Act which was consolidated in Section 78 TMA 1970).
An individual, clearly, can be physically present in this country without being resident here and we used to have to rely on the principle established by the Tischler case in reaching the profits made by overseas sportsmen and women and artistes who come to this country for quite brief engagements. The modern view certainly, is that a non-resident company which trades here equally is here and that it may similarly be reached. If the company has a branch presence here with all the physical trappings of its trade it is visibly here and will have a registered place of business, an address at which it may be found and at which legal notices may be served.
The principle of direct assessment is not confined to non-residents who actually come here. There is no bar on direct assessment of non-residents who are not here whether or not they have agents in the UK. This was made clear in the case of *Werle v Colquhoun* [2 TC 412]. The difficulty with direct assessment on a person who is not here lies in recovering the tax, although now that the Supreme Court rules allow service of writs abroad this may be a little easier provided there are assets in the UK. But it is still true to say that if a non-resident company

> acting through an agent has no such physical presence here and has nothing here the Revenue cannot, in practice, impose its charge effectively without more adequate machinery including that for the service of notices and returns as well as for the actual gathering of the tax. It was in such situations – where the non-resident had only an agent here – that the original form of Part VIII was intended to come to the Revenue's aid. In practice Part VIII is normally used today even in those cases where the taxpayer can be reached directly ...

This was written before the 1995 changes and before the mutual collection of tax agreements but the point is still valid.

## 38.2 Collection of tax from UK representative

The rules are set out three times:
(1) For IT the rules are in chapters 2B and 2C part 14 ITA. This does not apply to companies,[1] so effectively this applies to non-resident individuals and trusts.
(2) For CGT the rules are in part 7A TCGA.
(3) For CT the rules are in chapter 6 part 22 CTA 2010.
This does make a coherent discussion somewhat harder. In this chapter I set out the IT rules in full, and (in the absence of material differences) give the CGT and CT references in a footnote only.

Section 835U(1) ITA provides the basic rule:

> The obligations and liabilities of a non-UK resident are to be treated, for the purposes of the enactments to which this Chapter applies,[2] as if they were also the obligations and liabilities of the UK representative of the non-UK resident.

This is a collection provision (the metaphor often used is "machinery

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1 Section 835D ITA provides:
"This Chapter does not apply in relation to income tax chargeable on income of a company otherwise than as a trustee."

2 This relates back to s.835T ITA which provides:
(1) This Chapter applies to the enactments relating to income tax so far as they make provision for or in connection with the assessment, collection and recovery of tax, or of interest on tax.
(2) Those enactments have effect in accordance with section 835U in relation to amounts in respect of which a branch or agency is to be treated as the UK representative of a non-UK resident under Chapter 2B.

provision") and not a charging provision: the UK representative is only subject to tax if there is a charge to tax on usual principles on the non-resident principal. The INT Manual provides:

> **268010 Introduction - What are the machinery provisions for assessment and collection?** [April 2010]
> The machinery provisions alone cannot create or extend a tax liability on the non-resident. There has to be a charge to tax in respect of the non-resident under the domestic provisions in the first place. The provisions work by treating the tax obligations and liabilities of the non-resident as though they were additionally the obligations and liabilities of the UK representative. This provides a practical assessment and collection mechanism for non-residents. Once either the non-resident or the UK representative has paid the liabilities both parties are treated as having met their liabilities.

Section 835U goes on to deal with the discharge of obligations:

> (2) Subsection (3) applies if—
> (a) the UK representative of a non-UK resident discharges an obligation or liability imposed by this section that corresponds to one to which the non-UK resident is subject, or
> (b) a non-UK resident discharges an obligation or liability that corresponds to one to which the non-UK resident's UK representative is subject by virtue of this section.
> (3) The corresponding obligation or liability—
> (a) of the non-UK resident (in a case within subsection (2)(a)), or
> (b) of the UK representative (in a case within subsection (2)(b)),
> is discharged.
> (4) A non-UK resident is bound, as if they were the non-UK resident's own, by acts or omissions of the non-UK resident's UK representative in the discharge of the obligations and liabilities imposed on the representative by this section. ...

## 38.3 UK representative

### 38.3.1 *Why does it matter who is a UK representative?*

A UK representative is important for the two reasons:

(1) A UK representative is liable for tax due from the non-resident principal, the topic of this chapter.

(2) Income in relation to which a non-UK resident has a UK representative falls outside non-residents IT relief: see 37.6 (Disregarded income).

### 38.3.2 *Definition of "UK representative"*

Section 835E ITA gives the basic definition for IT:

> (1) This section applies if a non-UK resident carries on (alone or in partnership) any trade, profession or vocation through a branch or agency in the United Kingdom.
> (2) The branch or agency is the UK representative of the non-UK resident in relation to—
> (a) the amount of any income from the trade, profession or vocation that arises (directly or indirectly) through or from the branch or agency, and
> (b) the amount of any income from property or rights which are used by, or held by or for, the branch or agency.

Thus for IT and CGT a UK representative is in short a branch or agency.

For CT, the term PE is used instead of branch/agency. Section 969(3) CTA 2010 provides:

> (3) For the purposes of this Chapter, the following rules apply to a permanent establishment in the United Kingdom through which a non-UK resident company carries on a trade.
> *Rule 1*
> The permanent establishment is the UK representative of the non-UK resident company in relation to chargeable profits of the company attributable to that establishment.

In the following discussion "**the non-resident principal**" is the person for whom the UK representative is a representative (who the statute calls "the non-UK resident").

The question whether the non-resident principal is trading is crucial for the UK representative rules because these rules only apply if the non-resident principal is carrying on a trade, profession or vocation.[3]

The INT Manual provides:

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3 See 39.11 (When is there a trade in financial assets?).

**268030 Extent of UK representative's liability** [April 2010]
A person can only be the UK representative in respect of the permanent establishment/branch or agency with which they are linked. Where a non-resident has more than one UK permanent establishment/branch or agency, then it is possible that each will have a different UK representative. In those circumstances, each UK representative would only be responsible in respect of the part of their non-resident's liabilities and obligations arising from their own permanent establishment/branch or agency [*Neilsen Andersen & Co v Collins,* and *Tarn v Scanlan* 13 TC 91].

The former ITH explained "directly or indirectly" in s.835E(2)(a):

**914. General**
Section 79 [TMA 1970] is another 1915 amendment. It provides that a non-resident shall be chargeable on profits or gains arising directly or indirectly through any branch, agency etc here. The sort of thing that was happening, before this provision was introduced, was that an agent for a non-resident would negotiate a contract here and at the end of the oral negotiations the agent and the third party would agree to sign the formal documents abroad. The view the Revenue took, and defensibly so, was that in substance all had been done here apart from signing a piece of paper and that it was wrong for liability so to be avoided.
Problems of that sort are really problems of fact and proof as was mentioned in chapter 8 (ITH822). If the Revenue could have proved that there was an unwritten agreement made in London, it would have succeeded in a claim that the non-resident was trading here, and that is what we would argue today. Millions of pounds worth of business are done in the City of London every day on the basis of spoken agreements which are later confirmed in writing and nobody wishes to deny that the word is the contract. But, when the parties to the contract do not wish to act openly, proof is difficult to come by. What these words were meant to do was to enable the Revenue to say – "we must accept that this contract was made abroad because we cannot prove otherwise but a lot of negotiation took place in London and we want to look at the substance of the matter and the words 'directly or indirectly' will enable us to do that".

### 38.3.3 *Representative ceasing to act*

Rule 1 s.835E(3) ITA provides for the UK representative ceasing to act:

*Rule 1*
The UK representative continues to be the UK representative of the non-UK resident in relation to the amount even after ceasing to be a branch or agency through which the non-UK resident carries on the trade, profession or vocation concerned.

The INT Manual provides:

**268040 What assessments should be raised and how is that done?** [April 2010]
Where the trading activities in the UK have ceased the UK permanent establishment/branch or agency retains the obligations and liabilities as the UK representative even after the cessation. This provision is at Section 126(3) FA 1995 for income tax and at Section 150(2)(c) FA 2003 for corporation tax. So assessments can still be raised on the UK representative subject to the usual assessing time limits. Where however the trading was conducted through a branch or fixed place of business and that presence has discontinued there may be difficulties identifying any person as the UK representative or any assets within the UK upon which recovery may rely. It is therefore recommended that assessments for such UK branches are raised and tax brought into charge at as early a stage as possible.
Additionally, by EU Directive member states of the European Union are able to seek the assistance of another member state in the recovery of direct and indirect taxes (see the recovery guidance at REC1139).

### 38.3.4 *Separate personality*

Rule 2 s.835E(3) ITA provides for deemed separate personality:

*Rule 2*
The UK representative is treated in relation to the amount as a distinct and separate person from the non-UK resident (if the representative would not otherwise be so treated).

The SALF Manual provides:

**704 UK representatives of non-residents chargeable under Case I and II Schedule D** [February 2011]
*UK representative is treated as a separate person*
The UK representative and the non-resident are treated as separate

persons. This allows, for example, service of notices and collection to take place at the branch or agency/permanent establishment.

## 38.4 Partnerships

Rule 3 s.835E(3) ITA provides:

> *Rule 3*
> If the branch or agency is carried on by persons in partnership, the partnership, as such, is treated in relation to the amount as the UK representative of the non-UK resident.

Section 835F ITA provides:

> (1) Subsection (2) applies if a trade or profession carried on by a non-UK resident through a branch or agency in the United Kingdom is carried on by the non-UK resident in partnership.
> (2) The trade or profession carried on through the branch or agency is, for the purposes of section 835E and Chapter 2C, to be treated as including the notional trade or profession.
> (3) Subsection (4) applies (in addition to subsection (2) if that subsection also applies) if—
> (a) a trade or profession carried on by a non-UK resident in the United Kingdom is carried on by the non-UK resident in partnership, and
> (b) any member of the partnership is resident in the United Kingdom.
> (4) The notional trade or profession is, for the purposes of section 835E and Chapter 2C, to be treated as being a trade carried on in the United Kingdom through the partnership as such.
> (5) In this section "the notional trade or profession" means the notional trade from which the non-UK resident's share in the partnership's profits or losses is treated for the purposes of section 852 of ITTOIA 2005 as deriving.

The INT Manual provides:

> **268020 Who can be the non-resident's UK representative?** [April 2010]
> *Partnerships can be the UK representative of a non-resident*
> A partner in a partnership can be the UK representative of a non-resident. This will occur, for example, where a non-resident trades in the UK though the agency of a UK partnership (of which he or she is not a member). In such circumstances, the partners in the UK

partnership will be jointly liable, as UK representative, for the tax payable by the non-resident. This provision is at Section 126(5) FA 1995 for income tax and is implicit in Section 150 FA 2003 for corporation tax.

Where a business that is carried on by a partnership that includes non-resident partners is carried on in the UK through a permanent establishment/branch or agency, the permanent establishment/branch or agency is the UK representative of each non-resident partner. This provision is at Section 126(6) FA 1995 for income tax and is implicit in Section 150(2) FA 2003 for corporation tax.

Where a business is carried on in the UK by a partnership that includes both resident and non-resident partners, the partnership is treated as the UK representative of each non-resident partner. The partners are thus jointly liable for the tax payable by the non-resident partners on their shares of the partnership profit. This provision is at Section 126(7) FA 1995 for income tax and is implicit in Section 150 ICTA 1988 for corporation tax.

The SALF Manual provides:

**704 UK representatives of non-residents chargeable under Case I and II Schedule D** [February 2011]

*A partnership can be the UK representative of a non-resident*

A partner in a partnership can be the UK representative of a non-resident. This will occur, for example, where a non-resident trades in the UK though the agency of a UK partnership (of which he or she is not a member). In such circumstances, the partners in the UK partnership will be jointly liable, as UK representative, for the tax payable by the non-resident.

*Partnership, which includes non-resident partners, trading in the UK through a branch or agency/permanent establishment: the branch or agency/permanent establishment is treated as the UK representative of non-resident partners*

Where a business that is carried on by a partnership that includes non-resident partners is carried on in the UK through a branch or agency/permanent establishment, the branch or agency/permanent establishment is treated as the UK representative of each non-resident partner.

*Partnership trading in the UK which includes resident and non-resident members is treated as UK representative of non-resident partners*

Where a business is carried on in the UK by a partnership which includes both resident and non-resident partners, the partnership is treated as the UK representative of each non-resident partner. The partners are thus jointly liable for the tax payable by the non-resident partners on their shares of the partnership profit.

## 38.5 Agents not treated as UK representatives

Section 127(1) FA 1995 provides three exceptions which I call:
(1) "**the casual agent exemption**";
(2) "**the broker exemption**";
(3) "**the investment manager exemption**".
I consider the first of these here; for the IME and broker exemptions, see 39.1 (Investment manager exemptions).

## 38.6 Casual agent exemption

Section 835G ITA provides:

> (1) This section applies if a non-UK resident carries on (alone or in partnership) a business through an agent in the United Kingdom.
> (2) The agent is not the UK representative of the non-UK resident in relation to an amount within section 835E(2) arising to the non-UK resident from—
> (a) so much of the non-UK resident's business as relates to disregarded transactions, or
> (b) property or rights which, as a result of disregarded transactions, are used by, or held by or for, the agent on behalf of the non-UK resident.
> (3) "Disregarded transactions" are transactions—
> (a) carried out through the agent in the United Kingdom, and
> (b) in respect of which the agent does not act in the course of carrying on a regular agency for the non-UK resident.

The INT Manual provides:

> **268020 Who can be the non-resident's UK representative?** [April 2010]
> Section 127(1) FA 1995 lists the persons who cannot be the UK representative for income tax and capital gains tax:
> 1) Agents who are not regular agents. In general if a non-resident is trading in the UK through an agent that agent should be regarded as a regular agent. This was considered in the cases of *Neilsen*

*Andersen & Co v Collins* and *Tarn v Scanlan* (13 TC 121–2) when Scrutton LJ considered "the contrast intended to be drawn is between casual employment, temporary employment, for a transaction or few transactions, and regular appointment of a permanent agent who is there as representing the foreigner". ...

The former ITH provided:

**942. NRs: accepting TMA 70 s.82 exemption: regular agency**
... casual agents are protected from assessment. As a general rule if there is UK source income and there is an agent we would want to assess the agent. A non-resident trading here through an agent will usually clearly do so through a regular agency.
It may be less clear whether an agent is a regular agent when he acts for his principal in only one transaction. This was the issue in the case of *Willson v Hooker* 67 TC 585. Acting for an Isle of Man company, Mr Willson instructed a firm of surveyors to bid for some land in the UK and instructed solicitors concerning the purchase and sale of the land. The Court said that a regular agency is any agency that is not a casual or occasional agency and that it was impossible to regard Mr Willson as a casual or occasional agent. He was the person through whom all the transactions of the company in the UK were carried out in the relevant period and so did not enjoy protection.

CT does not need the same exemption, as a casual agent is not within the concept of PE.

## 38.7 Subsidiary points

### 38.7.1 *HMRC procedures*

The INT Manual para provides:

**268040 What assessments should be raised and how is that done?** [April 2010]
As already explained above (INTM268030)) both the non-resident and their UK representative have a personal responsibility for the tax obligations and liabilities arising from the UK permanent establishment/branch or agency. Either party is able to discharge those obligations and liabilities. So we can assess either or both parties if necessary. Once one party has paid the personal responsibility on the other party lapses for that self assessment period. Obviously in cases where self assessments are returned by or for a non-resident taxpayer and tax payments are

made at the appropriate times no further action would be needed. This guidance concerns the practicalities of how to handle cases where obligations and liabilities are not met.

Because the UK representative is personally responsible for the non-residents tax obligations and liabilities, a unique tax reference should be allocated to the UK representative in that capacity. Where the UK representative is an agent (rather than a branch or fixed place of business permanent establishment) that unique tax reference should be a distinct and different reference to the one allocated to the agent for their own business. Non-resident companies intending to set up places of business in the UK are obliged to notify Companies House (see **Self assessment** at INTM261000). The consequential process in place automatically generates tax references and allocates them to the office responsible for the UK registered office address. Where that process has not happened, or for non-corporates, a taxpayer record with unique tax reference will need to be created on notification or discovery of liability.

The High Court held in the case of *Tischler v Apthorpe* [2 TC 89] that a non-resident could be assessed directly "wherever he could be reached" including the UK branch address. The decision in that case was that an assessment raised directly on the non-resident at the UK branch address was valid, even though there was also a UK representative who could have been assessed under the machinery provisions (the TMA 1970 version *see* INTM268010). It is probably unusual for a non-resident to have both a physical UK branch and an appointed UK agent but the reasoning in that case supports the equal validity of assessments made on the non-resident either directly at their UK branch or at the overseas address. In that case, of course, the UK agent could not be responsible for the tax assessed as he had not been notified.

So, on a practical level, assessments should be addressed in the manner most suited to the facts of the case and with the object of informing the relevant persons of the liability and securing the necessary payment of tax. Depending upon how near to expiry the assessing time limits are this could include any but possibly all of the following:

Assessment for a branch or fixed place of business in the UK
Assessment for UK trade carried out through an agent
Partners and partnerships
Recovery action

*Assessment for a branch or fixed place of business in the UK*

- Assess in the name of the non-resident individual or company at the UK business address.
- Send a copy also, for information, to the non-resident's address abroad if known.
- Assess any person who clearly has the capacity of "UK representative" e.g. the manager of the UK operations, as "Mr X as UK representative of XYZ".

*Assessment for UK trade carried out through an agent*

- Assess in the form "Mr X as agent for XYZ" sent to the agent's address.
- Send a copy of the assessment on the agent, for information, to the non-resident at their address abroad if known.
- Assess the non-resident individual or company at their address abroad if

known.

*Partners and partnerships*

Where the UK representative is a UK partnership the partnership itself is the UK representative. In such circumstances the partners in the UK partnership will be jointly liable for the tax payable by the non-resident. It follows that any assessment that is required should be made on the partnership as agent for the non-resident. Where a non-resident is a partner in a partnership which trades in the UK directly, typically through a UK branch or fixed place of business, the form of assessment depends on whether there is a partner resident in the UK. If there is a UK resident partner the assessment should be made on the partnership as a whole but the UK resident partner will be jointly liable for the tax payable by the entire partnership. Where there is no UK resident partner then assessments on the branch profits of the non-resident partners should be made on the UK branch of the partnership.

The SALF Manual provides:

**704 UK representatives of non-residents chargeable under Case I and II Schedule D** [February 2011]

*General rule for the obligations and liabilities of UK representatives*

The general rule is that UK representatives are jointly responsible with the non-resident for all the tax obligations and liabilities in relation to the trade, profession or vocation carried on through the branch or agency/permanent establishment.

This joint responsibility extends to all matters relating to the assessment of tax and to the collection and recovery of tax. For example, it extends to all the mechanisms of self assessment, including notification of chargeability, the obligation to make a tax return and self assessment, liability to make interim and final payments of tax, and liability to surcharges, interest and penalties in connection with those obligations and liabilities.

Either party is able to discharge the obligations and liabilities arising, but equally any acts or omissions of the non-resident are treated as acts or omissions of the UK representative (but see also the first two paragraphs under Offences below in relation to tax offences).

Where the trigger for an obligation or liability is the receipt of formal notification, then the obligation or liability only falls on the UK representative once they have received the relevant notification (or a copy).

### 38.7.2 *Notices and information*

Section 835V ITA provides:

(1) An obligation or liability attaching to a non-UK resident ("X") by reason of a notice or other document having been given or served on X does not also attach to the UK representative of X by virtue of section 835U unless the notice or other document (or a copy of it) has been given to or served on the representative.
(2) An obligation or liability attaching to X by reason of a request or demand having been received by X does not also attach to the UK representative of X by virtue of section 835U unless the representative has been notified of the request or demand.
(3) Subsection (4) applies to obligations relating to the provision of information that are imposed on the UK representative of X by section 835U in a case where the representative is X's independent agent.
(4) The obligations do not require the UK representative to do anything except so far as it is practicable for the representative to do so.
(5) For this purpose, the representative must act to the best of the representative's knowledge and belief after taking all reasonable steps to obtain the necessary information.
(6) An obligation of X to provide information is not discharged by virtue of section 835U in a case where the UK representative of X has discharged the obligation only so far as required by subsection (4) of this section.
(7) X is not bound by virtue of section 835U by mistakes in information provided by the UK representative of X in discharging, so far as required under subsection (4) of this section, an obligation imposed on the representative by section 835U unless—
(a) the mistake is the result of an act or omission of X, or
(b) the mistake is one to which X consented or in which X connived.
(8) In this section "information" includes anything contained in a return, self-assessment, account, statement or report required to be provided to the Commissioners for Her Majesty's Revenue and Customs or to any officer of Revenue and Customs.

The SALF Manual provides:

**704 UK representatives of non-residents chargeable under Case I and II Schedule D** [February 2011]
*Obligations and liabilities are limited where the UK representative is independent of the non-resident*
Paragraphs 4 and 7 Schedule 23 FA 1995 & Section 148(3) and Section 150(5) FA 2003
Where the UK representative is an independent agent of the non-resident acting in the ordinary course of business, its obligations to

provide information are limited to ones within its competence to act for the non-resident.

'Independent agent' is defined at Paragraph 7 Schedule 23 FA 1995. The definition is based on that used in the OECD Model Tax Convention and UK double taxation agreements. Broadly, to be an 'independent agent', the agent must be both legally and economically independent of the non-resident. As an independent agent is not within the definition of permanent establishment for corporation tax purposes such an agent could not become the UK representative of a non-resident company.

The rules recognise that, where the UK representative is an independent agent, the agent may not be able to provide complete information about the affairs of the non-resident. The agent is therefore required to provide any information requested, for example a return, to the best of its knowledge and belief after taking all reasonable steps to obtain the information. The non-resident remains responsible for completing or correcting the information where necessary.

However, the non-resident can correct any error or omission made by the UK representative provided the non-resident did not know about it or participate in it.

### 38.7.3 *Criminal offences and penalties*

Section 835W ITA provides:

(1) A person is not by virtue of section 835U liable to be proceeded against for a criminal offence unless the person— (a) committed the offence, or (b) consented to or connived in its commission.

(2) An independent agent of a non-UK resident is not by virtue of section 835U liable to any civil penalty or surcharge in respect of an act or omission if conditions A and B are met.

(3) Condition A is that the act or omission is not—

(a) an act or omission of the independent agent, or

(b) an act or omission to which the agent consented or in which the agent connived.

(4) Condition B is that the independent agent is able to show that the amount of the penalty or surcharge will not be recoverable out of the sums mentioned in section 835X(3) (after being indemnified for any other liabilities under section 835X).

The SALF Manual provides:

**704 UK representatives of non-residents chargeable under Case I and II Schedule D** [February 2011]
*Offences*
Paragraph 5 Schedule 23 FA 1995 & Section 150(6) FA 2003
The criminal and civil liabilities of a UK representative in respect of the non- resident's tax affairs are limited in certain circumstances.
UK representatives cannot be guilty of a criminal offence under these rules as a result of something done by the non-resident unless:
- they committed the offence
- consented to its commission, or
- connived in its commission.

The same applies for the non-resident in relation to the acts of the UK representative.
UK representatives who are independent agents are not liable to civil penalties and surcharges unless:
- they committed an act or omission or consented to, or connived in, its commission, or
- they will be able to recover the penalty out of monies of the non-resident.

### 38.7.4 *Indemnities*

Section 835X ITA provides:

> (1) An independent agent of a non-UK resident is entitled to be indemnified for the amount of any liability of the non-UK resident which the agent has discharged by virtue of section 835U.
> (2) An independent agent of a non-UK resident is entitled to retain, from the sums mentioned in subsection (3), amounts sufficient to meet any liabilities which by virtue of section 835U the agent has discharged or to which the agent is subject.
> (3) The sums are those which—
> (a) (ignoring subsection (2)) are due from the independent agent to the non-UK resident, or
> (b) are received by the independent agent on behalf of the non- UK resident.

## 38.8 Significance and meaning of "independent agent"

An "independent agent" has three advantages:
(1) Lower information requirements; see 38.7.2 (Notices and information)

(2) Lower liabilities for penalties: see 38.7.3 (Criminal offences and penalties)
(3) A right to an indemnity: see 38.7.4 (Indemnities)

Section 835Y ITA provides the definition:

> (1) In this Chapter "independent agent", in relation to a non-UK resident ("X"), means a person who is the UK representative of X in respect of any agency in which the person is acting on behalf of X in an independent capacity.
> (2) For this purpose a person does not act in an independent capacity on behalf of X unless the relationship between them, having regard to its characteristics, is a relationship between persons carrying on independent businesses dealing with each other at arm's length.

This is based on the definition in the IME rules; see 39.6.2 (Investment manager condition C: independent relationship) and 74.5 (Independent agent).

CHAPTER THIRTY NINE

# INVESTMENT MANAGER EXEMPTIONS

## 39.1 Investment manager exemptions - Introduction

This chapter considers three related exemptions where investment managers or brokers act for non-resident clients.

In order to understand the exemptions, it is helpful first to note the tax issues which a non-resident would face (in the absence of relief) if it carried on a trade in the UK through a UK investment manager. It is necessary to consider separately (1) a non-resident company and (2) a non-resident individual or trust.

In the absence of these exemptions, if a non-resident *company* carried on a trade in the UK through a UK investment manager, the non-resident company would face a UK tax charge arising from the fact that it might be trading in the UK through a PE (ie the investment manager might be an agency PE). If so:

(1) The non-resident company would be subject to corporation tax on its profits.

(2) The investment manager would be a "UK representative" and that tax would be collected from it.

Similarly, in the absence of these exemptions, if a non-resident *individual or trust* carried on a trade in the UK through a UK investment manager, the non-resident would face UK tax difficulties arising from the fact that it might be trading in the UK through a branch or agency (ie the investment manager might be a branch or agency). If so:

(1) The non-resident individual or trust would be subject to income tax and CGT on its profits.

(2) The investment manager would be a "UK representative" and that tax would be collected from it.

Alternatively the position might be that the investment manager was not a branch or agency or PE of the non-resident, but nevertheless the non-resident was trading in the UK. In that case (whether a company or an individual or trust) it would in principle[1] be subject to income tax on its trading profits.

Clearly, if there were no relief, non-residents would not use UK investment managers (at least if there were any risk that their activities might be characterised as trading). The investment management exemptions override these tax charges. Assuming the various requirements are met the exemptions are as follows:

(1) An investment manager is not a permanent establishment of a non-resident company. The main significance of this is:
  (a) to disapply the corporation tax charge which applies when a non-resident company trades through a UK PE.[2]
  (a) to disapply the provisions allowing collection of tax from a PE (as its "UK representative").[3]

  This exemption is set out in ss.1145-1151 CTA 2010. I refer to this as **"IME PE relief"**.

(2) An investment manager is not a UK representative for IT and CGT. The main significance of this is to disapply the rules allowing the collection of IT/CGT from UK representatives of non-residents.[4] This exemption is set out in chapter 2B part 14 ITA and chapter 7A TCGA. I refer to this as "**IME UK representative relief".**

(3) UK source income generated through investment managers is one of the classes of income which qualifies for non-residents IT relief. This exemption is part of the code of non-residents IT relief set out in Chapter 1 Part 14 ITA.[5] I refer to this as "**IME non-residents IT relief**".

I refer to the exemptions together as "**the investment manager exemptions"** abbreviated to "**IME**". (References to investment managers in this label include brokers.) The term used in the HMRC manuals is "investment management exemption", in the singular. There are however best regarded as three separate (though linked) exemptions.

The rules are written out *four* times in four different places. The rules for brokers are similar to investment managers, but are set out separately

1 In practice a DTA would often provide relief.
2 See 74.1 (Why does permanent establishment matter?)
3 See 38.2 (Collection of tax from UK representatives).
4 See 38.2 (Collection of tax from UK representatives).
5 See 37.1 (Non-residents IT relief).

each time, so there are eight sets of rules. This does make a coherent exposition rather difficult. Where the rules repeat or overlap, I set out the text of IME non-residents IT relief, giving the equivalents of the other rules in the footnotes only, unless there are material differences.

SP 1/01 explains the policy considerations behind the investment management exemptions:

> 1. There are two policy objectives underlying the tax treatment of UK resident investment managers and their overseas clients. These objectives are that overseas investors should not be charged to UK tax in relation to investment transactions conducted on their behalf and that any fees earned by a UK resident investment manager for services performed for the non-resident should be fully chargeable to UK tax.
> 2. The UK tax system seeks to achieve these objectives by granting what is termed the Investment Manager Exemption. The exemption enables non-residents to appoint UK-based investment managers without the risk of UK taxation and is one of the key components of the UK's continuing attraction for investment managers. HMRC is committed to maintaining this environment by improving the exemption to meet developments in the investment management industry through providing greater flexibility and better explanations for investment managers and expanding the scope of exempt activities.

Other countries take the same view:

> The highly mobile nature of the funds management business suggests that income from portfolio foreign investments flowing to non resident investors should not be taxed in Australia. Even modest amounts of Australian tax on these investors is likely to impede the growth of this business. Only the income of the Australian funds manager should be subject to Australian tax.[6]

## 39.2 IME PE relief

I discuss IME PE relief in this chapter, though to see the topic in the round one needs to be familiar with the definition of PE, for which see 74.2

6 This view is expressed in "A Platform for Consultation" (Australia) para 30.61 December 2010 accessible *www.rbt.treasury.gov.au/publications/paper3/index.htm*.

(Meaning(s) of "permanent establishment").

SP 1/01 explains:

> 10. The Investment Manager Exemption legislation now only has relevance for corporation tax by providing greater clarity about what constitutes independence of investment managers in relation to the non-residents for which they act.

Section 1142 CTA 2010 provides:

> (1) A company is not regarded as having a permanent establishment 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 the agent's business.
> (2) Sections 1145 to 1151 apply for the purpose of supplementing subsection (1) in relation to transactions carried out on behalf of a non-UK resident company by a person in the United Kingdom acting as—
> (a) a broker (section 1145),
> (b) an investment manager (sections 1146 to 1150)...

Section 1145 CTA 2010 provides the relief for a broker:

> (1) This section applies if a transaction is carried out on behalf of a non-UK resident company in the course of the company's trade by a person in the United Kingdom acting as a broker.
> (2) In relation to the transaction, the broker is regarded for the purposes of section 1142(1) as an agent of independent status acting in the ordinary course of the broker's business if (and only if) each of conditions A to D is met. ...

Section 1146 CTA 2010 provides the relief for an investment manager:

> (1) This section applies if an investment transaction is carried out on behalf of a non-UK resident company in the course of the company's trade by a person in the United Kingdom acting as an investment manager.
> (2) In relation to the investment transaction, the investment manager is regarded for the purposes of section 1142(1) as an agent of independent status acting in the ordinary course of the investment manager's business if (and only if) each of conditions A to E is met ("the independent

> investment manager conditions"). ...

If a broker/IM does not qualify for the broker/IM exemption then it is deemed to be not an agent of independent status, so it is deemed to be a domestic law PE. The broker might however still be an agent of independent status in which case it is not an OECD PE, so treaty relief might apply.

## 39.3 IME non-residents IT relief

I discuss the IME aspects of non-residents IT relief in this chapter, though to follow it one needs to be familiar with the background rules of non-residents IT relief, for which see 37.1 (Non-residents income tax relief).
SP 1/01 explains:

> 10. ... For income tax [the investment manager exemption] raises the threshold for chargeability so that the same criteria apply when there is no treaty protection in the form of a permanent establishment article.[7]

For individuals and trustees, non-residents IT relief applies to "disregarded income".[8] This term includes "disregarded transaction income". This is where the IME non-residents IT relief comes into play. For individuals and trusts, s.814(1)(2) ITA provides relief for a broker:

> (1) Subsection (2) applies if a non-UK resident carries on (alone or in partnership) a business through a broker in the UK.
> (2) Income is "disregarded transaction income", subject to subsection (6), if—
> (a) it is transaction income, and
> (b) the independent broker conditions are met in relation to the transaction in question.

For individuals and trusts, s.814(3)(4) ITA provides relief for an investment manager:

7 That is, the IME provides the same relief as article 7 OECD Model Treaty: "The profits of an enterprise carried on by a resident of a Contracting State shall be taxable only in that State unless the enterprise carries on business in the other Contracting State through a permanent establishment situated therein."

8 See 37.6 (Disregarded income).

> (3) Subsection (4) applies if a non-UK resident carries on (alone or in partnership) a business through an investment manager in the UK.
> (4) Income is "disregarded transaction income", subject to subsection (6), if—
> (a) it is transaction income, and
> (b) the independent investment manager conditions are met in relation to the transaction in question.

For non-resident companies the drafting is similar and the result is the same. Non-residents IT relief applies to "disregarded company income". Section 816 ITA provides:

> (1) For the purposes of this Chapter income arising to a non-UK resident company is "disregarded company income" if it is ...
> (c) income arising from a transaction carried out through a broker in the United Kingdom acting as an agent of independent status in the ordinary course of the broker's business,
> (d) income arising from a transaction carried out through an investment manager in the United Kingdom acting as an agent of independent status in the ordinary course of the investment manager's business,
> ...

## 39.4 IME UK representative relief

I discuss IME UK representative relief in this chapter, though to see it in the round one needs to be familiar with the UK representative rules, for which see 38.2 (Collection of tax from UK representative).

Section 835H ITA provides relief for brokers:

> (1) This section applies if a non-UK resident carries on (alone or in partnership) a business through a broker in the United Kingdom.
> (2) The broker is not the UK representative of the non-UK resident in relation to an amount within section 835E(2) if—
> (a) the amount is transaction income in relation to a transaction carried out through the broker in the United Kingdom on behalf of the non-UK resident, and
> (b) the independent broker conditions are met in relation to the transaction (see section 835L).

Section 835I ITA provides relief for investment managers:

(1) This section applies if a non-UK resident carries on (alone or in partnership) a business through an investment manager in the United Kingdom.
(2) The investment manager is not the UK representative of the non-UK resident in relation to an amount within section 835E(2) if—
(a) the amount is transaction income in relation to an investment transaction carried out through the investment manager in the United Kingdom on behalf of the non-UK resident, and
(b) the independent investment manager conditions are met in relation to the investment transaction (see section 835M).

## 39.5 Defined terms in IME legislation

### 39.5.1 *"Investment manager"*

Section 827(1) ITA provides a commonsense definition:

In this Chapter "investment manager" means a person who provides investment management services.

### 39.5.2 *"Broker"*

There is no statutory definition. The former ITH provided:

**926. NRs: Machinery of assessment: commodity markets: broker**
A few words are called for about an important market operator, the broker. London has been a great market for centuries. Until a few decades ago vast amounts of produce were landed in, or trans-shipped in London docks and it was here and in other ports that the markets grew. They are run by Trade Associations which lay down rules designed to secure a fair, orderly and open market; to provide for membership, and to consider things like rates of brokerage. The actual constitution of the different markets varies but one would normally find as members some big producers, some major users, both of whom may have a seat in the market ring, the place of business. But the central character is the broker. A broker is a negotiator for commission, who will sell or buy for clients. Brokers have a long history, but, in modern usage, Bowstead, the writer of the standard work on agency, describes the broker in this way–

"A broker is an agent whose ordinary course of business is to negotiate and make contracts for the sale and purchase of goods and other property of which he is not entrusted with the possession or control."

Payne, a writer on British Commercial Institutions, says this of an import broker–

"The function of a broker is to bring two parties together for the purpose of

> concluding a contract. Brokers are generally produce brokers with whose aid very large transactions take place at the chief importing ports. They are often specialists who, through long experience of markets ... are able to buy and sell to better advantage than could the general import merchant ... he (the broker) is not associated with the physical movement of the goods, nor with clearing them through Customs. After selling a consignment by auction, or by private treaty, the broker is paid a commission or fee (brokerage) which, with the other expenses of sale is deducted from the gross selling price."

Brokers are thus associated with the great commodity markets and exchanges, professional negotiators who will act for buyers and sellers and have nothing to do with the work-a-day business of handling or insuring the goods. They constitute an essential link in the market mechanism, in making the function of the market-place in determining price, available to their clients. Another odd quality of brokers is that the same broker can, by the custom of certain markets, act both for buyer and seller.

This means in practice that if A has asked a broker to sell something and B has asked the same broker to buy the same thing, the broker can match the two. The market rules would require that the broker does this business in the open (so that any other broker can step in if he wishes) and that preserves the idea of open market dealing and the natural protection which it gives to buyer and seller. Although the broker has acted for both parties the open nature of the market mechanism ensures that the price is a fair market price. ...

**939 NRs: when to accept the TMA 70 s.82 broker exemption - General**

Brokers and general commission agents take a very limited part in the marketing process. They are there to make the advantages of the market-place available to their clients. Whatever the terms mean, we do not accept as a broker or as a general commission agent a man who does everything the client himself would do in running the business were he himself here to do it, even if the agent acts for more than one client. Both expressions are primarily to do with commodity markets and that is what they were really intended for.

But over the years the application of the broker and general commission agent exemption has been extended. Stockbrokers, for example, will generally fall within Section 82(1) [TMA].[9] We have certainly accepted that there can be general commission agents and brokers in the field of shipping and that the exemption is sometimes appropriate. In insurance, on the other hand, we resist the suggestion that an underwriting agent can be a general commission agent. Insurance brokers will not normally be carrying on a non-resident's trade. If it seems that they do then they will arguably be acting in the capacity of underwriting agents and we would deny the exemption. If, in Districts, there are cases outside the usual commodity markets, where exemption under Section 82(1) appears to have been given but this treatment has not definitely and fairly recently, say within the last twenty years, been approved or condoned by

9 Section 82 (now repealed) provided: "Nothing in this Part of this Act shall render a non-resident person chargeable in the name of a broker ...In this subsection, 'broker' includes a general commission agent."

International Division, it would be sensible to consider asking for advice on the next convenient occasion.

### 39.5.3 *"Transaction income"*

Section 814(5) ITA provides the definition:

> In this Chapter "transaction income", in relation to a transaction carried out through a broker or investment manager in the UK on behalf of a non-UK resident, means income which arises to the non-UK resident from—
> (a) so much of the non-UK resident's business carried on (alone or in partnership) through the broker or investment manager as relates to the transaction, or
> (b) property or rights which, as a result of the transaction, are used by, or held by or for, the broker or investment manager on behalf of the non-UK resident.

### 39.5.4 *"Investment transaction"*

Section 827 ITA provides the definition:

> (2) In this section "investment transaction" means any transaction of a description specified for the purposes of this section in regulations made by HMRC.
> (3) Provision made in regulations under subsection (2) may, in particular, have effect in relation to the tax year current on the day on which the regulations are made.

The regulations are the Investment Manager (Specified Transactions) Regulations 2009. This is six pages long, so a full discussion would be a lengthy affair.

The label "investment transaction" is not strictly appropriate because the transaction will be a *trading* transaction and the so-called investment will be trading stock.

## 39.6 Investment manager conditions

Section 818(1) ITA provides:

> The independent investment manager conditions are met in relation to an investment transaction carried out on behalf of a non-UK resident by an investment manager in the UK if conditions A to E are met.

I refer to these as “**investment manager conditions A to E**”.

### 39.6.1 *Investment manager conditions A and B*: *investment manager*

Section 818 ITA provides:

> (2) Condition A is that at the time of the transaction the investment manager is carrying on a business of providing investment management services.
> (3) Condition B is that the transaction is carried out in the ordinary course of that business.

These are the equivalent of broker conditions A and B.

### 39.6.2 *Investment manager condition C: independent relationship*

Section 818(4) ITA provides:

> Condition C is that, when the investment manager acts on behalf of the non-UK resident in relation to the transaction, the relationship between them, having regard to its legal, financial and commercial characteristics, is a relationship between persons carrying on independent businesses dealing with each other at arm’s length.

The requirement is equivalent to the rule that an independent agent is not a PE. The reference to “legal financial and commercial characteristics” is draw from the INTM’s explanation of the PE rule and SP 1/01. So guidance on what is an independent agent for PE is relevant here.[10]
SP 1/01 provides:

> 35. The manager must act for the non-resident in an independent capacity. This means ascertaining whether, having regard to its legal, financial and commercial characteristics, the relationship between the manager and the non-resident is a

10 See 74.5 (Independent agent).

> relationship between persons carrying on independent businesses that deal with each other on arm's length terms.

This is imprecise, so the SP offers a bright line test which may offer a safe harbour for collective funds.[11] If this test is satisfied one is back to the

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11 36. The relationship will be considered to be independent if the non-resident has the following characteristics:
(a) the non-resident is a widely held collective fund or, if not,
(b) the non-resident is not a widely held collective fund but is either being actively marketed with the intention that it become one or is being wound up or dissolved.
37. A fund will be regarded as widely held if either no majority interest in the fund is ultimately held by five or fewer persons and persons connected with them, or no interest of more than 20% is held by a single person and persons connected with that person. The fund may need to establish a track record before new investors are obtained and will therefore have 18 months from the commencement of trading in the UK to meet the widely held test. Where investment management services are provided to a collective investment scheme constituted as a partnership, participants in the scheme will not be regarded as connected persons for this purpose if their only connection is membership of the partnership. This means that if the investment manager is a partner in the fund it will not be treated as connected with the other partners in the fund for the purpose only of the Independent Capacity Test, although there may still otherwise be connection under s 839 TA 1988/s 993 ITA 2007 between the participants, for example as partners in another capacity.
38. Actively marketed means there must be evidence of ongoing genuine attempts to obtain third party investment into the fund in order to meet the widely held test and that the terms on which interests in the fund are offered are not prohibitive or discriminatory for that class of business.
39. If the fund has one of the above two characteristics the independent capacity test will be met without the need to refer to any other factors.
40. In other cases the independent capacity test will be met:
(a) where the provision of services to the non-resident and persons connected with the non-resident is not a substantial part of the investment management business. Where that part does not exceed 70% of the investment manager's business, either by reference to fees or to some other measure (where that would be more appropriate), it will not be regarded as substantial. Further, if in the first 18 months from the start of a new investment management business the services provided to the non-resident exceed 70% of the business, they will not be treated as a substantial part of the business provided that they are consistently below 70% in subsequent periods.
(b) where the provision of services to the non-resident represents more than 70% of the investment manager's business 18 months after the start of a new investment management business but that was for reasons outside the manager's control and the manager had taken all reasonable steps to bring it below 70%. The investment manager will be expected to provide all relevant information to support a contention that the services are a substantial part of the manager's business for reasons beyond

vagueness of the law:

> 41. If none of the above tests are satisfied HMRC will have regard to the overall circumstances of the relationship between the non-resident and the investment manager in determining whether they are carrying on independent businesses that deal with each other on arm's length terms. It is not possible to describe every scenario in which the relationship may still meet this test but the guidance in this Statement of Practice should provide certainty to the vast majority of non-residents trading in the UK through an investment manager and HMRC will also continue to provide advice for any other circumstances.
> 42. Some funds adopt a master/feeder structure. Where the investment manager manages an opaque master fund, eg a company, which has feeder funds then the independence test will be applied as if the master fund were transparent by looking at the beneficial ownership of each feeder fund to determine whether the master fund is independent.
> 43. Similarly, if the investment manager acts for one or more sub-funds owned by an umbrella fund it is the beneficial ownership of the latter that will determine whether the independence test is met.
> 44. It should be noted that a subsidiary may be considered independent of its parent company for the purposes of the test, notwithstanding the parent's ownership of the share capital.

### 39.6.3 *Investment manager condition D: 20% rule*

Section 818(5) ITA provides:

> Condition D is that the requirements of the 20% rule are met (see s.819).[12]

### 39.6.4 *Investment manager condition E: customary remuneration*

Section 818 ITA(6) provides:

> Condition E is that the remuneration which the investment manager receives in respect of the transaction for the provision of investment management services to the non-UK resident is not less than is customary for that class of business.

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the manager's control and to demonstrate what steps have been taken to rectify that position.

12 See 39.7 (The 20% rule).

This is the equivalent of broker condition C. It overlaps with investment manager condition C since an arm's length relationship would normally involve customary remuneration.

SP 1/01 explains the meaning of "customary remuneration":

> 60. The UK investment manager must receive remuneration at a rate that is not less than customary for the services. The legislation does not define what is "customary" nor does it specify from whom remuneration must be received although, as already explained, HMRC will not regard a UK investment manager as acting in an independent capacity on behalf of the non-resident unless the relationship between them is that of persons carrying on independent businesses and dealing with each other at arm's length.
> 61. HMRC will be guided by the OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations when determining whether a pricing structure applies the customary rate and will look at whether the net effect of any provision made or imposed by means of a transaction or series of transactions provides the UK investment manager with a level of remuneration which would have been achieved at arm's length. All circumstances will be taken into consideration, including whether that remuneration has been reduced below the arm's length rate in any way either before or after payment to the UK investment manager.
> 62. HMRC recognises that remuneration structures through which the non-resident pays fees in a particular class of investment management take numerous forms, with variations including, for example, investment terms intended to attract certain investors or to "lock in" an investment. The arm's length definition of customary rate for the independent investment manager means that such arrangements between unconnected parties would not jeopardise this test. Transactions made at arm's length may include directly or indirectly reduced or rebated fees for unconnected investors in the non-resident[.] Similarly, rebated, reduced or zero fee arrangements which are made between the manager and the unconnected non-resident for genuine commercial reasons, such as where the manager is receiving a separate fee in respect of the assets in which the non-resident is investing, would be regarded as transactions made at arm's length.
> 63. In determining whether remuneration has been reduced below the arm's length rate in any way HMRC will consider both the remuneration received by the UK investment manager and any amounts payable to any person:
> – for services provided to the non-resident, or
> – in connection with the non-resident, or
> – that relate to the performance of the non-resident.
>
> These amounts, which may be payable by either the non-resident or the UK investment manager, will be treated as reducing the remuneration received in the UK below the customary rate unless they can be shown to be at an arm's length rate.
> 64. HMRC consider that in order to meet the customary rate test fees payable to

a UK investment manager should be recognised for UK tax purposes when earned. A cash payment may be deferred or reinvested in the fund but this should not affect the recognition of the fee income. As a result, the UK manager would pay tax on the fee for the period when earned and no difficulty with the customary rate test is envisaged in these circumstances. If cash settlement of management fees is deferred the manager may have effectively made a loan to, or investment in, the non-resident, as a result of which the return on that loan or investment would be attributable to the manager and may need to be taken into account for the 20% test.

Paras 64 onwards do not stand up to much examination.

65. Where a UK investment manager, a partner, director or employee of that manager, or a person connected with any of these, acquires a security or an interest of some other kind, in the non-resident or in another entity, for services provided by the manager:

– to the non-resident, or
– in connection with the non-resident,

the customary rate test will only be met if it can be shown that the manager or partner brings the security or other interest into charge to UK tax at its market value or, in the case of a director or employee, that the security or other interest is taxed as employment income in accordance with Part 7 ITEPA 2003. The definition of "security" here will be that found in s420 ITEPA 2003. An interest is intended to apply to an interest in a security or securities and any other interest not within the s420 ITEPA definition.

66. Where an option is brought into UK tax charge at full market value at the time it is exercised HMRC will not regard this remuneration as less than the arm's length rate for the purposes of the customary rate test.

67. Preferential investment terms involving reduced or rebated fees for directors or staff of the investment manager may be a benefit provided by reason of employment and thus may give rise to an employee income tax charge under ITEPA 2003. Similarly, where the investment manager is a partnership, preferential fee terms may be offered to partners who acquire interests in the non-resident, in which case the ensuing personal tax consequences will apply. HMRC will not ordinarily regard these terms as reducing the investment manager's fees for services below the arm's length amount unless significant UK tax avoidance or evasion is suspected, in which case all the facts and circumstances will be considered to determine whether the rate of remuneration is below the arm's length amount.

68. The vast majority of non-residents easily meet the customary rate test. However, HMRC has occasionally encountered structures in which offshore arrangements have been used to evade or avoid UK tax. Commonly, such structures involve arrangements whereby fees charged to the non-resident are diverted to an offshore vehicle at a non-arm's length rate. Such arrangements

represent an abuse of the exemption, place compliant[13] UK managers at a competitive disadvantage and may result in a non-resident failing to meet the terms of the exemption unless remedial action is taken.

The SP then turns to consider what evidence may be required:

69. HMRC has published guidance in its International Manual on what documentation and evidence is required to demonstrate an "arm's length" reward. At the time of publication of this Statement that guidance appears at INTM433030 of the Manual which can be found at http://www.hmrc.gov.uk/manuals/intmanual/index.htm and it is advisable to check that the most up to date advice is being followed.
70. The legislation considers the obligations and liabilities of the non-resident and whether the non-resident is exempt from UK tax on its UK trading profits. A non-resident may be a taxable person and in considering whether that is the case, and whether the UK agent has been rewarded with an arm's length rate, it may be appropriate in some circumstances for HMRC to ask for information such as statutory financial statements of the non-resident and its agents and a full and factual functional analysis of all services provided to the non-resident.
71. In circumstances where such information is requested to ascertain whether the remuneration has been at the customary rate HMRC would normally ask the UK investment manager, but in some circumstances may ask the non-resident, to provide such information as may reasonably be considered necessary. The information powers available to HMRC would include those relevant to the tax liabilities of the non-resident but where reasonable cooperation is provided by the UK investment manager and/or, where appropriate, the non-resident it is intended that a reasonable opportunity will be given to supply the information voluntarily before the use of information powers is considered.
72. Where appropriate documentation, including a factual functional analysis and an acceptable transfer pricing methodology, is in place to support a tax return, the investment manager will have an opportunity to agree an adjustment to the return to meet the customary rate test or for any other reason, or to have adjustments determined through litigation where such an agreement has not been reached, without the non-resident having thereby failed the customary rate test.
73. However, where the investment manager does not have the appropriate

13 A note on terminology. The word "compliant" has now become an essentially contested concept, that is, it admits of two distinct conceptions that are a battleground for profound substantive disagreements. HMRC use the term to mean those who comply with the legal rules of taxation *and* a more insubstantial spirit of the legislation (of which one suspects HMRC consider themselves the final arbiter). This was a novel linguistic turn in 2001 and most practitioners would regard "compliant" as apt to describe everyone who comply with the legal requirements of taxation. Contrast the two views of the taxpayer/HMRC relationship discussed in 67.7 (Above-minimum disclosure for sake of good relations with HMRC).

documentation and methodology in place at the time of making a return and the remuneration for that period is less than the arm's length rate, it is possible that the customary rate test has not been met. HMRC would expect the non-resident and the investment manager to ensure that adequate measures are taken to prevent the fund or its investors being exposed to UK tax and will give reasonable notice of possible action, and the reasons for it, to both the non-resident and its agents if it discovers any circumstances in which the non-resident may not have met the Investment Manager Exemption tests.

74. Each case will be considered on its own facts and it is possible that appropriate corrective action through adjustment to the customary rate will still enable the test to be met. It is not possible to describe every scenario but this general approach is intended to provide certainty on what the legislation requires and to reassure non-residents that a disproportionate outcome will not arise from a corrected failure to meet the test.

## 39.7 The 20% rule

Section 819(1) ITA provides:

> The requirements of the 20% rule are met if conditions A and B are met.

I refer to these as "**20% rule conditions A and B**".

> (2) Condition A is that in relation to a qualifying period[14] it has been or is the intention of the investment manager and the persons connected with the investment manager that at least 80% of the non-UK resident's relevant disregarded income[15] should consist of amounts to which none

14 Section 820 ITA provides:

"(1) This section applies for the purposes of this Chapter.

(2) If section 819 applies for the purposes of section 813, a "qualifying period" means—

(a) the tax year in which the transaction income is chargeable to income tax, or

(b) a period of not more than 5 years comprising two or more tax years including that one.

(3) If section 819 applies for the purposes of section 816, a "qualifying period" means—

(a) the accounting period of the non-UK resident company in which the transaction in question is carried out, or

(b) a period of not more than 5 years comprising two or more complete accounting periods including that one."

15 Section 821 ITA provides:

"(1) This section applies for the purposes of this Chapter.

(2) If section 819 applies for the purposes of section 813, the "relevant disregarded

of them has a beneficial entitlement.
(3) Condition B is that, so far as there is a failure to fulfil that intention, that failure—
(a) is attributable (directly or indirectly) to matters outside the control of the investment manager and persons connected with the investment manager, and
(b) does not result from a failure by any of them to take such steps as may be reasonable for mitigating the effect of those matters in relation to the fulfilment of that intention.

### 39.7.1 *Beneficial entitlement*

Section 822(1) ITA provides:

> This section applies for the purposes of this Chapter.

In fact the expression "beneficial entitlement" only appears in the 20% rule condition A, s.819(2) ITA, so the definition is only needed for that purpose.

> (2) A person has a "beneficial entitlement" to relevant disregarded income if the person has or may acquire a beneficial entitlement that is, or would be, attributable to the relevant disregarded income as a result of having an interest or other rights mentioned in subsection (3).

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income" of the non-UK resident for the qualifying period is the total of the non-UK resident's income for the tax years comprised in the qualifying period which derives from the transactions mentioned in subsection (4).
(3) If section 819 applies for the purposes of section 816, the "relevant disregarded income" of the non-UK resident company for the qualifying period is the total of the non-UK resident company's income for the accounting periods comprised in the qualifying period which derives from the transactions mentioned in subsection (5).
(4) The transactions referred to in subsection (2) are investment transactions—
(a) carried out by the investment manager on the non-UK resident's behalf, and
(b) in relation to which the independent investment manager conditions are met, ignoring the requirements of the 20% rule.
(5) The transactions referred to in subsection (3) are transactions—
(a) carried out by the investment manager on the non-UK resident company's behalf, and
(b) in relation to which the investment manager does not fall to be treated as a permanent establishment of the non-UK resident company, ignoring the requirements of the 20% rule."

(3) The interests and rights referred to in subsection (2) are—
(a) an interest (whether or not an interest giving a right to an immediate payment of a share in the profits or gains) in property in which the whole or any part of the relevant disregarded income is represented, or
(b) an interest in, or other rights in relation to, the non-UK resident.

### 39.7.2 *Position where 20% rule not met*

Section 823 ITA provides:

> (1) This section applies in the case of an investment transaction in relation to which the independent investment manager conditions are met, except for the requirements of the 20% rule.
> (2) This Chapter has effect as if the requirements of that rule were met in relation to the transaction but only in relation to—
> (a) so much of the transaction income of the non-UK resident as falls within subsection (3), if this section applies for the purposes of section 813, or
> (b) so much of the income of the non-UK resident company deriving from the transaction as falls within subsection (3), if this section applies for the purposes of section 816.
> (3) Income falls within this subsection if it does not represent income—
> (a) which is relevant disregarded income of the non-UK resident, and
> (b) to which the investment manager or a person connected with the investment manager has or has had any beneficial entitlement.

Section 824 ITA (non-resident collective investment scheme) is not discussed here.

### 39.7.3 *HMRC practice*

SP 1/01 provides:

> 45. In essence the requirement is that the investment manager and persons connected with it, including connected charities, must not have a beneficial entitlement to more than 20% of the non-resident's chargeable profit arising from transactions carried out through the investment manager. The definition of connected persons is that in s 839 TA 1988/s 993 ITA 2007.
> 46. Management fees paid to the investment manager and persons connected with it are not included in the chargeable profit provided they would be allowable in computing the profit of the non-resident were it chargeable to UK

tax. This applies equally to incentive fees, performance fees or incentive allocations which are calculated by reference to any increase in the net asset value or profits of the relevant non-resident. This treatment of incentive allocations is explained further below.

47. Where the 20% threshold is exceeded, the part of the income of the non-resident to which the investment manager and connected persons are beneficially entitled is excluded from the limitation of charge. The limitation of charge will apply to the part to which they are not beneficially entitled provided the other tests in the investment manager provisions are met.

48. The 20% test is treated as satisfied throughout any period, not exceeding five years, for which it is met in respect of the total taxable income of the period arising from transactions carried out through the investment manager. It is also treated as satisfied if the manager intended to meet that test but failed to do so, wholly or partly, for reasons outside the manager's control, having taken any reasonable steps to fulfil that intention. This means that the manager must fulfil the intention to keep its beneficial entitlement within 20% of the total taxable income for the period insofar as it is reasonable to do so, but is not required to get within that figure at any cost, for instance where there are good commercial reasons for not achieving that.

49. This is an example of how the test may be met throughout a period of five years:

| Years | 1 | 2 | 3 | 4 | 5 |
|---|---|---|---|---|---|
| Taxable income of non-resident | £100 | £200 | £200 | £250 | £250 |
| Entitlement of manager to above | £32 | £58 | £40 | £35 | £5 |
| Expressed as percentage for each year | 32% | 29% | 20% | 14% | 2% |
| Average % over qualifying period | 32% | 30% | 26% | 22% | 17% |

It may be assumed that the test is satisfied for year one because (a) in this example it was the manager's intention to have a beneficial entitlement to an average of 20% or less in aggregate over a five year period and (b) that intention was fulfilled. Had the 20% beneficial entitlement been achieved before the five years were up, then that shorter period would have been the qualifying period. A second qualifying period of up to five years could include years two, three, four, five and six and so on.

50. As with any other tests for the exemption, unless specified otherwise, the UK tax rules regard companies, including LLCs, as opaque and the FA 2003 rules apply, while partnerships are transparent and FA 1995 applies. In addition, the rule for non-resident companies at Schedule 26(5) FA 2003 treats partnership collective investment schemes in which they invest as assumed companies for the purposes of the 20% test.

51. In relation to a tax-transparent fund having overseas investors, the non-residents will be participants in the fund. In such circumstances the 20% test would be automatically broken where a non-resident participant is connected to the investment manager since this would mean that all the non-resident participants were connected under s 839(4) TA 1988/s 993(4) ITA 2007 by virtue of their being partners in the same partnership. The investment manager

and connected persons would then be entitled to all the income of that non-resident. Accordingly, where the investment management services are provided to a collective investment scheme (as defined in the Financial Services and Markets Act 2000) the 20% test is applied by looking at the scheme as a whole rather than at the individual participators. It is not then relevant that the investment manager may be connected to the non-resident as partner (s 127(10) and paragraph 5 Schedule 26 FA 2003) or that the non-resident participants themselves carry on a financial trade as the availability of the exemption is instead tested solely by reference to the nature of the activities of the notional company represented by the scheme.

52. In certain circumstances the investment manager may be connected with the participants because both are partners in one or more partnerships which have an interest in the fund in question. Where the 20% test is failed as a consequence of aggregating the manager's income with that of certain partners who are not connected persons otherwise than as a result of s 839(4) TA 1988/s 993(4) ITA 2007, ie by being partners in a partnership, the failure will be regarded as a failure under s 127(4)(b) FA 1995 and paragraph 4(b) Schedule 26 FA 2003 to fulfil an intention to satisfy the test. But in certain situations that failure will be considered as—

(a) attributable to matters outside the control of the manager and persons connected with it; and
(b) as not being the result of a failure to take reasonable steps to mitigate the effect of those matters in relation to the fulfilment of that intention.

In those situations the 20% test will be met. The legislation will be applied in this way where:

– the connected persons are partners other than solely in a fund under consideration; and
– partnership is the only reason that the manager is connected with them.

## A remarkable fudge.

53. Where overseas pension funds are set up under trust the trustees do not have beneficial ownership of the pension fund income although they may be the legal owners. The 20% test will not therefore apply where the trustee is connected to the UK investment manager. In practice it would be unusual for an overseas pension fund to be carrying on a financial trade. ...[16]

55. Some non-residents remunerate investment managers with profit or incentive allocations and in consultations HMRC, investment managers and advisors reached a consensus that these are performance fees in substance. As such, these are income in nature and where they are recognised by the UK manager as fee income the allocations may be treated as fees payable by the non-resident when computing the chargeable profit. Furthermore, where HMRC is satisfied that some of the allocations are due to an overseas service provider as remuneration

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16 The paragraph omitted here discusses "control"; see 69.4.2 (Control over a company's affairs).

for those services at the arm's length rate those allocations will have the same treatment in computing relevant excluded income.

56. Deferred fees, or securities or interests provided as reward, may in turn generate some form of return. The legislation draws no distinction between the forms in which the profits of the fund are attributed to deferred fees or other investments as the test is based on beneficial entitlement to the chargeable profits of the non-resident and if the manager's beneficial entitlement to those profits, including the return on the securities, interests or deferred fees, exceeds 20% the test will not have been met.

57. Options to acquire any securities or interests in the non-resident, within the meanings at s 420 ITEPA 2003, need only be considered in the context of the 20% test when the options are exercised.

58. Some investments in a non-resident may be linked to structured products issued to customers which provide a return based on the performance of the non-resident, an example of which would be a bank investing in a non-resident fund and selling a product to a customer on which the return is linked to the performance of the fund. In such circumstances the beneficial entitlement to the income of the non-resident remains with the investor in the non-resident, in this example the bank, and not the holder of the structured product, ie the customer.

***Interaction of the 20% test and the independence test.***

59. The independence test and the 20% test apply quite separately. For example, a UK investment manager acts for an overseas trading fund constituted as a company. If the investment manager is not acting in an independent capacity in relation to the fund company then the whole of the income of the fund is liable to assessment. If the independence test is satisfied, then the 20% test must be separately addressed. If the investment manager's interest in the fund company is 25% then that share of the fund's trading income is liable to assessment.

## 39.8 Independent broker conditions

Section 817 ITA provides:

(1) The independent broker conditions are met in relation to a transaction carried out on behalf of a non-UK resident by a broker in the UK if—
(a) conditions A to D are met, if this section applies for the purposes of section 813 [individuals/trustees], or
(b) conditions A to C and E are met, if this section applies for the purposes of section 816 [companies].

I refer to these as **"broker conditions A to E"**, to avoid confusion with the myriad other conditions ITA.

### 39.8.1 *Broker conditions A and B: broker's business*

Section 817 ITA provides:

> (2) Condition A is that at the time of the transaction the broker is carrying on the business of a broker.
> (3) Condition B is that the transaction is carried out in the ordinary course of that business.

The former ITH provided:

> **940. NRs: accepting TMA 70 s82 broker exemption: in course of business**
> The exemption in Section 82(1) applies only to transactions which the broker carries out (on behalf of the non-resident) "in the ordinary course of his business as such". In modern times it has become common for brokers to extend their business beyond mere "broking" but it does not follow that, just because what they do is now customarily done by brokers, they do it in the ordinary course of their business as brokers. Thus stockbrokers and commodity brokers often provide investment management schemes for clients. But investment management does not thereby become an ordinary function of a broker. However, there are special provisions for investment managers which are considered in ITH951.

### 39.8.2 *Broker condition C: customary remuneration*

Section 817(4) ITA provides:

> Condition C is that the remuneration which the broker receives in respect of the transaction for the provision of the services of a broker to the non-UK resident is not less than is customary for that class of business.

### 39.8.3 *Broker condition D: UK representative*

Section 817(5) ITA provides:

> Condition D is that the broker does not fall for the purposes of Chapter 2B of this Part, or of Chapter 1 of Part 7A of TCGA, to be treated as a UK representative of the non-UK resident in relation to

> [1] any other income which is chargeable to income tax, or
> [2] amounts which are chargeable to capital gains tax,
> for the same tax year as the transaction income.

This condition applies to individuals/trustees and not to companies.

### 39.8.4 *Broker condition E: permanent establishment*

Section 817(6) ITA provides:

> Condition E is that the broker does not fall to be treated as a permanent establishment of the non-UK resident company in relation to any other transaction of any kind carried out in the same accounting period of the non-UK resident company as the transaction in question.

The wording is the equivalent of broker condition D for companies (using the company tax concept of PE rather than the individual/trustee concept of branch/agency). Of course it would be simpler if the two were aligned.

## 39.9 Transactions through brokers

Section 828 ITA provides:

> (1) For the purposes of this Chapter a person is regarded as carrying out a transaction on behalf of another if the person—
> (a) undertakes the transaction, whether on behalf of or to the account of the other, or
> (b) gives instructions for it to be so carried out by another.
> (2) In the case of a person who acts as a broker or investment manager as part of only of a business, this Chapter has effect as if that part were a separate business.

## 39.10 Relevance of financial trading to IME

The question whether the non-resident client is trading is crucial for the IME. Unless the non-resident client is trading, the three IME exemptions are not needed:

(1) In the absence of a trade, a non-resident company is not subject to CT even if it has a permanent establishment and so the company does not have to rely on IME PE relief.

(2) In the absence of a trade, there can be no UK representative and the non-resident does not need to rely on IME UK representative relief.
(3) In the absence of a trade, non-residents may qualify for non-residents IT relief and do not have to rely on IME non-residents IT relief.

SP 1/01 acknowledges this:

> 14. The Investment Manager Exemption legislation has no relevance unless the non-resident is trading in the UK.
> 15. If the transactions carried out through the investment manager are part of the trade carried on by the non-resident then, unless the [IME] tests ... are satisfied the income from that trade, including any profit from the realisation of securities, etc, is taxable. ...

## 39.11 When is there a trade in financial assets?

"Trade" has no short definition and the general question of what a trade is needs a book to itself. The question discussed in this section is when there is a trade of dealing in securities, options and futures (which I shall abbreviate to securities or "financial assets" or "stock exchange transactions"). The trading/non-trading distinction here is important but elusive.

### 39.11.1 *Terminology*

**"Investment"** or "investing" is a word with several meanings.[17]

In one sense all securities are "investments". We have investment managers, investment brokers, investment companies or trusts. This is a convenient and common usage. However various distinctions are sometimes drawn which narrow the meaning of investment.

In a tax context, one ought to distinguish between:
(1) investing in securities and
(2) *trading* in securities. (In tax terminology "dealing" is an informal synonym of trading, but I think it is clearer to use the statutory term.)

In correct tax terminology a trader is not "investing" and holds securities

17 There is a helpful discussion of this terminology in a commercial context Graham & Dodd, "Security Analysis" ($6^{th}$ ed., 2009) chap 4 (distinctions between investment and speculation). For a discussion in a UK tax context, see Kessler and Brown, *Taxation of Charities and Non-Profit Organisations* ($8^{th}$ ed, 2011), para 5.9 (Investment).

as trading stock and not as "investments". I stress this because one sometimes finds the word "investment" used in a trading context.[18] This is not surprising because in the finance industry, the terms "investing", "trading" and "dealing" are all used as synonyms because for brokers and investment managers the distinction is irrelevant.

A distinction is sometimes drawn between

(1) investing in securities and

(2) gambling or speculating.

I discuss the meaning of gambling or speculating further below. The important point here is that in this sense gambling or speculating (whatever that means) is not investing.

Nevertheless, in the absence of trade, the matter is usually investment, and the trading/non-trading tax distinction can be described as a trading/investment distinction. This is doubted in *Wannell v Rothwell* 68 TC 719 at p.730:

> [Counsel for HMRC] mildly criticised para 11 for having posed the question 'trade or no trade?' but then, having treated that as equivalent to 'trade or investment?' I think there is some force in that criticism, since the word 'investment' has many shades of meaning, both in taxing statutes and elsewhere, and it is not used in the statutory provisions now under consideration.

This is strictly correct. It is possible to acquire financial assets in a manner which is not trading but which is not necessarily described as investment. (In particular, financial transactions have sometimes been described as "gambling" and classified as neither trading nor investment.) However, for most practical purposes that can be disregarded in the present context, and 'trade or no trade?' can be regarded as equivalent to 'trade or investment?'.

This discussion of terminology does not identify the dividing line between trading and investment, but it is an essential start if we are to know what we are talking about.

### 39.11.2 *Principles*

The principles are summarised in *Cooper v C & J Clark*:

18 See 39.5.4 ("Investment transaction").

> [1] First, marketable securities, being income-yielding assets usually capable of appreciating in value, are prima facie purchased and sold by way of investment and not by way of trade.
> [2] Secondly, a series of purchases and sales may sometimes, if carried out pursuant to a deliberate and organised scheme of profit-making, amount to a trade.
> [3] Thirdly, it is easier to characterise a series of purchases and sales as a trade in a case where they are made by a trading entity[19] as opposed to an individual.
> [4] Fourthly, in the case of a trading entity that characterisation is more easily made where the purchases and sales are substantial in relation to its other activities, all the more so where they are of frequent occurrence and extend over a long period of time.[20]

This is uncontentious and helpful as far as it goes.

### 39.11.3 *"Speculative" transactions*

*Cooper v C & J Clark* continues:

> Fifthly, it is sometimes helpful, although not decisive, to ask whether a series of sales and purchases is speculative or not. The reason why the question is sometimes helpful is that the answer may throw light *in one direction or the other,* but it is not decisive because according to the circumstances either a trade or a course of investment may be speculative.[21]

What does speculative mean? Graham and Dodd canvas various possible definitions, and suggest the following "as in harmony with the popular understanding of the term and the requirements of reasonable precision":

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19 By "trading entity" it is not entirely clear whether the judge had in mind:
(1) an entity actually carrying on a trade (such as the taxpayer company in *C&J Clark*, which was a shoe manufacturer); or
(2) any company with articles authorising it to carry on a trade, whether or not it carries on any activity apart the transactions in financial assets.
The general rule is that it is easier to characterise a series of purchases and sales as a trade in any case where they are made by any company with articles authorising it to carry on a trade. See 39.11.4 ("Gambling" and distinction between individuals and companies).

20 54 TC 670 at p.676.

21 54 TC 670 at p.676; emphasis added.

> An investment operation is one which, upon thorough analysis, promises safety of principal and a satisfactory return. Operations not meeting these requirements are speculative.[22]

In particular, a stock exchange transaction is described as "speculative" if it is risky and especially if the purchaser stands to make or lose money depending on how the market moves in the short term.

In that sense, stock exchange transactions are often if not mostly speculative (though it is a question of degree and some transactions are more speculative than others).

The passage from *C&J Clark*, while describing the issue of whether a transaction is speculative as "sometimes helpful" does not inform us whether a positive answer supports a conclusion of trading or non-trading, which somewhat undermines the helpfulness of the question. It is considered that to ask whether a transaction is speculative in the sense of high-risk is very rarely if ever going to be helpful. See *Lewis Emanuel v White*:

> The word 'speculation' is not, I think, as a matter of language, an

22 Graham & Dodd, "Security Analysis" (6th ed., 2009) p.106.
Fred Schwed Jr gives a similar explanation of this vague word in "Where are the Customers' Yachts?" (1940) Chapter 8:
"Investment and speculation are said to be two different things, and the prudent man is advised to engage in the one and avoid the other. This is something like explaining to the troubled adolescent that Love and Passion are two different things. He perceives that they are different, but they don't seem quite different enough to clear up his problems.
Investment and speculation have been so often defined that a couple more faulty definitions should do no harm, the science of economics having reached a point where further confusion is impossible. Thus,
- Speculation is an effort, probably unsuccessful, to turn a little money into a lot.
- Investment is an effort, which should be successful, to prevent a lot of money from becoming a little.
If you take a thousand dollars down to Wall Street and attempt to run it up to $25,000 in the course of a year, you are speculating. If you take $25,000 down there and attempt to earn a thousand dollars a year with it (by buying twenty-five four per cent bonds) you are investing. ..."
Sometimes the word "speculative" is used to describe a transaction made with a view to profit (as opposed to a transaction intended to hedge a financial risk). In that sense it is relevant to ask whether a transaction is speculative, since different principles apply to hedging transactions, but hedging is a rather special case.

> accurate antithesis either to the word 'trade' or to the word 'investment': either a trade or investment may be speculative.[23]

### 39.11.4 *"Gambling" and distinction between individuals and companies*

In order to avoid confusion in this area, it is essential to bear in mind that the word "gambling" may be used in two senses.

In the strict sense:

(1) gambling[24] contracts were unenforceable; and
(2) gambling activity is not a trade.

I refer to this as the gaming/wagering sense. The Gaming Act 2005[25] has abolished the former contract law rule that gaming/wagering contracts were invalid but the rule remains that the activity of gaming/wagering is not a trade and the profits (if any) are not subject to income tax, or CGT.[26]

In a loose sense, "gambling" means more or less the same as speculative, in the sense discussed above: that is, high-risk. The purchase of a future or option, say, may be a gamble in the loose (high-risk) sense, but it is not gambling in the strict (betting/wagering) sense.

In *Lewis Emanuel v White* the Judge said:

> ... it is certainly true, at any rate in the case of an individual, that he may carry out a whole range of financial activities which do not amount to a trade but which could equally not be described as an investment, even upon a short-term basis. These activities include betting and gambling in the narrow sense. They also include, it seems to me, all sorts of Stock Exchange transactions. For want of a better phrase, I will describe this class of activities as gambling transactions.

It seems a little strange to describe all sorts of stock exchange transactions as gambling, but the terminology makes a little more sense if one bears in mind that it was written in 1965, when the cult of the equity had only just

23 42 TC 369 at p.377; this passage was cited with approval in *Wannell v. Rothwell* 68 TC 719 at p.730.

24 Also called gaming, wagering and betting.

25 Section 63 Financial Services Act 1986 had already substantially restricted the rule that bets on stock market movements were void.

26 Section 51 TCGA. The rationale is that losses are more likely than profits, and one could not tax the profits without allowing some relief for losses.

begun, and before it had received judicial notice.[27] Before then, the only assets recognised as investments were gilts and mortgages, and stock exchange transactions would not normally be regarded as investments: they were felt to be too risky. They would not naturally be regarded as trading, so they were put into the category of non-trading non-investments.

Of course it does not matter for individuals whether one describes transactions in financial assets as investment or as gambling (in the loose high-risk sense), since the tax consequence is the same: the profits are subject to CGT and not IT.

This line of thinking is the historic basis for the rule that the test for whether a company is trading is different from the test of whether an individual is trading, and companies are more likely to be trading than individuals. The reason for the rule is said to be that companies (unlike individuals) are usually entitled only to trade or to invest. They cannot carry on non-trading non-investment activities of the kind that the judge categorised as "gambling" (in the sense of high-risk). The judge continued:

> It seems to me, however, that in general it is much more difficult to bring the activities of a company within this class of gambling transactions. An individual may do as he pleases: a corporation must act within the limitations of its memorandum of association. All companies have power to invest; many companies have power to deal [ie trade] in securities; few companies can have power to enter into gambling transactions - i.e., by [the judge's] definition, transactions otherwise than by way of investment or trade. Where a transaction can be brought within the scope of an authorised object - e.g., investment or dealing - one would not readily treat the transaction as having been carried out ultra vires in pursuit of an unauthorised object - e.g., gambling. In other words, one expects a trading company's activities, apart from capital investment, to be by way of trade.

The reasoning is now invalid:

(1) Nowadays one would not readily describe conventional stock exchange transactions as "gambling".

(2) Companies powers have increased.

The BI Manual notes the point (2). It cites *Lewis Emanuel v White* and

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27 *Sinclair v Lee* [1993] Ch 497 at p.512: "The cult of the equity, ... did not really begin until the mid or late 1950s."

comments:

> **65701. By individuals and companies** [November 2005]
> ... Since then Company Law has been amended. [Section 39(1) Companies Act 2006 says:
>
> > 'The validity of an act done by a company shall not be called into question on the ground of lack of capacity by reason of anything in the company's constitution.'][28]

It is considered that the rule continues to be valid that companies (assuming their articles authorise trading) are more easily held to be trading than individuals.[29] However the basis of that rule cannot now be the reason given in *Lewis Emanuel* (that the transactions carried out by individuals should generally be classified as non-trading non-investment transactions but companies, unlike individuals, must either trade or invest, so they are more likely to be trading). One could simply say that the rule is now established and continues to hold even if its reasons have ceased to be sound. However, if needed the rule has another, sounder basis. This is that one badge or indication of trade is "trading structure" and companies (if their articles authorise trading) have that element of "trading

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28 I have for convenience updated the text of the Manual which refers to the Companies Act 1985; there is no material difference.
The manual then quotes from *Cooper v C & J Clark* and continues with a passage which does not wholly address the problem it identified:
"Where companies undertake transactions in derivatives it is necessary to look at the context in which those transactions take place. In the case of *Morgan Grenfell Ltd v Welwyn Hatfield District Council* [1995] 1 All ER 1 the local authority entered into interest rate swaps with another local authority facilitated by Morgan Grenfell. One of the preliminary points in the case considered by the courts was whether or not the interest rate swaps were a gaming or wagering contract. The court held that in the context of interest rate swaps, for contracts entered into by parties or institutions involved in the capital market and the making or receiving of loans, the normal inference would be that such contracts were not gaming or wagering but were commercial or financial transactions.
It is therefore possible for a derivative contract entered into by a company to be part of the company's trading activities, if it is entered into to hedge exposure to risk in a commercial or financial transaction. See also CFM13580.
When all the facts have been gathered in a particular case it should be possible to conclude whether or not there is a trade. However any cases of doubt or difficulty, which cannot be resolved locally should be referred to Business Tax (Technical)."

29 See 39.11.2 (Principles) item [3].

structure" which individuals do not.

It is considered that to ask whether or not the transactions are gambling (in the loose sense of high-risk) is the same as to ask whether or not the transactions are speculative: it can never be helpful in determining whether or not transactions are to be classified as trading.

Since different tests apply to determine whether companies and individuals are trading, I consider the cases for individuals and for companies separately.

### 39.11.5 *Trading by individuals*

There have been two UK cases discussing whether individuals are trading in financial assets. The first is *Salt v Chamberlain* 53 TC 143 where Oliver J said:

> Where the question is whether an individual engaged in speculative dealings in securities is carrying on a trade, the prima facie presumption would be, as Pennycuick J. suggested in the Lewis Emanuel case 42 TC 369, that he is not. It is for the fact-finding tribunal to say whether the circumstances proved in evidence or admitted take the case out of the norm.

In *Salt v Chamberlain* the individual relied on the following matters to justify a conclusion of trading. There was a relatively large number of transactions, about 50 sale/purchase transactions per annum, over a four-year period. A substantial proportion of the transactions concerned options (rather than securities yielding income). One-third of purchases and sales were within the settlement period, and many others were within a short period thereafter. The purchases were financed in part by borrowing. On these facts the General Commissioners found that the taxpayer was not trading, and on appeal the judge held that the Commissioners were entitled to reach that conclusion.

A similar approach was applied in Hong Kong Inland Revenue Board of Review Decision *Case No. D 42/90.* The following aspects of the matter might have justified a conclusion of trading. The individual's transactions were in Hang Seng Index futures contracts which had a short lifespan and produced no income. The individual ran an "active" account (the number of transactions is not recorded). The Board held that the taxpayer was not trading.[30]

The second UK case is *Wannell v Rothwell* 68 TC 719. In this case there were about 60 sale/purchase transactions per annum. The assets traded were shares and commodities. Some of the money used was borrowed. The taxpayer was aiming at quick profits and had no intention of taking possession of the commodities or (with rare exceptions) of holding shares. The Special Commissioner did not decide whether the taxpayer was trading, but the Judge found that the Special Commissioner would have been "almost bound" to reach the conclusion that the taxpayer was trading.

In assessing the significance of the turnover of assets, one should in my view take into account that it is, I think, more common now to actively manage a portfolio than it was in the past.

Business income Manual provides:

> **65701. By individuals and companies** [November 2005]
> *Share Transactions by Individuals*
> Transactions by individuals in shares and securities are not generally trading transactions. Such transactions normally fall within the charge to Capital Gains Tax. This is also true of transactions in futures, options or other derivative contracts.
> [The Manual cites the passage from *Lewis Emanuel v White* 42 TC 369 discussed above[31] and continues:] Pennycuick did not accept that an individual speculating on the price movement in shares without intending to hold the shares even as short term investments was trading. He considered that such transactions are analogous to gambling, and so fall short of trading.

The rule that an individuals' transactions are not generally trading is sound; see 39.11.4 ("Gambling" and distinction between individuals and companies).

> The question of whether an individual is trading is a question of fact. And if agreement cannot be reached, an issue for the Commissioners to decide. It is therefore important that all the salient facts are obtained, when an individual claims to be carrying on a financial trade. Once the facts are established the position usually speaks for itself.
> The tax cases provide some useful pointers. But each case is dependent on its own facts. It is therefore vital to establish the facts first of all.
> The decided cases make it very clear that there is no definitive checklist for

30 Accessible *www.info.gov.hk/bor/eng/pdf/dv5_second/d4290.pdf.*

31 See 39.11.3 ("Speculative" transactions) and 39.11.4 ("Gambling" and distinction between individuals and companies).

determining whether an individual is trading or not. The 'badges of trade' are only a guide. The presence of one, two or more of them is not conclusive. The position is summed up by Oliver J in *Salt v Chamberlain* (1979) 53 TC 143 at page 154:

> '... I doubt whether the question whether in any given case a person is or is not carrying on a trade is capable of solution by the application of a logical progression of propositions culled from decided cases. The question is, I think, one of overall impression'.

In that case Mr Salt decided to put his expertise in computer technology for forecasting share movements to personal use speculating on the stock market. He effected some 200 purchases and sales of stocks and shares, financing himself by means of bank loans and insurance policies as well as personal means. The Commissioners determined that the Appellant was not trading and Oliver J upheld their decision.

It follows that reliance on the number and frequency of transactions, and the short term nature of the holdings of shares may be misleading. It is necessary to view these badges taking account of the fact that the assets are financial assets. To determine if a speculative activity is trading (or an adventure in the nature of trade), it is important to consider whether the operations are carried out in the same way as any ordinary trader in those assets operates. Established traders in shares operate to minimise, or limit, the exposure to chance. They do this in a variety of ways.

- They have customers who sell to them and buy from them regularly, to whom they market their services, and will quote prices for buying and selling. The prices quoted will be spread, so they can achieve profits. They make profits from moving huge volumes of shares very quickly.
- They hedge large holdings of a security with derivative instruments to ensure that if they hold on to positions for any length of time, they have only a limited exposure to general market movements.
- They have very strict rules about the degree of risk to which any trader is allowed to expose the firm.

So, while share traders do buy and sell shares to profit from anticipated market movements it is not the sole way in which they make a profit. Speculation is only part, and a strictly controlled part, of a more complex trading operation. Their operations are designed to make profits whichever way market prices move, by turning over stock as a wholesaler or as a retailer. Whether an individual operates in the same way as a share trader is a question of fact. So, it is necessary first of all to establish how the individual operates and what action he or she takes to minimise risk and secure profits.

*Derivatives Transactions by Individuals*

Individuals sometimes contend that options and futures are different to shares, because they are not income producing assets unlike shares which produce dividends, and they are usually dealt in by way of trade. However, financial futures and options are contracts closely tied to movement in prices of shares, interest rates or share indices. They are often used in exactly the same way as shares. It is therefore important to establish the facts when an individual contends that he or she is trading in derivatives. So, as for transactions in shares

> and securities, the question is whether the individual has organised his or her activities in a way that amounts to trading or is simply speculating on price movements.
> Derivative traders do not simply enter into contracts and await price movements, such traders operate in exactly the same way as stock market traders. They trade by turning over the assets in large volumes at a dealing margin. They buy and sell to those customers of the market who want to use the derivatives. Like share dealers, they will hedge against market movement so that their exposure to it is kept within strict limits. So, in determining whether an individual is trading in futures, options or contracts for differences, the factors which need to be considered are essentially the same as those for an individual trading in shares.
> Some of the derivative exchanges, including LIFFE, have now largely abandoned floor trading in favour of a screen based trading system, where prices are displayed and contracts can be made electronically. Some former LIFFE 'locals' now deal in derivatives in this way. They should still be considered to be trading given their background and involvement in the derivatives market, if there has not been a significant change in the nature of the activities. In cases where there has been a significant change in the nature of their activities, then a decision should be reached on the basis of the facts of the case.
> When all the facts have been gathered in a particular case it should be possible to conclude whether or not there is a trade. However, if once you have established the facts, there are doubts or difficulty, which cannot be resolved locally, you should refer the case to Business Tax (Technical) following ADM 6.109.

### 39.11.6 *Trading by trustees*

There are no tax cases on whether trustees of a private trust are trading, but it is considered that their position is in principle similar to individuals. In *Smith v Anderson* (a non-tax case discussing an early unit trust) James LJ said:

> In my opinion, nothing that is to be done under this deed by the trustees comes within the ordinary meaning of "business", any more than what is done by the trustees of a marriage settlement who have large properties vested in them, and who have very extensive powers of disposing of the investments, changing the investments, and selling them and reinvesting in other investments, according to their discretion and judgment, with or without the consent of their cestuis que trust. That is not a business. No doubt there is power ... to dispose of the investments and reinvest in some similar securities ... This appears to me to be no more than the power of varying investments which you would find in an

ordinary trust deed ...[32]

### 39.11.7 *Trading by companies*

There have been two cases discussing whether companies are trading in financial assets. Each concerned a trading company using spare cash to carry out stock exchange transactions.

In *Lewis Emanuel v White* 42 TC 369 the company carried out over 100 transactions per annum (described as "a very large number"). The majority were sold in the same year, often within a matter of weeks. It was held that the only possible conclusion was one of trading.

In *Cooper v C & J Clark* 54 TC 670 the company made only 13 transactions over nine months. The commissioners findings of trade were upheld, though only just (the judge would not have found there was a trade). So I think we can say that is an example of a non-trade.

It is considered the company's own classification of its activity as trading/non trading (in the company's constitution, board resolutions and accounts) is a matter of considerable weight which in an otherwise marginal case ought to be decisive. However an activity may constitute a trade even it the activity is ultra vires the company. *Lewis Emanuel* was such a case: 42 TC at p.377.

UK resident companies also need to consider the derivative contract rules in part 7 CTA 2009, which are not discussed here.

### 39.11.8 *SP 1/01*

SP 1/01 provides some heavily guarded generalities, and anyone who tries to use this guidance will find that it does not take them very far.[33] For what it is worth, the material is set out here:

> 16. Whether or not a taxpayer is trading is a question to be determined by reference to all the facts and circumstances of the particular case. This applies as much to financial transactions as to other activities.
> 17. In determining the question of trading, any transactions carried out through an investment manager are to be considered in the context of the status and world-wide activities of the non-resident. It is not possible

32 15 Ch D 247 at p.276.

33 There is similar (qualified) guidance in SP 3/02.

> in this statement to consider every possible set of circumstances but, for example, an individual is unlikely to be regarded as trading as a result of purely speculative transactions.[34]
> 18. For a company, a transaction will generally be either trading or capital in nature. (This may also be the case for non-corporate collective investment vehicles whether open-ended or closed.)

The point of para 18 is that the transaction will not give rise to non-trading income; see 39.11.9 (Transaction income (former schedule D case VI))).

> If the main business of a non-resident company is a trade outside the financial area, or an investment holding business, the activities in the UK would normally amount to trading only if they constituted or were part of a separate financial trade. But if, exceptionally, activities which are an integral part of the profit earning activities of a non-financial trade are carried out through a UK investment manager (eg hedging on the London terminal markets by a non-resident dealer in physical commodities) then that might amount to trading here. The view to be taken on a particular case will depend on all the facts of that case.
> 19. The active management of an investment portfolio of shares, bonds and money market instruments such as bills, certificates of deposit, floating rate notes and commercial paper does not constitute a trade.

The use of the term "investment" (if it carries its normal tax meaning) makes para 19 tautologous. Presumably the word is used in the wider sense, in which case the sentence makes an important point. But the author adds a qualification to neutralise that:

> But every case must be considered in the light of its own facts.
> 20. HMRC view short positions as conceptually the same as long positions and synthetic positions are conceptually the same as the equivalent 'real' positions. Neither going short nor taking synthetic positions using derivatives are in themselves indicative of trading. Furthermore, synthetic positions that give exposure to part of an asset are conceptually the same as synthetic positions that give exposure to the whole of an asset. Thus a synthetic position that gives exposure only to a bond's credit risk is no more or less likely to be a trading transaction than a synthetic or real position that gives exposure to the bond's coupon, liquidity, credit and currency risks. These techniques

34 Likewise SP 3/02 para 8.

may constitute investment in themselves or may form part of an investment activity.
21. Where futures and options are used by non-residents who are collective investment vehicles (whether open-ended or closed), pension funds and other bodies which either do not trade or whose client trade is outside the financial area, SP 03/02 "Tax Treatment of Derivative Transactions" will be applied.
22. ... [35] The criteria for deciding whether a non-resident financial company is an investment company or a trading company are the same as those which apply to a resident company.

BI manual expands on this:

**20250 - Trade: badges of trade: income producing assets** [April 2008]
... *Financial assets*
Normally transactions by individuals and companies in financial assets, such as shares, options and futures, do not amount to trading for tax purposes. Shares are generally held for investment, either to gain from income or capital growth. Short-term transactions, which cannot be classed as investments, usually fall short of trading, being in a class of transaction analogous to gambling or speculation. If you have a case of this kind please refer to BIM20252 and BIM65701.
**20252. Tax treatment of financial transactions** [April 2008]
Financial transactions include the acquisition, holding, dealing with and disposal of financial assets such as shares and bonds, but also include taking synthetic positions in relation to such assets or corresponding indices, or discrete components of them.
In our view, there is no conceptual difference between a 'real' and a synthetic financial transaction (for example, buying a share or entering into a derivative contract that replicates the risks and rewards of ownership). We also accept the following propositions:
a) Short positions are conceptually the same as long positions.
Buying a share because you take the view that its price will rise and shorting a share because you think its price will fall are conceptually the same. In simple terms, a view is merely being taken on the direction of movement. It follows that synthetic long and short positions are conceptually the same as one another and the equivalent real transactions.
b) Derivatives that give exposure to part of an asset are conceptually the same as derivatives that give exposure to the whole asset.
A view may be expressed on a bundle of components embedded in an

35 The omitted text discusses whether the financial trade is carried on in the UK; see 13.11.2 (Buying and selling through an agent). This is distinct from the question of whether there is a trade.

instrument, for example the coupon, liquidity, credit risk and currency of a bond, or alternatively a view may be expressed on one or a combination of these components. There is no conceptual difference between taking a view on all components by buying the instrument or entering a derivative contract that replicates ownership, or taking a view on one or a combination of the components via derivatives. There is no conceptual difference between taking a view on the direction of movement (as with simply long and short positions) or taking a view on the magnitude or timing of movements, or other components.

c) Multi-derivative or hybrid strategies should not be unbundled. Given the wide range of situations this principle can apply to, three examples are set out below. These are intended to be illustrative and not a definitive list.

In all cases involving any such "bundling" we would expect there to be evidence that the transactions were executed in pursuit of a clear prior strategy.

(i) Two or more derivatives

Where, for example, the view is that the price will increase but only within a certain band, and the most efficient way to express that single view is via a series of derivative transactions, those transactions should be considered as a whole and not each in isolation.

(ii) A derivative and another financial asset (e.g. shares)

Where the view is that an asset would not be acquired at current value but would be at a set lower value, a put option is written at that lower value, i.e. as a cost efficient method of acquisition. The writing of the option and the potential acquisition of the asset should be considered as a whole and not each in isolation.

(iii) A sequential series of similar derivative strategies

A derivative that is close to maturity generally has greater liquidity than a derivative identical in every way, other than having a longer period to maturity. 'Rolling' short dated derivative strategies such that there is a sequential series of similar derivatives should be viewed as a whole and not each in isolation.

In our view, taking short positions and using synthetics to express views on all or any of the components of risk associated with an asset or index are not in themselves indicative of trading. All of these approaches may form part of an investment strategy and some of them may constitute investment in themselves.

In our view, financial transactions such as those described in this guidance may constitute either investment, trading, or speculation which, whilst not amounting to investment even on a short-term basis, nevertheless falls short of trading. Where such transactions are undertaken pursuant to an organised strategy, the question may arise in particular cases whether that strategy is consistent with an investment or trading objective. This is always a question of fact to be decided by reference to all of the facts and circumstances of particular cases.

For further guidance on specific circumstances in which financial transactions are taxed as part of a trade, see the Corporate Finance Manual at CFM5301a, the General Insurance Manual at GIM5000+ and Chapter 2 of the Life Assurance Manual.

Outside of such arrangements, short-term transactions in financial instruments that are not integral to a financial trade, such as banking, or not undertaken pursuant to an organised trading strategy, are likely in our view to constitute speculation that amounts to neither investment nor trading.

### 39.11.9 *Transaction income (former schedule D case VI)*

One welcome rule is that stock exchange transactions must either be trading or non-trading, and cannot fall within any other category of trading income. Section 779(1) ITTOIA provides:

> No liability to income tax arises as a result of Chapter 8 of Part 5 (income not otherwise charged) in respect of a gain arising to a person in the course of dealing in—
> (a) commodity or financial futures,
> (b) traded options, or
> (c) financial options.[36]

This makes obsolete some difficult case law under which transactions in futures were held to be non-trading but to fall within the former Schedule D case VI. There is no scope for other stock exchange transactions to fall within this category: *Jones v Leeming* 15 TC 333.

### 39.11.10 *Commentary*

The trading/non-trading distinction in financial assets raises three difficulties:

(1) *Uncertainty:* The case law is old and investment practice has since changed considerably. It does not address the many varieties of transaction carried out by hedge funds and other sophisticated investors/traders, and even in the case of straightforward transactions, it is often unclear whether or not there is a trade.
(2) *Complexity:* There are some complex and narrow exemptions which

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36 For completeness, this continues:
(2) The reference in subsection (1) to a gain arising in the course of dealing in commodity or financial futures includes a gain regarded as so arising under section 143(3) of TCGA 1992 (gains arising from transactions otherwise than in the course of dealing on a recognised futures exchange, involving authorised persons).
(3) In this section—
"commodity or financial futures" means commodity futures or financial futures that are for the time being dealt in on a recognised futures exchange,
"financial option" has the meaning given by section 144(8)(c) of TCGA 1992, and
"traded option" has the meaning given by section 144(8)(b) of that Act.

recognise and address this problem and (more or less) treat stock exchange transactions as non-trading:

(a) the IME discussed in this chapter;

(b) an exemption for authorised investment funds introduced in an attempt to stop funds relocating to Ireland or Luxembourg;[37]

(c) chapter 6 part 3 OFTR.[38]

(3) *Irrationality:* The line drawn between trading/non trading in transactions in financial assets (insofar as it is discernible) is arbitrary.

These three problems follow from one underlying problem: there is no clear *economic* line to be drawn between trading and non-trading, in the context of stock exchange transactions. There is an economic distinction between buying for short term and buying for long term holding[39] and to the extent that this intuition underlies the trading/non-trading distinction it is not wholly irrational. However this economic line is nowhere close to the tax trading/non-trading distinction; and there is no reason why the two activities should be taxed differently. As far as I am aware, competing jurisdictions sensibly do not attempt to draw any comparable distinction.

It is suggested that all transactions in financial assets, defined along the lines of the IME, should in principle be deemed non-trading.[40] The IME, AIF and OFTR exemptions can be repealed. That would be a simplification with little if any tax loss.

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37 Authorised Investment Funds (Tax) (Amendment) Regulations, SI 2009/2036 (31 pages of regulations accompanied by 107 pages of draft guidance).

38 See 32.27 (Transactions treated as non-trading).

39 "We believe that according the name investors to institutions that trade actively is like calling someone who repeatedly engages in one-night stands a romantic." (Attributed to Warren Buffet - I would be grateful to any reader who could supply the reference).

40 There could be some limited exceptions, eg if a company elects for trading treatment, and the hedging of trading risks.

CHAPTER FORTY

# LOANS FROM NON-RESIDENT COMPANIES

## 40.1 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, directly or through an IP trust, it will be taxable on an arising basis or on the remittance basis. If it is received by a non-resident discretionary trust or company, it will be income within the scope of s.624 and the TAA provisions. By contrast a loan, even if interest-free, does 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 and s.87.[1] Receipt of the loan in the UK may be a taxable remittance under s.624, s.720 or s.731;[2] or if the sum loaned represents foreign income/gains of the individual.[3] A loan to a transferor or settlor may bring s.727 ITA[4] and s.633 ITTOIA into effect which is important if the settlor has no power to enjoy or the trust is not settlor-interested.[5] A loan to trustees may give rise to a charge under Schedule 4B TCGA.[6] The liability to repay the loan may not be deductible for IHT purposes.[7]

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1 See 27.4.4 (Interest-free loan and enjoyment of asset in kind).

2 See 24.5 (Section 624 remittance basis); 26.14 (Section 720 remittance basis); 27.34 (Section 731 remittance basis).

3 See 10.14.5 (T lends to R). Remittance condition D might also apply.

4 See 26.11 (Transferor receives capital sum).

5 See 24.14 (Settlor receives capital sum).

6 See 46.5 (Trustee borrowing).

7 See 56.1 (IHT deduction for debts).

Loans *to* non-resident companies raise different issues, not discussed here.

## 40.2 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.

Company law restrictions on loans to directors and connected persons may need to be considered. This will depend on the applicable law of the company.

If the company is held by a trust, the trustees need to consider whether they can properly permit the company to make the loan.

## 40.3 Loans to participators

Section 455 CTA 2010 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.

In this chapter I assume that the company is not UK resident when the loan is made.

## 40.4 Benefits to participators

Section 1064 CTA 2010 imposes a charge where a "close company incurs an expense in, or in connection with, the provision for any participator of ... benefits or facilities of any kind". 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".

## 40.5 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.[8] A discussion of the meaning of "taxable cheap loan" and the quantum of the charge is outside the scope of this book. For DTA relief see 65.26 (DTA defence to BiK charge).

### 40.5.1 *Remittance basis employee*

The BiK earnings of an employment-related loan may be chargeable overseas earnings if (in short) the duties of the employment are performed wholly outside the UK. If so, it is suggested that the earnings cannot be remitted so no tax charge can arise.[9]

### 40.5.2 *Loan to shadow director: HMRC practice*

Where living accommodation is provided by a company, HMRC say that they are keen to take the point that the occupier of the property may be a shadow director of the company, so that a benefit in kind charge arises.[10] In relation to interest-free loans from offshore companies, the same technical point arises. However in this case HMRC do not seem to argue the point. There are various possible explanations for this discrepancy.

One reason may be that borrowers (unlike occupiers) are less likely to be shadow directors. Of course a person who borrows interest-free from a company is not necessarily a shadow director. Perhaps the person occupying a property purchased by the company is more at risk of becoming a shadow director, because the company's acts to acquire the property and licence the individual to occupy are more likely to 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) may be less likely to be at the direction of the individual. But it is of course a question of fact in each case.

The motivation for (purporting to) take the living accommodation point may be to discourage IHT planning on the family home, not the collection of income tax. That is a second possible explanation.

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8 See 65.11 (Who is a shadow director?).

9 See 65.24 (Benefit in kind: remittance basis taxpayer). If that is wrong, imponderable questions arise as to what happens if the money lent is remitted here and spent. Contrast 27.36.1 (Interest-free (or low-interest) loan).

10 See 65.10 (Shadow directors).

## 40.6 Meaning of "employment-related loan"

### 40.6.1 *"Loan"*

Section 173(2)(a) ITEPA provides:

> "loan" includes any form of credit,

EIM para 26108 provides:

> **26108. Meaning of loan** [March 2007]
> Loan means more than just lending money. It includes any form of credit. It follows that any kind of advance by reason of the employment is covered. For example, any amount shown in the employer's books or records as owed by an employee will count as a loan.
> *Grant v Watton*
> The case of *Grant v Watton* (71 TC 333) concerned credit extended by a company of which Grant was a director, to his sole trade and later to a partnership in which Grant was the general partner. In the High Court Pumfrey J. considered the meaning of credit –
>
> > "... credit is granted where payment is not demanded until a time later than the supply of goods to which the payment relates. Credit is the deferral of payment of a sum which, absent agreement, would be immediately payable."
>
> Regarding the application of Section 175 ITEPA 2003 to an overdrawn director's loan account see EIM26505.

### 40.6.2 *"Making" a loan*

Section 173(2)(b) ITEPA provides:

> references to making a loan (and related expressions) include arranging, guaranteeing or in any way facilitating a loan.

EIM 26110 [March 2007] summarises this and continues:

> **Loan made by a third party – employee benefit trust**
> It is not uncommon for a third party, such as an employee benefit trust (EBT), to make a loan to a beneficiary who is also an employee of the employer which is associated with the EBT. It is sometimes suggested that the loan is not an "employment-related loan" (EIM26113) because

> the definition of that term does not include a loan provided by a third party.
>
> Whilst it is true that the definition includes no reference to a third party loan provider, HMRC does not accept that the loan is not an employment-related loan. The definition of "employment-related loan" includes a loan made by an employee's employer. As "making" a loan includes "in any way facilitating" a loan, if the employer provides the money to fund the EBT, the employer is regarded as making the loan. Consequently for the purposes of the loan benefit rules, the EBT is ignored and the loan is treated as made directly by the employer to the employee. It follows that the loan is an employment-related loan.

Suppose:

(1) A company is held by a trust, and lends funds to the trustees ("loan 1").

(2) The trustees lend funds to a beneficiary who is a shadow director ("loan 2").

At first sight this would not be an employment-related loan because it is not made by the "employer". But if loan 1 is made in order to allow the trustees to lend to the beneficiary, it might be said that the company has facilitated loan 2. The same applies to a back-to-back loan, ie if the company deposits funds with a bank, the trustees borrow from the same bank on the security of that deposit, and the trustees then lend to the beneficiary.

Section 174(4) ITEPA provides:

> References in this section to a loan being made by a person extend to a person who—
>
> (a) assumes the rights and liabilities of the person who originally made the loan, or
>
> (b) arranges, guarantees or in any way facilitates the continuation of a loan already in existence.

EIM para 26111 provides:

> **Loans taken over from another person**
>
> If the rights over an existing loan are taken over by another person the loan will remain within the charge if it was within the charge when it was first made.
>
> A loan within the scope of the charge cannot be removed from it by the

original lender handing his or her rights over to another person. But a loan that was not within the charge when it was first made can be brought within it if it is taken over by a person mentioned in EIM26113.

### 40.6.3 *"Employment-related"*

"Employment-related" loan is defined in s.174 ITEPA:

> (1) For the purposes of this Chapter an employment-related loan is a loan—
> (a) made to an employee[11] or a relative 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...

"Control" has the meaning in s.995 ITA: see s.719 ITEPA.

### 40.6.4 *Loan to relative of employee*

Section 174 ITA provides:

> (1) For the purposes of this Chapter an employment-related loan is a loan—
> (a) made to an employee or a relative of an employee...

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11 For the definition of "employee" see 12.2.1 ("Employer", "employee" and "employment").

12 "Material interest" is defined in s.68 ITEPA.

Section 174(6) ITEPA defines "relative" quite widely:

> For the purposes of this section a person ('X') is a relative of another ('Y') if X is—
> (a) Y's spouse or civil partner,
> (b) a parent, child or remoter relation in the direct line either of Y or of Y's spouse or civil partner,
> (c) a brother or sister of Y or of Y's spouse or civil partner, or
> (d) the spouse or civil partner of a person falling within para (b) or (c).

However s.174(5) ITEPA brings in a wide exception:

> 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.

In general therefore straightforward loans to relatives of employees or shadow directors are not caught.

### 40.6.5 *Change in employee status*

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 a "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. This was deliberate. EN ITEPA provides:

> 76. Where the Schedule E legislation provides that an amount shall be treated as an emolument of an employment only if provided in a year when the employment is held, this Act reproduces that limitation. The sections in the benefits code make it clear that such amounts or benefits will only be treated as earnings if they are paid/provided in a year in

which the employment is held. If they are paid/provided at any other time they will not be treated as earnings and will be outside the "general earnings" to which section 17 [ITEPA] applies.

### 40.6.6 *Employee coming to work in the UK*

The EI Manual provides:

**26105. Loans in foreign currencies: Taxation of overseas loans** [March 2007]

...

*Taxation of overseas loans in foreign currencies*

An employment-related loan (see EIM26102) made to an employee who comes to work in the UK is within the scope of the beneficial loans rules if:

• the loan is made at a time when the employee's earnings are already chargeable to UK income tax as employment income (for example, if a loan is made after the employee has taken up employment in the UK and is resident and ordinarily resident in the UK for the year in which the loan is made); or

• the loan is made in contemplation of the employee working or living in the UK (for example, if the loan is made as part of a package with a view to the employee working in the UK); or

• the employee, at a time when the employee's earnings are chargeable to UK income tax as employment income, in any way facilitates the continuation of a loan which was already in existence before the employee came to work in the UK.

As far as the final bullet is concerned, this is relevant where, for example, the loan is made not by the employer but by a third party such as a bank which is not connected with the employer and where the capital repayments and interest are deducted from the employee's salary. In these circumstances, the question is whether the loan continues when the employee is in the UK without any further involvement by the employer, or whether the employer does something which makes it easier for the employee to continue to have the loan.

An employer would not be facilitating the continuation of a loan merely because

• the loan is conditional on the employee continuing in the employment, or

• the employer deducts the interest and repayments of capital from the employee's salary.

If the employer pays a subsidy to the lender – for example, by paying

annual interest on behalf of the employee – that would not necessarily mean that the employer was facilitating the continuation of the loan. The subsidy itself might however be taxable as an employment-related benefit under Section 201 ITEPA.
On the other hand the employer would be facilitating the continuation of the loan if
• the loan was conditional on the employer continuing to make regular payments to subsidise the interest which the employer might cease to make at any time, or
• the employer chose month by month or year by year whether to subsidise the loan.

## 40.7 Foreign currency loan

There is (somewhat miserly) provision for foreign currency loans. Section 181 ITEPA provides:

(1) "The official rate of interest" for the purposes of this Chapter means the rate applicable under section 178 of FA 1989 (general power of Treasury to specify rates of interest).
(2) Regulations under that section may make different provision in relation to a loan if—
(a) it was made in the currency of a country or territory outside the United Kingdom, and
(b) the employee normally lives in that country or territory, and has actually lived there at some time in the period of 6 years ending with the tax year in question.

The EIM provides:

**26106. Official rates for certain foreign currencies** [March 2007]

| Currency | Period from | Period to | Official Rate |
|---|---|---|---|
| Japanese Yen | 6 June 1994 | | 3.9% |
| Swiss franc | 6 June 1994 | 5 July 1994 | 5.7% |
| | 6 July 1994 | | 5.5% |

There has been no change in either rate since 1994.
[The manual summarises s.181 and continues:] The intention of these rules is to give relief for employees working temporarily in the UK, where interest rates in the overseas country are lower than interest rates in the UK. The relief does not apply to employees who come to the UK

and live here permanently.
The expressions "normally lives" and "lived" have their natural commonsense meaning. An employee who came to work in the UK for four years and who returned home after the four years can be said to "normally live" in the home country. It is not necessary to maintain a residence in the overseas country during the period of employment in the UK. The terms "lives" and "has lived" connote a degree of continuance if not permanence. A holiday in the home country for an employee working in the UK would not in itself be sufficient to establish that the employee had "lived" in the overseas country within the meaning of these rules. "Living" implies more than returning for a short holiday.

## 40.8 Transactions in securities

### 40.8.1 *Introduction*

The provisions relating to transactions in securities ("**the TIS provisions**") require a book to themselves. This chapter focuses on the points most relevant to the themes of this book.
Section 684 ITA provides:

(1) This section applies to a person where—
(a) the person is a party to a transaction in securities or two or more transactions in securities (see subsection (2)),
(b) the circumstances are covered by section 685 and not excluded by section 686,
(c) the main purpose, or one of the main purposes, of the person in being a party to the transaction in securities, or any of the transactions in securities, is to obtain an income tax advantage, and
(d) the person obtains an income tax advantage in consequence of the transaction or the combined effect of the transactions.

### 40.8.2 *"Transaction in securities"*

This expression is defined in s.684(2) ITA:

In this Chapter "transaction in securities" means a transaction, of whatever description, relating to securities, and includes 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.

A sale of shares is of course a transaction in securities. A redemption of debentures is caught.[13]

### 40.8.3 *"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) also includes a reference to the interest of a member of the company as such, whatever the form of that interest.

## 40.9 "Income tax advantage"

"Income tax advantage" is defined in s.687 ITA:

> (1) For the purposes of this Chapter the person obtains an income tax advantage if—
> (a) the amount of any income tax which would be payable by the person in respect of the relevant consideration if it constituted a qualifying distribution exceeds the amount of any capital gains tax payable in respect of it, or
> (b) income tax would be payable by the person in respect of the relevant consideration if it constituted a qualifying distribution and no capital gains tax is payable in respect of it.
> (2) So much of the relevant consideration as exceeds the maximum amount that could in any circumstances have been paid to the person by way of a qualifying distribution at the time when the relevant consideration is received is to be left out of account for the purposes of subsection (1).
> (3) The amount of the income tax advantage is the amount of the excess or (if no capital gains tax is payable) the amount of the income tax which would be payable.
> (4) In this section "relevant consideration" has the same meaning as in section 685.

13 This is self-evident but if authority is needed, see *IRC v Parker* 43 TC 396 at p.434.

In what follows the expression is referred to as Income Tax Advantage (initial capitals) to remind readers that it is used in a defined and artificial sense.

Is a loan received "in consequence of a transaction in securities"? This must depend on the circumstances. The first step is to identify the transaction in securities.

## 40.10 The motive defence

Section 684(1)(c) ITA requires:

> the main purpose, or one of the main purposes, of the person in being a party to the transaction in securities, or any of the transactions in securities, is to obtain an income tax advantage

I refer to this as **"the motive defence"**.

## 40.11 The TIS circumstances

Section 685 ITA provides:

> (1) The circumstances covered by this section are circumstances where condition A or condition B is met.

I refer to "**TIS circumstances condition A and B**" to avoid confusion with the myriad other conditions in ITA.

> (2) Condition A is that, as a result of the transaction in securities or any one or more of the transactions in securities, the person receives relevant consideration in connection with—
> (a) the distribution, transfer or realisation of assets of a close company,
> (b) the application of assets of a close company in discharge of liabilities, or
> (c) the direct or indirect transfer of assets of one close company to another close company,
> and does not pay or bear income tax on the consideration (apart from this Chapter).
> (3) Condition B is that—
> (a) the person receives relevant consideration in connection with the transaction in securities or any one or more of the transactions in

securities,
(b) two or more close companies are concerned in the transaction or transactions in securities concerned, and
(c) the person does not pay or bear income tax on the consideration (apart from this Chapter).

The person need not receive the consideration directly from the company.[14]

### 40.11.1 *Relevant consideration*

Section 685 ITA provides:

> (4) In a case within subsection (2)(a) or (b) "relevant consideration" means consideration which—
> (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.
> (5) In a case within subsection (2)(c) or (3) "relevant consideration" means consideration which consists of any share capital or any security issued by a close company and which is or represents the value of assets which—
> (a) are available for distribution by way of dividend by the company,
> (b) would have been so available apart from anything done by the company, or
> (c) are trading stock of the company.

"Consideration" has an artificial definition. Section 685(8) ITA provides:

> References in this section to the receipt of consideration include references to the receipt of any money or money's worth.

Section 685(6) ITA restricts the concept of assets:

14 This is self-evident but if authority is needed see *IRC v Wiggins* 53 TC 639.

> The references in subsection (2)(a) and (b) to assets 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.

Section 685(7) ITA restricts the concept of share capital:

> So far as subsection (2)(c) or (3) relates to share capital other than redeemable share capital, it applies only so far as the share capital is repaid (on a winding up or otherwise); and for this purpose any distribution made in respect of any shares on a winding up or dissolution of the company is to be treated as a repayment of share capital.

### 40.11.2 *Miscellaneous definitions*

Section 685(9) ITA provides:

> In this section—
> "security" includes securities not creating or evidencing a charge on assets;
> "share" includes stock and any other interest of a member in a company.

## 40.12 Discussion

### 40.12.1 *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.

Are the TIS circumstances 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 the circumstances would be satisfied.

None of this matters unless there is a transaction in securities. The loan is not itself a transaction in securities.

If the company had to sell securities in order to raise funds to make the loan, then the loan may be said to be in consequence of that sale. If the company already possessed the cash, or acquired it without a transaction in securities, then s.684 does not apply.

Even if there is a transaction in securities, the escape clause may apply if the transaction is for commercial reasons.

40.12.2 *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 a remittance basis taxpayer? There is no IT advantage unless the proceeds are received in the UK.)

However, S does not receive distributable consideration so the TIS circumstances are not satisfied even if S does obtain an income tax advantage.[15]

15 *Hague v IRC* 44 TC 619.

CHAPTER FORTY ONE

# RATES OF TAX AND PERSONAL ALLOWANCES

## 41.1 IT rates – Introduction

A full discussion of rates of income tax would need a very long chapter. I concentrate on two common types of income: interest and dividends. Rates of tax on trustees and PRs are not considered here.

It may be helpful first of all to list the seven possible rates of income tax on individuals for which ITA provides terminology:

| **Name** | **Rate** | **Applicable to** |
|---|---|---|
| *Non-dividends* | | |
| Starting rate for savings | 10% | Savings income up to starting rate limit |
| Basic rate | 20% | Other income up to basic rate limit |
| Higher rate | 40% | Income above basic rate limit |
| Additional Rate | 50% | Income above higher rate limit |
| *Dividend income* | | |
| Dividend ordinary rate | 10% | Dividends up to basic rate limit |
| Dividend upper rate | 32.5% | Dividends above basic rate limit |
| Dividend additional rate | 42.5% | Dividends above higher rate limit |

The terminology is somewhat inapt. The (so called) "higher rate" is actually an intermediate rate between the basic rate and the top rate (unhelpfully named the "additional rate"). Similarly the dividend upper rate is an intermediate rate between the dividend ordinary rate (which is not "ordinary") and the top dividend rate (unhelpfully named the dividend additional rate). I reluctantly adopt the statutory terminology since anything else is even more confusing.

The effective rate on dividends is different from the rates set out above because one must allow for the tax credit and grossing up: the effective rates on net dividends are:

| Name | Effective Rate |
|---|---|
| Dividend ordinary rate | 0% |
| Dividend upper rate | 25% |
| Dividend additional rate | 36.11% |

## 41.2 Basic/higher/additional rates

Section 10 ITA introduces the basic/higher/additional rates:

> (2) Income tax on an individual's income up to the basic rate limit is charged at the basic rate (except to the extent that, in accordance with section 12, it is charged at the starting rate for savings).
> (3) Income tax is charged at the higher rate on an individual's income above the basic rate limit and up to the higher rate limit.
> (3A) Income tax is charged at the additional rate on an individual's income above the higher rate limit.

These rates apply unless disapplied by any other provisions. Section 10(4) provides:

> This section is subject to—
> section 13 (income charged at the dividend ordinary and dividend upper rates: individuals), and
> any other provisions of the Income Tax Acts which provide for income of an individual to be charged at different rates of income tax in some circumstances.

The important provisions for our purposes are ss.12 and 13 ITA.

## 41.3 Starting rate for savings income

Section 12(1) ITA provides:

> Income tax is charged at the starting rate for savings (rather than the basic rate) on so much of an individual's income up to the starting rate limit for savings as is savings income.

This replaces the basic rate with a different (more favourable) rate, the starting rate for savings.

### 41.3.1 *"Savings income"*

Savings income is defined in s.18 ITA:

> (1) This section applies for the purposes of the Income Tax Acts.
> (2) "Savings income" is income—
> (a) which is within subsection (3) or (4), and
> (b) which is not relevant foreign income charged in accordance with section 832 of ITTOIA 2005 (relevant foreign income charged on the remittance basis).

There are five categories of savings income within s.18(3) and (4):

> (3) Income is within this subsection if it is—
> (a) income chargeable under Chapter 2 of Part 4 of ITTOIA 2005 (interest),
> (b) income chargeable under Chapter 7 of Part 4 of ITTOIA 2005 (purchased life annuity payments), other than income from annuities specified in section 718(2) of that Act (annuities purchased from certain life assurance premium payments or under wills etc),
> (c) income chargeable under Chapter 8 of Part 4 of ITTOIA 2005 (profits from deeply discounted securities), or
> (d) income chargeable under Chapter 2 of Part 12 of this Act (accrued income profits).
> (4) Income is within this subsection if—
> (a) it is chargeable under Chapter 9 of Part 4 of ITTOIA 2005 (gains from contracts for life insurance etc), and
> (b) an individual is, or personal representatives are, liable for income tax on it (under section 465 or 466 of that Act).

"Savings income" does not properly describe these disparate categories of income, but it serves as a short label and there is no better term.

In short, the rates of tax on:
(1) UK interest; and
(2) foreign interest when the arising basis applies
are the starting/basic/higher/additional rates, 10%/20%/40%/50%.

### 41.3.2 *Rates of tax on interest under remittance basis*

If the remittance basis applies, foreign interest income[1] is taxed at the **basic**/higher/additional rates, **20%**/40%/50%. This is achieved by the clumsy but effective technique of providing that such income is not "savings income". How much is at stake? At most the difference between the starting rate and the basic rate, for income up to the starting rate limit. In 2010/11, this is 10% of £2,440 = £244.

Before the 2008 reforms I said:

> There is a (perhaps good) reason for dealing with foreign interest income in this way. A UK resident foreign domiciled individual will often have different types of foreign income. If he remitted only some of his income, it would be necessary, in the absence of this rule, to investigate whether the remitted income represents interest (taxable at 10%) or some other source of income (taxable at 20%). Because of this rule it is not necessary to ask this question.

Now that the ITA mixed fund rule requires precisely that investigation, this has ceased to be a valid reason. But the amount of tax involved is trivial.

## 41.4 Rates of tax on dividend income

### 41.4.1 *"Dividend income"*

Dividend income is defined in s.19 ITA:

> (1) This section applies for the purposes of the Income Tax Acts.
> (2) "Dividend income" is income which is—
> (a) chargeable under Chapter 3 of Part 4 of ITTOIA 2005 (dividends etc from UK resident companies),
> (b) chargeable under Chapter 4 of that Part (dividends from non-UK resident companies),
> (c) chargeable under Chapter 5 of that Part (stock dividends from UK resident companies),
> (d) chargeable under Chapter 6 of that Part (release of loan to participator in close company), or

1 Including the interest-like income of the other categories specified in s.18(4) ITA.

> (e) a relevant foreign distribution chargeable under Chapter 8 of Part 5 of ITTOIA 2005 (income not otherwise charged).
> (3) In subsection (2) "relevant foreign distribution" means a distribution of a non-UK resident company which—
> (a) is not chargeable under Chapter 4 of Part 4 of ITTOIA 2005, but
> (b) would be chargeable under Chapter 3 of that Part if the company were UK resident.

"Dividend income" does not properly describe these categories of income, but it serves as a short label. "Dividend-type income" would be slightly more accurate but it seems best to adopt the statutory terminology.

41.4.2 *Rates of tax on dividend income*

Section 13 ITA provides:

> (1) Income tax is charged at the dividend ordinary rate on an individual's income which—
> (a) is dividend income,
> (b) would otherwise be charged at the basic rate, and
> (c) is not relevant foreign income charged in accordance with section 832 of ITTOIA 2005 (relevant foreign income charged on the remittance basis).
> (2) Income tax is charged at the dividend upper rate on an individual's income which—
> (a) is dividend income,
> (b) would otherwise be charged at the higher rate, and
> (c) is not relevant foreign income charged in accordance with section 832 of ITTOIA 2005.
> (2A) Income tax is charged at the dividend additional rate on an individual's income which—
> (a) is dividend income,
> (b) would otherwise be charged at the additional rate, and
> (c) is not relevant foreign income charged in accordance with section 832 of ITTOIA 2005.

The scheme of s.13 is to replace the basic/higher/additional rates with different rates. Thus the rates of tax on UK dividend income are the dividend ordinary/upper/additional rates, 10%/32.5/42.5%. After allowing the tax credit and grossing up, the effective rates on net dividends are 0%/25%/36.11%.

Foreign dividend income is taxed at the dividend ordinary/upper rates, 10%/32.5% when the arising basis applies, and with benefit of a tax credit and grossing up if the complex conditions of s.397AA ITTOIA are met.

### 41.4.3 *Foreign dividend income under remittance basis*

If the remittance basis applies, foreign dividend income taxed on the remittance basis does not fall within s.13 as it does not meet the condition of s.13(1)(c) or s.13(2)(c) or s.13(2A)(c). This is consistent with the treatment of foreign interest income. However unlike foreign interest income, the amounts involved may be very substantial. The result is that for a remittance basis taxpayer who remits, foreign dividend income is taxed more heavily than UK dividend income. If the dividend income is from another MS, the discrimination is contrary to EU law.

## 41.5 Settlor-interested trust: rates of tax on settlor

Section 619 ITTOIA provides (so far as relevant):

> **619 Charge to tax under Chapter 5**
> (1) Income tax is charged on—
> (a) income which is treated as income of a settlor as a result of section 624 (income where settlor retains an interest), ...
> (2) For the purposes of Chapter 2 of Part 2 of ITA 2007 (rates at which income tax is charged), where income of another person is treated as income of the settlor and is charged to tax under subsection (1)(a) ... above, it shall be charged in accordance with whichever provisions of the Income Tax Acts would have been applied in charging it if it had arisen directly to the settlor.

This is a welcome simplification from the rules which applied before 2006. Unfortunately the old rules applied for the IT settlement provisions and for s.720. The FA 2006 simplified the settlement provisions but overlooked s.720! So the old rules still need to be considered in that context.

What about foreign dividend income which qualifies for the s.624 remittance basis, but is later remitted and becomes taxable under the s.624

remittance basis?[2] This is taxable at the dividend ordinary/upper/additional rates, 10%/32.5%/42.5%.

## 41.6 Rates of tax on transferor within s.720 ITA

Section 745 ITA provides:

> (1) Income tax at the basic rate, the starting rate for savings or the dividend ordinary rate is not charged under section 720 or 727 in respect of any income so far as it has borne tax at that rate by deduction or otherwise.
> (2) Subsection (1) does not affect the tax charged if section 724(2) applies (benefit provided out of income of person abroad charged in year of receipt).
> (3) Subsection (4) applies to any income that—
> (a) is treated as arising to an individual under section 721 or 728, and
> (b) apart from this Chapter is dividend income,
> so far as subsection (1) does not apply to the income.
> (4) The charge to income tax under section 720 or, as the case may be, section 727 operates by treating the income as if it were income within section 19(2) (meaning of "dividend income").

So there are two rules: one rule for dividend income; and another rule for other income. Dividend income is taxed at the rates usually applied to dividends: the dividend ordinary/dividend upper rates, with the benefit of the tax credit in the case of UK dividends. This also applies to foreign dividends of a foreign domiciled transferor if the usual s.720 remittance basis does not apply (because the dividends are received in the UK).

Section 745 ITA provides a special rule for dividend income. It says nothing about interest. Accordingly, interest within s.720 is taxed at the basic/higher/additional rates of 20%/40%/50%.

## 41.7 Entitlement to personal allowances

### 41.7.1 *Entitlement to personal allowances under UK domestic law*

There are eight categories of individuals who qualify for personal

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2 See 24.5 (Section 624 remittance basis).

allowances under chapters 2 and 3 part 3 ITA. Section 56(2) ITA 2007 sets out the first of these (UK residents):

> The individual meets the requirements of this section if the individual—
> (a) is UK resident for the tax year, or
> (b) meets the condition in subsection (3).

Section 56(3) ITA 2007 sets out the next seven categories. The most important category is EEA nationals. These are presumably included because a relief for UK residents but not for EEA nationals would be incompatible with EU freedom of establishment.[3] The rest is a strange ragbag:

> An individual meets the condition in this subsection if, at any time in the tax year, the individual—
> (za) is a national of an EEA state,
> (a) is resident in the Isle of Man or the Channel Islands,[4]
> (b) has previously resided in the UK and is resident abroad for the sake of the health of—
> (i) the individual, or
> (ii) a member of the individual's family who is resident with the individual,
> (c) is a person who is or has been employed in the service of the Crown,
> (d) is employed in the service of any territory under Her Majesty's protection,
> (e) is employed in the service of a missionary society, or
> (f) is a person whose late spouse or late civil partner was employed in the service of the Crown.

*Commentary*

There is scope here for simplification: the case for repeal of the entire list, apart from EEA nationals, seems very strong.

### 41.7.2 *Commonwealth citizens*

Before 2010/11 there was an additional category, namely, Commonwealth

3 See 51.3 (Freedom of establishment).

4 This category has been included since 1910: I would be grateful for any reader who could suggest the reason.

citizens. The tax law rewrite considered that this rule was contrary to the Human Rights Act.[5] Accordingly this category was deleted by the FA 2009. EN FA 2009 provides:

> 14. Previously, there was an entitlement for some individuals to claim purely by virtue of being a Commonwealth citizen but by meeting no other condition. Commonwealth citizens will no longer qualify for personal allowances, married couple's allowance, blind person's allowance and relief for life assurance premiums by reference to their Commonwealth citizenship status alone. They may, of course, continue to qualify under the other conditions or through DTA provisions if appropriate.
> 15. This change will mainly affect citizens of the following countries: Bahamas; Cameroon; Cook Islands; Dominica; Maldives; Mozambique; Nauru; Niue; St Lucia; St Vincent & the Grenadines; Samoa; Tanzania; Tonga; and Vanuatu.

The objection was that granting personal allowances to an individual solely on the basis that they are a Commonwealth citizen would be discriminatory on the grounds of nationality.[6] The rewrite did not consider that there was the unlawful discrimination in providing allowances to EEA nationals, as the distinction between EEA nationals and the rest of the world is justified by the distinct legal relationship which the UK has with the EEA.[7]

This rule was just about the last remaining example of special treatment for commonwealth citizens in UK tax legislation, so the issue does not have immediate tax implications in other areas but it does illustrate two interesting points: a significant restriction on the UK's ability to impose tax; and the (in)significance of the commonwealth (at least in a Human Rights context); for the tax law rewrite rejected the argument that the legal relationship which the UK has with the commonwealth would justify the discrimination).

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5 EN ITA para 135.

6 Art.14 ECHR (Prohibition of discrimination) in conjunction with Art.1 of 1st Protocol (Right to property).

7 Private correspondence.

### 41.7.3 *Personal allowances under DTAs: non-residents*

The last category of individuals entitled to personal allowances relates to DTAs.

The OECD model convention does not affect the rule that personal allowances are limited to UK residents (and other specific categories).[8] However some DTAs do this. For instance, art. 25(1) of the UK/Austria DTA provides:

> Subject to the provisions of paragraph (3) of this Article, individuals who are residents of Austria shall be entitled to the same personal allowances, reliefs and reductions for the purposes of UK tax as British subjects[9] not resident in the UK. ...

Non-resident British subjects qualify for personal allowances as they are nationals of an EEA state (the UK) so individuals who are treaty-resident in Austria will likewise do so.

Sometimes there is a restriction. Article 25(3) provides:

> Nothing in this Convention shall entitle an individual who is a resident of a Contracting State [Austria] and whose income from the other Contracting State [UK] consists solely of dividends, interest or royalties (or solely of any combination thereof) to the personal allowances, reliefs and reductions of the kind referred to in this Article for the purposes of taxation in that other Contracting State.

One could avoid the restriction by procuring income other than dividends, interest and royalties (maybe annual payments) but the amounts involved are small.

As far as I can see, the treaties which confer personal allowances are:

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8 OECD model Convention art. 24(2) specifically so provides:
"This provision shall not be construed as obliging a Contracting State to grant to residents of the other Contracting State any personal allowances, reliefs and reductions for taxation purposes on account of civil status or family responsibilities which it grants to its own residents."

9 Defined in s.51 British Nationality Act 1981.

| | |
|---|---|
| Austria* | Myanmar (formerly Burma) |
| Belgium* | Namibia |
| Fiji | Netherlands* |
| Greece | Portugal* |
| Ireland | Swaziland |
| Kenya* | Sweden* |
| Luxembourg* | Switzerland* |
| Mauritius* | Zambia* |

* includes restriction where income consists solely of dividends, interest or royalties

This form is found only in a small group of older DTAs whose number will continue to diminish. However the RDR Manual provides:

> **10340 Non-resident individuals who may claim Personal Allowances under the provisions of Double Taxation Agreements** [March 2011]
> Non-resident individuals who satisfy one of the conditions below are entitled to United Kingdom Personal Allowances
> [1] an individual who is a national of Israel or Jamaica or
> [2] [EEA Nationals] or
> [3] an individual who is a national and also a resident of Argentina, Australia, Azerbaijan, Bangladesh, Belarus, Bolivia, Bosnia and Herzegovina*,Botswana, Canada, China, Côte d'Ivoire (Ivory Coast), Croatia*, Egypt, Gambia, India, Indonesia, Japan, Jordan, Kazakhstan, Korea, Lesotho, Malaysia, Montenegro*, Morocco, New Zealand, Nigeria, Oman, Pakistan, Papua New Guinea, Philippines, Russian Federation, Serbia*, South Africa, Sri Lanka, Sudan, Switzerland, Taiwan, Tajikistan, Thailand, Trinidad and Tobago, Tunisia, Turkey, Turkmenistan, Uganda, Ukraine, Uzbekistan, Venezuela, Vietnam, Federal Republic of Yugoslavia*, Zimbabwe
> (*Note: Entitlement continues under the Double Taxation Treaty the UK had with the former Yugoslavia until such time as a new agreement takes effect.) or
> [4] an individual who is a resident of Austria, Barbados, Belgium, Fiji, Germany, Greece, Ireland, Kenya, Luxembourg, Mauritius, Myanmar (Burma), Namibia, Netherlands, Portugal, Swaziland, Sweden, Switzerland, Zambia
> (Please note: If individual is a resident, but not a citizen of Austria,

Belgium, France,[10] Germany, Kenya, Luxembourg, Mauritius, Netherlands, Portugal, Sweden, Switzerland or Zambia, they are not entitled to personal allowances if their income consists solely of dividends, interest and royalties or any combination of them).

Category [3] is essentially the same as my list set out above, except that Germany should be deleted following the new DTA (dated 2010) and Barbados is also in the list in error. I do not understand why the countries in categories [1] and [2] are in this list, as their DTAs do not seem to provide for personal allowances. Yet this RDR passage was updated in March 2011. I would be grateful for any reader who could explain this.

The form to claim the relief is R43.

### 41.7.4 *Personal allowances under DTAs: remittance basis claimants*

Remittance basis claimants (who would otherwise qualify for personal allowances as they are by definition UK resident) lose their personal allowances (and CGT annual exemption) by making a remittance basis claim.[11] This disallowance is overriden (so the right to personal allowances and CGT annual exemption is restored) by a DTA if applicable.[12] The treaties which confer personal allowances are those set out in the list above, with the exception of Myanmar and Greece.[13]

This treaty relief only affects remittance basis taxpayers subject to the £30k remittance basis charge (ie long-term residents) where:

(1) the individual is UK resident (so a remittance basis claim is made); and
(2) the individual is treaty-resident in the jurisdiction concerned (so that DTA relief applies).

So this point will not be a common one, though it will arise from time to time.

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10 France is listed here in error.

11 See 9.10 (Effect of remittance basis claim on personal allowances).

12 Jane Kennedy (Financial Secretary to the Treasury) accepted this in the public Bill committee debate on the Finance Bill, Hansard 19 June 2008 col 818, accessible *www.publications.parliament.uk/pa/cm200708/cmpublic/finance/080619/am/80619s05.htm*.

13 The antique treaties of Myanmar and Greece only grant personal allowances to residents of Myanmar/Greece who are not domestic-law UK resident; they do not help domestic-law UK residents even if also residents of Myanmar/Greece.

## 41.8 Rates of CGT

Section 4 TCGA (as introduced by para 2 Sch 1 F(No.2)A 2010) provides:

(1) This section makes provision about the rates at which capital gains tax is charged, but is subject to section 169N (rate in case of claim for entrepreneurs' relief).
(2) Subject to the following provisions of this section, the rate of capital gains tax in respect of gains accruing to a person in a tax year is 18%.
(3) The rate of capital gains tax in respect of gains accruing to—
(a) the trustees of a settlement, or
(b) the personal representatives of a deceased person,
in a tax year is 28%.
(4) If income tax is chargeable at the higher rate or the dividend upper rate in respect of any part of the income of an individual for a tax year, the rate of capital gains tax in respect of gains accruing to the individual in the year is 28%.
(5) If no income tax is chargeable at the higher rate or the dividend upper rate in respect of the income of an individual for a tax year, but the amount on which the individual is chargeable to capital gains tax exceeds the unused part of the individual's basic rate band, the rate of capital gains tax on the excess is 28%.
(6) [This relates to entrepreneur relief not discussed here]
(7) The reference in subsection (5) to the unused part of an individual's basic rate band is a reference to the amount by which the basic rate limit exceeds the individual's Step 3 income.
(8) For the purposes of this section, "the Step 3 income" of an individual means the individual's net income less allowances deducted at Step 3 of the calculation in section 23 of ITA 2007 for the purpose of calculating the individual's income tax liability.
(9) Section 989 of ITA 2007 (the definitions) applies for the purposes of this section as it applies for income tax purposes.

Para 18 Sch 1 F(No.2)A 2010 provides the transitional rule:

In relation to the tax year 2010-11—
(a) the reference in section 4(2), (3) and (4) of TCGA 1992 (as substituted by paragraph 2) to gains accruing in a tax year, and
(b) the reference in section 4(5) of that Act (as so substituted) to the amount on which the individual is chargeable to capital gains tax,
do not include gains accruing before 23 June 2010.

CHAPTER FORTY TWO

# NATIONAL INSURANCE CONTRIBUTIONS

## 42.1 NICs – Introduction

NICs should be regarded as a collection of seven more or less distinct taxes. Section 1(2) SSCBA classifies them semi-numerically:

> Contributions under this Part of this Act shall be of the following six classes—
> (a) Class 1, earnings-related, payable under section 6 below, being—
> (i) primary Class 1 contributions from employed earners; and
> (ii) secondary Class 1 contributions from employers and other persons paying earnings;
> (b) Class 1A, payable under section 10 below by persons liable to pay secondary Class 1 contributions and certain other persons;
> (bb) Class 1B, payable under section 10A below by persons who are accountable to the Inland Revenue in respect of income tax on general earnings in accordance with a PAYE settlement agreement;
> (c) Class 2, flat-rate, payable weekly under section 11 below by self-employed earners;
> (d) Class 3, payable under section 13 or 13A 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.

Each class of NIC requires a book to itself, except for class 1 which requires many volumes. I focus on matters closest to the themes of this book. I do not consider the special rules for mariners, aircrew, diplomats and service personnel.

SSCBA does not apply in Northern Ireland[1] so it refers to "Great Britain". (Northern Ireland has its own equivalent legislation not discussed here.) SSCR applies in both jurisdictions, so it usually refers to the UK, or to "GB and Northern Ireland".

## 42.2 Meaning of "employed" and "self-employed"

Section 2(1) SSCBA provides:

> (1) In this Part of this Act and Parts II to V below—
> (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)[2] with general earnings; and
> (b) "self-employed earner" means a person who is gainfully employed in Great Britain otherwise than in employed earner's employment (whether or not he is also employed in such employment).

The SSCBA, confusingly, (mis)defines the word "employment" to include trades and professions.[3] But in the definition the 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.)

In this chapter I use the word "**employee**" to mean an "employed earner" and "**self-employed**" means a "self-employed earner".

## 42.3 Meaning of "secondary contributor"

Section 6(4) SSCBA provides:

> The primary and secondary Class 1 contributions referred to in subsection (1) above are payable as follows—

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1 Section 177 SSCBA provides:
"(5) The following provisions extend to Northern Ireland—
section 16 and Schedule 2; section 116(2); and this section.
(6) Except as provided by this section, this Act does not extend to Northern Ireland."

2 The odd expression "elective office" is not defined and the words in brackets are otiose.

3 Section 122(1) SSCBA.

(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[4] (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.
> ...

| **Column (A)** | **Column (B)** |
|---|---|
| 9. Employment by a foreign employer where—<br>(a) in pursuance of that employment the personal service of the person employed is made available to a host employer; and<br>(b) the personal service is rendered for the purposes of the business of that host employer; and | 9. The host employer to whom the personal service of the person employed is made available. |

4 Section 4 Social Security Act 1975 is now s.7 SSCBA.

(c) that personal service for the host employer begins on or after 6th April 1994.

The identity of the employer is a question of contract/employment law.[5]

## 42.4 Territorial Limitation

Tax Bulletin 79 explains:

> For NIC purposes the world can be usefully divided into:
> **European Economic Area (EEA)**
> EC Treaty and EC Regulation [formerly 1408/71 and now 883/2004] applies to employees moving between EEA Member States to work. It modifies SSCBA 1992 and regulations.
> **RA/DCC Countries**[6]
> Bi-lateral Social Security agreements modify SSCBA 1992 and regulations.
> **Rest of The World** ("ROW")
> SSCBA 1992 and contributions regulations are unmodified.

Reciprocal agreements are not considered in this book. I first consider what the NI Manual calls "ROW" [rest of the world] rules, and then the EU rules.

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5 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 has been flagged as no longer current, however the author is not currently aware of this passage being moved elsewhere.)
This is only relevant to mariners as others are caught by the SSCER.

6 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.

## 42.5 ROW: Employed in GB

Unless the individual is employed *in* GB, they are not an employed or self-employed earner, and so in principle no NIC liability arises.[7] 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.

### 42.5.1 *First year abroad*

Reg. 146 SSCR provides an extension to the employed in GB rule:

> (1) Where an earner is gainfully employed outside the United Kingdom, and that employment, if it had been in Great Britain or Northern Ireland, would have been employed earner's employment, that employment outside the United Kingdom shall be treated as employed earner's employment for the period for which under para (2)(a) contributions are payable in respect of the earnings paid to the earner in respect of that employment provided that—
> (a) the employer has a place of business in Great Britain or Northern Ireland (as the case may be);
> (b) the earner is ordinarily resident in Great Britain or Northern Ireland (as the case may be); and
> (c) immediately before the commencement of the employment the earner was resident in Great Britain or Northern Ireland (as the case may be).
> (2) Where, under para (1), the employment outside the United Kingdom is treated as an employed earner's employment, the following provisions shall apply in respect of the payment of contributions—
> (a) primary and secondary Class 1 contributions shall be payable in respect of any payment of earnings for the employment outside the United Kingdom during the period of 52 contribution weeks from the beginning of the contribution week in which that employment begins to the same extent as that to which such contributions would

7 See 42.2 (Meaning of "employed" and "self-employed").

have been payable if the employment had been in Great Britain or Northern Ireland (as the case may be);

(b) subject to regulations 148 and 148A, any earner by or in respect of whom contributions are or have been payable under sub-para (a) shall be entitled to pay Class 3 contributions in respect of any year during which the earner is outside the United Kingdom from and including that in which the employment outside the United Kingdom begins until that in which he next returns to Great Britain or Northern Ireland (as the case may be);

(c) Class 1A contributions and Class 1B contributions shall be payable in respect of the period specified in sub-para (a).

Thus employment outside the UK is treated as employment in the UK (and so subject to NIC) for 52 weeks, provided the following conditions are satisfied:

(1) The employer has a place of business in the UK.
(2) The employee is ordinarily resident in UK.
(3) The employee was UK resident immediately before the employment commenced.

NI Manual provides:

**33027Class 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.

## 42.6 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.

### 42.6.1 *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.

### 42.6.2 *First year in UK exemption*

Reg. 145(2) SSCR provides an exception:

> Where a person is ordinarily neither resident nor employed in the UK and, in pursuance of employment which is mainly employment outside the UK by an employer whose place of business is outside the UK (whether or not he also has a place of business in the UK) that person is employed for a time in Great Britain or Northern Ireland (as the case may be) as an employed earner and, but for the provisions of this paragraph, the provisions of sub-para (a) of para (1) would apply, the conditions prescribed in that sub-paragraph and in sub-para (b) of that

paragraph shall apply subject to the proviso that—

(a) no primary or secondary Class 1 contribution shall be payable in respect of the earnings of the employed earner for such employment;

(b) no Class 1A contribution shall be payable in respect of something which is made available to the employed earner or to a member of his family or household by reason of such employment; and

(c) no Class 1B contribution shall be payable in respect of any PAYE settlement agreement in connection with such employment,[8]

after the date of the earner's last entry into Great Britain or Northern Ireland (as the case may be) and before he has been resident in Great Britain or Northern Ireland (as the case may be) for a continuous period of 52 contribution weeks from the beginning of the contribution week following that in which that date falls.

Thus employment in the UK is not subject to NIC for 52 weeks provided the following conditions are satisfied:

(1) employee not ordinarily resident in UK;
(2) employee not ordinarily employed in UK;
(3) employment mainly outside the UK;
(4) employer has a place of business outside the UK.[9]

NI Manual provides:

**33023 ROW – Exemption** [November 2005]

The exemption lasts until the employee has been resident in GB for a continuous period of 52 weeks starting from the beginning of the contribution week following the week in which the worker arrives in GB to take up employment.

A further 52 week period may commence where an employee returns to the overseas employment and then commences a new secondment in GB.

The exemption does not apply to:

- EEA nationals as this would contravene the principle behind 1408/71 see NIM33005

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8 I have corrected a disastrous typographical error in the SSCR by inserting a paragraph break here. The last paragraph (beginning "after the date") governs paras (a), (b) and (c). This can be seen to be correct from context and by comparing the predecessor, reg.119(2) SSCR 1979.

9 It might be inferred that the relief only applies if the employer's principal place of business is outside the UK, but the better view is that any place of business outside the UK is sufficient, and this is consistent with reg.146(2).

- 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.

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.

### 42.6.3 *Student exemption*

Reg. 145(3) SSCR provides an exception for students and apprentices:

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10 [Author's Note] I have retained this sub-paragraph which was deleted (I think accidentally) in early 2006.

Where a person to whom para (1)(a) would otherwise apply is not ordinarily resident in the UK and is not a person to whom the provisions of para (2) apply, the proviso in para (2) shall nevertheless apply if either—

(a) during a vacation occurring in a course of full-time studies which that person is pursing [*sic*] outside the UK, 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 UK 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 UK.

### 42.6.4 *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

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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 …"

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.

## 42.7 Primary and Secondary Class 1 NIC: HMRC examples

Tax Bulletin 79 provides:

**Example 1 (Angus)**
**Resident/Not Ordinarily Resident UK - Sent from ROW country to work in the UK - contractual employer in ROW country but seconded to the UK "host" employer.**
**An Australian employer assigns A, who normally works in Australia to the UK for 2 years. Residence status is resident in the UK but not ordinarily resident in years 1 and 2.**
A 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, A will become liable for contributions in the UK. As his contractual employer has no place of business in the UK, the UK "host" employer to whom personal service is made available is the secondary contributor - liable for the employer part of the National Insurance. [Para 9 to Regulation 3, Social Security Categorisation of Earners Regulations 1978].
When he is in the UK, A 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.
**A makes a short trip back to Australia in year 2 to brief the Australian company.**
After 14 months in the UK, A 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. A 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 A 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, A 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 A 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 A to his UK employer?

We consider that this would be a strong indicator that A'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 A had travelled to China for 3 days to act on behalf of the UK company?**

A'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 A 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 A has been sent to the UK and become ordinarily resident here?

If A'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 (Patel)**

Mrs P 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 P 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 P 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 £8333.33×5/365×100,000 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 P 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 P 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×£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.

## 42.8 ROW: Class 2 NIC

Reg. 145(1)(c) (d) SSCR provide that the requirements are:

> (c) as respects entitlement of a self-employed earner to pay Class 2 contributions, that that earner is present in Great Britain or Northern Ireland (as the case may be) in the contribution week for which the contribution is to be paid;
> (d) as respects liability of a self-employed earner to pay Class 2 contributions, that the self-employed earner is ordinarily resident in Great Britain or Northern Ireland (as the case may be), or, if he is not so ordinarily resident, that before the period in respect of which any such contributions are to be paid he has been resident in Great Britain [or Northern Ireland][13] (as the case may be) for a period of at least 26 out of the immediately preceding 52 contribution weeks under the Act, the Social Security Act 1975 or the National Insurance Act 1965 or under some or all of those Acts.

Thus there are two possible connecting factors and if either is present, Class 2 NIC is due:
(1) ordinary residence in UK;
(2) residence for 26 out of 52 contribution weeks.

## 42.9 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

13 These words are omitted (presumably accidentally) from the SSCR but the context requires them.

case may be) during that year and has been or is liable to pay Class 1 or Class 2 contributions in respect of an earlier period during that year,

(iii) that person has arrived in Great Britain or Northern Ireland (as the case may be) during that year and was either ordinarily resident in Great Britain or Northern Ireland (as the case may be) throughout the whole of that year or became ordinarily resident during the course of it, or

(iv) that person not being ordinarily resident in Great Britain or Northern Ireland (as the case may be), has arrived in that year or the previous year and has been continuously present in Great Britain or Northern Ireland (as the case may be) for 26 complete contribution weeks, entitlement where the arrival has been in the previous year arising in respect only of the next year.

## 42.10 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

14 [Author's Note] Regulations made under s.1043 Companies Act 2006 impose a registration duty on a foreign incorporated company which establishes a place of business in GB; Northern Ireland has equivalent legislation.

commensurate with the service, sub-contracts services to a UK business.[15]

## 42.11 Residence and ordinary residence

The NIC legislation does not define residence or ordinary residence. For residence, the NI Manual states:

> **29009 DL Conditions of domicile or residence**
> You should operate Residence Manual[16] guidance in deciding whether a person is domiciled or resident. Any difficulties on residence should be submitted to CNR [Centre for Non-Residents].

So the IT rules are applied.

For ordinary residence, the NI Manual states:

**33032 Special Cases: ROW – Meaning of "ordinarily resident" – Factors to consider** [July 2002]

... 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.<br>**No** – indicates the person ceasing to be ordinarily resident. |
| 2. What will be the purpose(s) of the return visit(s)? | Visit(s):<br>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.<br>If the visit(s) is in connection with the employment abroad, for instance, training, this is not such a strong indication of ordinary residence. |

15 This has been flagged as no longer current, however the author is not currently aware of this passage being moved elsewhere.

16 This is presumably a reference to the former Residence Guide now replaced by the RDR Manual.

| | |
|---|---|
| 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).<br>**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.<br>**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.<br>**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.<br>**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, first 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 or its successor, HMRC 6, will find completely different guidance. Ordinary IT principles should be applied.

## 42.12 The EU Regulation

The position within the EU is governed by Regulation 883/2004 of 29

April 2004 on the coordination of social security systems. EU regulations do not have short titles (which were introduced in the UK in 1845) so this is here called "Regulation 883/04".

This chapter considers the position from 1 May 2010. Before then the position was governed by regulation 1408/71. I do not discuss the transitional rules.

HMRC have published guidance ("**NIC guidance**").[17]

The regulation covers social security benefits but this chapter only considers the NIC aspects. The NIC guidance provides:

> Where under the EU Regulations the UK's social security legislation applies, the employee and employer (or person treated as the employer) must pay UK Class 1 National Insurance contributions (and the employer pays Class 1A National Insurance on certain UK taxable benefits and Class 1B National Insurance where there is a PAYE Settlement Agreement.) All the earnings are treated as arising from activity in the UK.
> Where, under the EU rules, the social security legislation of another Member State applies then no UK National Insurance is due.

## 42.13 Persons covered by Regulation 883/04

Article 2 Regulation 883/04 provides:

> 1. This Regulation shall apply to
> [1] nationals of a Member State,
> [2] stateless persons and refugees residing in a Member State who are or have been subject to the legislation of one or more Member States,
> [3] as well as to the members of their families and to their survivors.[18]

NIC guidance provides:

> The new EU Regulations apply to nationals of the EU Member States. They also apply to stateless persons and refugees residing in a Member

17 *www.hmrc.gov.uk/nic/work/new-rules.htm*

18 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 irrelevant for NIC, though it may be relevant for other purposes governed by the regulation.

State, members of their families and survivors if those people have previously been subject to the legislation of a Member State.

The UK has exercised its opt out in the Treaty of Amsterdam and will not be applying the new rules to people going to or from Iceland, Liechtenstein, Norway and Switzerland. The old rules in 1408/71 will continue to apply.

The UK has also opted out of applying the new EU rules to third country nationals legally resident in a Member State and will continue to apply the old rules.

### 42.13.1 Persons within Regulation 1408/71

The NIC guidance provides:

In the UK, the old EU rules in 1408/71 are being kept for third country nationals legally resident in a Member State. This is because the UK has chosen to opt out of laws extending the new regulations to third country nationals.
Example (Hank)
H is a US national who has lived and worked in the UK for ten years and pays Class 1 National Insurance. The UK Border Agency has agreed he can live and work legally in the UK. His UK employer Big Bank posts H to the Frankfurt office for six months. Because he is a US national legally resident in the UK, the new rules do not apply to H. H continues to be subject to the old rules. Big Bank should apply to HMRC Residency for a Form E101 for H and he remains subject to UK National Insurance in Frankfurt. He is exempt from German contributions.

This has made the position much more complicated. The old rules are not discussed here but I hope to cover them in a future edition.

### 42.13.2 *Forms*

The NIC guidance provides:

The EU Regulations provide for a system of forms so that employers and employees can demonstrate that they are entitled to operate the legislation of one Member State and be exempt contributions under the legislation of another. Under the old EU Regulations this was the E101 Form. Under the new EU Regulations the E101 will be replaced by Form

A1.
For employees coming to the UK from the other Member States, you should operate National Insurance contributions from the start of the employment unless you hold a valid E101 (or from 1 May 2010 Form A1 or an E101) showing that they are exempt National Insurance in the UK and subject to the legislation of another Member State.
For employees going to work in another Member State, you should apply to HM Revenue & Customs (HMRC) NIC&EO to find out whether the employee should remain in UK National Insurance and you can be issued Form E101 (or Form A1 after 1 May 2010). As long as the UK's legislation continues to apply, you should continue to operate employer and employee National Insurance rather than the contributions of the other Member State.

## 42.14 EEA: Tie-breaker rules

Article 11.1 sets out the principle of a tie-breaker rule:

> 1. Persons to whom this Regulation applies shall be subject to the legislation of a single Member State only. Such legislation shall be determined in accordance with this Title.

### 42.14.1 *Place of employment rule*

Article 11.3 Regulation 883/04 provides a place of employment rule for employees and self-employed:

> 3. Subject to Articles 12 to 16:
> (a) a person pursuing an activity as an employed or self-employed person in a Member State shall be subject to the legislation of that Member State;

The key phrase "pursuing an activity" is defined in article 11.2:

> 2. For the purposes of this Title, persons receiving cash benefits because or as a consequence of their activity as an employed or self-employed person shall be considered to be pursuing the said activity. This shall not apply to invalidity, old-age or survivors' pensions or to pensions in respect of accidents at work or occupational diseases or to sickness benefits in cash covering treatment for an unlimited period.

Article 11.3 continues with some more specialist rules:

> (b) a civil servant shall be subject to the legislation of the Member State to which the administration employing him/her is subject;...
> (d) a person called up or recalled for service in the armed forces or for civilian service in a Member State shall be subject to the legislation of that Member State;
> (e) any other person to whom subparagraphs (a) to (d) do not apply shall be subject to the legislation of the Member State of residence,[19] without prejudice to other provisions of this Regulation guaranteeing him/her benefits under the legislation of one or more other Member States.

## 42.14.2 *Year abroad rule for employees*

Article 12 Regulation 883/04 provides a rough equivalent of the year abroad rule for employees:

> 1. A person who pursues an activity as an employed person in a Member State on behalf of an employer which normally carries out its activities there and who is posted by that employer to another Member State to perform work on that employer's behalf shall continue to be subject to the legislation of the first Member State, provided that the anticipated duration of such work does not exceed 24 months and that he/she is not sent to replace another person.
> 2. A person who normally pursues an activity as a self-employed person in a Member State who goes to pursue a similar activity in another Member State shall continue to be subject to the legislation of the first Member State, provided that the anticipated duration of such activity does not exceed 24 months.

## 42.14.3 *Two places of employment*

The place of employment rule cannot act as a tie-breaker if there are two places of employment. In this case Art.13 Regulation 883/04 provides:

> 1. A person who normally pursues an activity as an employed person in two or more Member States shall be subject to:

19 Art.1(j) provides: "'residence' means the place where a person habitually resides."

> (a) the legislation of the Member State of residence if he/she pursues a substantial part of his/her activity in that Member State or if he/she is employed by various undertakings or various employers whose registered office or place of business is in different Member States, or
> (b) the legislation of the Member State in which the registered office or place of business of the undertaking or employer employing him/her is situated, if he/she does not pursue a substantial part of his/her activities in the Member State of residence....

What is "substantial"? NIC guidance provides:

> When determining whether a substantial part of the activity of an employed person is pursued in a Member State HMRC will take into account:
> · the working time and/or
> · the remuneration
>
> If less than 25 per cent of the person's working time is carried out in the UK and/or less than 25 per cent of the person's remuneration is earned in the UK this will be an indicator that a substantial part of all the activities of the worker is not pursued in the UK. Other criteria may also be taken into account. HMRC may look at the past but must also look at the position in the next 12 months. This will allow HMRC to take account of changing circumstances.

Regulation 883/04 continues with further tie-breakers:

> 3. A person who normally pursues an activity as an employed person and an activity as a self-employed person in different Member States shall be subject to the legislation of the Member State in which he/she pursues an activity as an employed person or, if he/she pursues such an activity in two or more Member States, to the legislation determined in accordance with paragraph 1.
> 4. A person who is employed as a civil servant by one Member State and who pursues an activity as an employed person and/or as a self-employed person in one or more other Member States shall be subject to the legislation of the Member State to which the administration employing him/her is subject.
> 5. Persons referred to in paragraphs 1 to 4 shall be treated, for the purposes of the legislation determined in accordance with these provisions, as though they were pursuing all their activities as employed or self-employed persons and were receiving all their income in the

Member State concerned.

## 42.15 EEA: Self-employed rules

### 42.15.1 *Year abroad rule for self-employed*

Article 13.2 Regulation 883/04 provides a year abroad rule for the self-employed:

> 2. A person who normally pursues an activity as a self-employed person in two or more Member States shall be subject to:
> (a) the legislation of the Member State of residence if he/she pursues a substantial part of his/her activity in that Member State; or
> (b) the legislation of the Member State in which the centre of interest of his/her activities is situated, if he/she does not reside in one of the Member States in which he/she pursues a substantial part of his/her activity.

## 42.16 Special cases by agreement

Article 16.1 provides:

> 1. Two or more Member States, the competent authorities of these Member States or the bodies designated by these authorities may by common agreement provide for exceptions to Articles 11 to 15 in the interest of certain persons or categories of persons.

## 42.17 Class 4 contributions

Section 15 SSCBA provides:

> (1) Class 4 contributions shall be payable for any tax year in respect of all profits which—
> (a) are immediately derived from the carrying on or exercise of one or more trades, professions or vocations,
> (b) are profits chargeable to income tax under Chapter 2 of Part 2 of the Income Tax (Trading and Other Income) Act 2005 for the year of assessment corresponding to that tax year and
> (c) are not profits of a trade, profession or vocation carried on wholly outside the UK.
> (2) Class 4 contributions in respect of profits shall be payable—

(a) in the same manner as any income tax which is, or would be, chargeable in respect of those profits (whether or not income tax in fact falls to be paid), and
(b) by the person on whom the income tax is (or would be) charged,
in accordance with assessments made from time to time under the Income Tax Acts.
(3A) Where income tax is (or would be) charged on a member of a limited liability partnership in respect of profits arising from the carrying on of a trade or profession by the limited liability partnership, Class 4 contributions shall be payable by him if they would be payable were the trade or profession carried on in partnership by the members. ...
(5) For the purposes of this section the year of assessment which corresponds to a tax year is the year of assessment (within the meaning of the Tax Acts) which consists of the same period as that tax year.

A trade carried on wholly outside the UK is exempt from class 4 NIC. This is almost impossible for a sole trader, though it may be possible for a partnership.[20] But in such a case the self-employed earner would not be employed in the UK, and so would be exempt anyway.

What about unremitted trading profits of a remittance basis taxpayer? The word "chargeable" is ambiguous in that although all trading profits are strictly chargeable under part 2 ITTOIA, the context may show that unremitted profits of a remittance basis taxpayer, (un)taxed on the remittance basis, do not count as "chargeable".[21] It is considered that that is the case here, so a remittance basis taxpayer pays class 4 NIC on taxable (remitted) profits only. That is consistent with the general scheme of the remittance basis.

## 42.18 Partnerships

Para 4 Sch 2 SSCBA provides:

(1) Where a trade or profession is carried on by two or more persons jointly, the liability of any one of them in respect of Class 4 contributions shall arise in respect of his share of the profits of that trade or profession (so far as immediately derived by him from carrying it on); and for this purpose his share shall be aggregated with his share of the

20 See 13.3 (Trading income of UK resident).
21 See 9.12 (Nature of charge on remitted RFI).

profits of any other trade, profession or vocation (so far as immediately derived by him from carrying it on or exercising it).

(2) Where sub-paragraph (1) above applies, the Class 4 contributions for which a person is liable in respect of the profits of the trade or profession carried on jointly (aggregated, where appropriate, as mentioned in that sub-paragraph) shall be charged on him separately.

CHAPTER FORTY THREE

# CAPITAL GAINS OF INDIVIDUALS

## 43.1 Territorial scope of CGT

### 43.1.1 *"Chargeable" gains*

Section 15(2) TCGA provides:

> Every gain shall, except as otherwise expressly provided, be a chargeable gain.

The expression "chargeable" gain is a label which brings in an uncountable number of rules, for wherever the drafter wishes to provide an exemption, they typically provide that gains of the specified nature are not chargeable. However, the term "chargeable" gain does not bring in a territorial limitation. All gains are in principle "chargeable" gains regardless of residence or domicile of the person to whom the gains accrue.

### 43.1.2 *Territorial scope of CGT*

Section 2(1) TCGA provides:

> [1] Subject to any exceptions provided by this Act, and without prejudice to sections 10 and 276,
> [2] a person shall be chargeable to capital gains tax in respect of chargeable gains accruing to him in a year of assessment
> [a] during any part of which he is resident in the UK, or
> [b] during which he is ordinarily resident in the UK.

This provision refers to a "person" and so applies to individuals and trustees, personal representatives and companies (but companies are taken out of the scope of CGT by the Corporation Tax Acts).

In principle, therefore, a person who is neither resident nor ordinarily resident in the UK during a tax year is not within the charge to CGT. The expression "neither resident nor ordinarily resident" is clumsy and the case of someone who is ordinarily resident but not resident is very rare, maybe wholly theoretical. I generally abbreviate the expression to "non-resident" and leave "and not ordinarily resident" to be understood.

A non-resident person is in principle outside the scope of CGT regardless of domicile and regardless of the situs of the asset disposed of. (By contrast income tax is charged on UK source income, and IHT is charged on UK situate property, regardless of the residence of the individual.)

Section 2[1] TCGA refers to two exceptions to the general rule:

(1) A non-resident trader with a UK branch or agency.[1]

(2) Exploration and exploitation assets on the continental shelf (not discussed in this book).

A third, important, exemption concerns temporary non-residents.[2]

It follows that an individual (wherever domiciled) can in principle avoid CGT if they dispose of an asset in the tax year before they acquires the status of UK resident or ordinarily resident – or if they postpone the disposal until the tax year after they have lost that status. A simple form of CGT planning for an individual whose stay in the UK is a short-term one is not to dispose of assets giving rise to chargeable gains while UK resident.[3]

On years of arrival and departure see 6.16 (CGT statutory split year principle).

## 43.2 CGT remittance basis

Section 12 TCGA provides:

> (1) This section applies to foreign chargeable gains accruing to an individual in a tax year ("the foreign chargeable gains") if—
> (a) s. 809B, 809D or 809E of ITA 2007 (remittance basis) applies to the

1 See 43.8 (Non-resident trader with UK branch).

2 See 8.1 (Temporary non-residence). This is not technically an exception to the general rule, as the legislation does not impose a tax charge on gains accruing to a non-resident. It deems the gains to accrue later when the individual is resident. But it comes to the same thing.

3 See 6.20 (CGT planning – postponing disposals until non-resident).

individual for that year, and
(b) the individual is not domiciled in the UK in that year.
(2) Chargeable gains are treated as accruing to the individual in any tax year in which any of the foreign chargeable gains are remitted to the UK.
(3) The amount of chargeable gains treated as accruing is equal to the full amount of the foreign chargeable gains so remitted in that year.
(4) In this section "foreign chargeable gains" means chargeable gains accruing from the disposal of an asset which is situated outside the UK.
(5) See Chapter A1 of Part 14 of ITA 2007 for the meaning of "remitted to the UK" etc.

The CGT remittance basis applies only to foreign domiciled individuals. (By contrast, the IT remittance basis also applies to individuals who are resident but not ordinarily resident.) The use of the word "individual" means that trustees and personal representatives do not qualify for the remittance basis.

The CGT remittance basis applies to foreign situate assets.[4] (By contrast, the RFI remittance basis applies to foreign source income, which is a different concept.)

What is the position if an individual changes domicile during a tax year? It might be logical if gains accruing during the non-domiciled part of the year qualify for the remittance basis but it is not possible to read s.12(1)(b) to give that result. It is considered that the remittance basis is not available.[5] But in practice perhaps this rarely happens.[6] See too 10.24 (CGT disposal not for market value).

### 43.2.1 *Date of disposal under remittance basis*

The gain is treated as accruing in the tax year of remittance. By implication the gain is to be treated as not accruing on the date of the actual disposal, when it actually accrues. This is relevant to EIS reinvestment relief. The time limits for EIS relief depend on the time that the gain accrued (not the time that the disposal takes place).[7]

4 See 71.1 (Situs of assets for CGT).
5 See 6.2.1 ("Residing in the UK in a tax year" and "for a tax year").
6 See 6.24 (Year of acquisition of UK domicile).
7 Para 1 Sch 5B TCGA 1992.

The time limits for rollover relief depend on the time of disposal.[8] The drafter of the former para 16(4) Schedule A1 TCGA clearly considered that the pre-2008 s.12(1)[e] TCGA altered the time of disposal so that the asset is regarded as disposed of at the time of remittance (not at the time of the actual disposal).[9]

### 43.2.2 *2010 CGT rate increase: transitional rules*

The F(No.2) A 2010 increased the CGT rate from 18% to 28% for gains accruing on or after 23 June 2010. Para 20(1) Sch 1 F(no.2)A 2010 provides:

> Chargeable gains treated as accruing to an individual under section 12(2) of TCGA 1992 (non-UK domiciled individuals to whom remittance basis applies) in the tax year 2010-11 are to be treated for the purposes of this Schedule as accruing on the day the related foreign chargeable gains are remitted.

Thus gains remitted before 23 June 2010 are taxed at 18% and gains remitted between 23 June 2010 and 5 April 2011 are taxed at the rate of 28%. even if the disposal took place before that date.

There is no express transitional rule where a disposal took place before 23 June 2010 and the gains are remitted after 2010/11, eg in 2011/12. The gains are deemed to accrue in the year of remittance so the new rate applies. (The transitional rule was only needed because it would not have been clear when within the tax year remitted gains were deemed to accrue.)

Para 20(2) provided a special rule where nominated gains are remitted:

> For the purposes of sub-paragraph (1), foreign chargeable gains under section 809J of ITA 2007 (section 809I: order of remittances) in the tax year 2010-11 are to be treated as remitted before 23 June 2010.

## 43.3 Interaction of remittance basis and abolition of taper

Para 56 Sch 2 FA 2008 provides:

8 Section 152(3) TCGA 1992.

9 See the 6th edition of this book para 29.4.

(1) The amendments made by para 31(2) and (3) have effect where the intervening year is the tax year 2008-09 or any subsequent tax year.
(2) The amendments made by paras 41 and 43 have effect where the eligible year is the tax year 2008-09 or any subsequent tax year.
(3) The other amendments made by paras 23 to 55 have effect in relation to chargeable gains accruing or treated as accruing in the tax year 2008-09 or any subsequent tax year.

The important provision here is para 56(3).[10] This removes taper and indexation relief on gains on disposals before 2008/09 which are remitted after 2008/09. All computations of unremitted gains made before 2008 will need to be recomputed.

CGT Draft Clauses FAQ provides:

**Q. How will the gain be calculated for a non-domiciled individual with overseas assets if the gain arises in this tax year but is remitted next tax year?**
A. A gain arising to a non-domiciled individual in the current tax year, 2007-08, will be calculated under the usual rules, and [indexation allowance][11] will be available where appropriate. But that gain is chargeable in the next tax year, 2008-09, because the individual remits the gain in that year. No taper relief will be available and the single 18% CGT rate will apply.[12]

### 43.3.1 *Disposals before 2008/09: transitional rules*

Suppose an asset was disposed of before 2008/09 for £300 with an indexed and tapered gain of £100 and an unindexed and untapered gain of £200.

If all the £300 is remitted before 2008/09 then £100 is subject to CGT (at an effective 40% rate).

If all £300 is remitted after 2008/09 then £200 is subject to CGT (at the 18% rate).

---

10 Sub-paras (1) (2) relate to specialist topics, s.56A, 279A and 279B TCGA.

11 *Sic*. Perhaps the author meant to say “taper relief” but confused that with indexation allowance.

12 Accessible *www.hmrc.gov.uk/cgt/faqs-cgt-reform.htm* 24 January 2008 [2008] STI 171.

What happens if (say) £150 is remitted before 2008/09 then £50 is subject to CGT at the then rate. If the remaining £150 is remitted after 2008/09 what happens? The one thing that is pretty certain is that the drafter did not ask himself this question.

## 43.4 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 F had disposed of the shares in consideration of the distribution: s.122 TCGA. The gain is taxable if the liquidator transfers to the shareholder money in the UK. The same applies if the liquidator transfers assets (land or chattels) enjoyed *in specie* here. It should normally be possible to avoid this.

## 43.5 CGT planning: making property non-UK situate

### 43.5.1 *Moveable assets in UK*

Moveable assets could in principle be moved offshore prior to a disposal. Consider whether an export licence is needed.

### 43.5.2 *Unincorporated UK business carried on by foreign domiciliary*

A business could be transferred to a foreign incorporated company under s.162 TCGA and shares later sold. Watch stamp duty. Even if the company were subsequently to become non-resident on emigration of shareholder/directors, no tax would arise except on growth in value since transfer to the company.

### 43.5.3 *Debts*

There are two ways to deal with a UK situate debt on a security. It may be possible to make the asset non-UK situate. It might 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.[13]

## 43.6 Structure for UK trading company

It is not ideal for a foreign domiciled individual to carry on trade through a UK incorporated company which they own absolutely, as a disposal of that asset would give rise to CGT. If the foreign domiciliary does not want to go to the trouble and expense of using an offshore trust, what is the alternative? One possibility is to use a foreign incorporated UK resident company. The shares in the company will not be UK situate for CGT.[14] A possible drawback is that s.720 ITA may apply unless the motive defence can be used.[15] 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 does not carry on a business. With a little care it can be arranged that a holding company does not carry on a business.[16]

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13 See *Chitty on Contracts*, (29th ed, 2008) para 22-028 (Substituted contract).

14 See 71.6 (Registered shares/debentures: non-UK company)

15 See 25.4.1 (Foreign incorporated company) and 29.34 (Transfer to UK resident foreign incorporated company).

16 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

## 43.7 UK resident trust

A UK resident trust is in principle subject to CGT even if the settlor is a foreign domiciliary. One might avoid this problem for the future by exporting the trust (appointing non-resident trustees) but there may in principle be a migration charge.[17] This applies even if the assets are not situated in the UK. The remittance basis does not apply as that only applies to "individuals"; trustees are not individuals.

One solution may be to transfer assets from the trust to foreign domiciled beneficiaries absolutely. Although this involves a disposal by the trustees, it may be possible to claim CGT hold-over relief. The relief applies on a disposition to a UK resident foreign domiciled beneficiary, even though that beneficiary may later be able to dispose of the asset without a CGT charge.

## 43.8 Non-resident traders with UK branch

Section 10 TCGA provides:

> (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

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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).

17 See 7.5 (Liability of trustees for exit charge)

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.

CHAPTER FORTY FOUR

# GAINS OF NON-RESIDENT TRUSTS: S.86

## 44.1 3 May 2011CGT on trusts – Introduction

A trust is in principle treated as a taxable unit. If the trustees are UK resident, they are in principle subject to CGT even if the beneficiaries have no connection with the UK. Non-resident trustees are not subject to CGT[1] even if their beneficiaries are resident in the UK. These rules present an obvious means of CGT avoidance. HMRC's first answer to this is the anti-avoidance rules in ss.86, 87 TCGA. In outline:

(1) A settlor who has an "interest in the settlement" (as widely and artificially defined) is liable to CGT on gains accruing to the non-resident trustees. I refer to this as the "**s.86 charge**".
(2) UK resident beneficiaries of a non-resident trust may be subject to tax if they receive capital payments from the trustees. I refer to this as the "**s.87 charge**".

A full discussion of these provisions requires a long book to itself. The discussion here focuses on the most common issues.

## 44.2 Fundamental s.86 conditions

Section 86(1) TCGA sets out five sets of conditions for s.86 to apply. I refer to these as "**the fundamental s.86 conditions**".

## 44.3 Qualifying settlement

Section 86(1) provides:

1 See 43.1 (Territorial scope of CGT).

> This section applies where the following conditions are fulfilled as regards a settlement in a particular year of assessment—
> (a) the settlement is a qualifying settlement in the year;

"Qualifying settlement" is a label for a set of rules not discussed here. "Settlement" is not expressly defined here so the standard IT/CGT definition applies.

## 44.4 Trustee residence condition

The next s.86 condition is in s.86(1)(b):

> (b) the trustees of the settlement fulfil the condition as to residence specified in subsection (2) below;

This takes us to s.86(2) TCGA which provides:

> The condition as to residence is that—
> (a) the trustees are neither resident nor ordinarily resident in the UK during any part of the year, or
> (b) the trustees are resident and ordinarily resident in the UK during any part of the year, but at any time of such residence and ordinary residence they fall to be regarded for the purposes of any double taxation relief arrangements as resident in a territory outside the UK.

Condition (a) is that the trustees are non resident; for convenience I refer to condition (b) as that the trustees are **"dual resident"**. This is a slightly artificial use for the term "dual resident", which would naturally be used with a slightly wider meaning[2] but it is difficult to think of a better term and no difficulty arises as long as one bears that meaning in mind.

## 44.5 Settlor residence and domicile condition

The next s.86 condition is in s.86(1)(c):

> (c) a person who is a settlor in relation to the settlement ("the settlor"):
> [i] is domiciled in the UK at some time in the year and

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2 On the terminology see 50.2.1 (Types of residence).

[ii] is either resident in the UK during any part of the year or ordinarily resident in the UK during the year;

Section 86 does not apply to a foreign domiciled settlor, whether or not they claim the remittance basis. This is a surprising inconsistency with the general scheme of the FA 2008. Where an individual does not wish to pay the £30,000 remittance basis charge, it may be worthwhile setting up a non-resident trust to ensure that gains are taxed on a s.87 capital payment basis and not on an arising basis.

## 44.6 Settlor-interested condition

The next s.86 condition is in s.86(1)(d):

(d) at any time during the year the settlor has an interest in the settlement;

The term "settlor-interested" in a s.86 context[3] is a label for a complex set of rules which are not discussed here.

If a settlement becomes (or ceases to be) settlor-interested, s.86 TCGA applies for the whole tax year, This is unlike the IT rules (where if a settlor is excluded s.624 ITTOIA ceases to apply from the date of the exclusion).[4] There is reason for the distinction, because the s.86 charge is on gains less losses for the entire year, and splitting the year would involve some trouble. The rule does however mean that CGT planning by excluding the settlor must be carried out well in advance.

## 44.7 Section 86 amount condition

The next s.86 condition is in s.86(1)(e):

(e) by virtue of disposals of any of the settled property originating from the settlor, there is an amount on which the trustees would be chargeable to tax for the year under section 2(2) if the assumption as to residence specified in subsection (3) below were made.

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3 The same term is used in an IT context with a different meaning: see 24.3.1 (The concepts of "settlor-interested").

4 See 24.3.4 (Settlement ceasing to be settlor-interested).

I refer to this as the "**s.86 amount condition**".

### 44.7.1 *Assumption as to residence*

This takes us to s.86(3) TCGA which provides:

> [a] Where subsection (2)(a) above[5] applies, the assumption as to residence is that the trustees are resident and ordinarily resident in the UK throughout the year; and
> [b] where subsection (2)(b) above applies, the assumption as to residence is that the double taxation relief arrangements do not apply.

Para [a] deals with a non-resident trust and para [b] deals with a dual resident trust.

In para [b] the assumption is not in fact an assumption "as to residence": the assumption is a disapplication of treaty relief.

### 44.7.2 *Section 86 amount*

The condition in s.86(1)(e) is merely that there is an amount, which I call "**the s.86 amount**". The quantum of the s.86 amount matters because the amount of the charge depends on that.

Para 1(1) Sch 5 provides:

> In construing section 86(1)(e) as regards a particular year of assessment, the effect of section 3 shall be ignored.

This disapplies the trustee annual exemption (which seems fair because the settlor has their own annual exemption).

## 44.8 Year of death of settlor

The next s.86 condition is in s.86(1)(f):

> Para 3, 4 or 5 does not prevent this section applying.

5 See 44.4 (Trustee residence condition).

This sets out three conditions which are best considered separately.
Para 3 Sch 5 TCGA provides:

> Section 86 does not apply if the settlor dies in the year.

What is the reason for this rule? Presumably it was thought unfair to tax the settlor's estate on post-death gains, and too much trouble to split the year into disposals before/after the death.

## 44.9 Death or divorce of certain beneficiaries

The last two s.86 conditions are set out in paras 4 and 5 Sch 5 TCGA:

> 4(1)This paragraph applies where for the purposes of section 86(1)(d) the settlor has no interest in the settlement at any time in the year except for one of the following reasons, namely, that—
> (a) property is, or will or may become, applicable for the benefit of or payable to one of the persons falling within para 2(3)(b) to (db) above,
> (b) income is, or will or may become, applicable for the benefit of or payable to one of those persons, or
> (c) one of those persons enjoys a benefit from property or income.
> (2) This paragraph also applies where sub-para (1) above is fulfilled by virtue of 2 or all of paras (a) to (c) being satisfied by reference to the same person.
> (3) Where this paragraph applies, section 86 does not apply if the person concerned dies in the year.
> (4) In a case where—
> (a) this paragraph applies, and
> (b) the person concerned falls within para 2(3)(b), (d) or (db) above,
> section 86 does not apply if during the year the person concerned ceases to be married to, or a civil partner of, the settlor, child or grandchild concerned (as the case may be).
> 5 (1) This paragraph applies where for the purposes of section 86(1)(d) the settlor has no interest in the settlement at any time in the year except for the reason that there are 2 or more persons, each of whom—
> (a) falls within para 2(3)(b) to (db) above, and
> (b) stands to gain for the reason stated in sub-para (2) below.
> (2) The reason is that—
> (a) property is, or will or may become, applicable for his benefit or payable to him,
> (b) income is, or will or may become, applicable for his benefit or payable to him,
> (c) he enjoys a benefit from property or income, or
> (d) 2 or all of paras (a) to (c) above apply in his case.

> (3) Where this paragraph applies, section 86 does not apply if each of the persons concerned dies in the year.

I cannot see the point of this, though it does offer a kind of symmetry with para 3. I rather doubt if it ever has applied or ever will apply.

## 44.10 Application of s.86

Assuming all eight fundamental s.86 conditions are satisfied, we proceed to s.86(4) TCGA which provides:

> Where this section applies—
> (a) chargeable gains of an amount equal to that referred to in subsection (1)(e) above shall be treated as accruing to the settlor in the year, ...

## 44.11 Interaction of s.86 and s.13 TCGA

Suppose a settlor-interested trust within s.86 TCGA owns a non-resident company within s.13 TCGA, and a gain accrues to the company. The gain is treated as accruing to the trustees. In the absence of express provision, this gain would not fall within s.86 because the s.86 amount condition would not be satisfied: the gain does not accrue "by virtue of disposals of any of the settled property".[6] The company property is not settled property. Para 1(3) Sch 5 TCGA deals with this:

> In a case where—
> (a) the trustees are participators in a company in respect of property which originates from the settlor, and
> (b) under section 13 gains or losses would be treated as accruing to the trustees in a particular year of assessment by virtue of so much of their interest as participators as arises from that property if the assumption as to residence specified in section 86(3) were made,
>
> the gains or losses shall be taken into account in construing section 86(1)(e) as regards that year as if they had accrued by virtue of disposals of settled property originating from the settlor.

6 See 44.7 (Section 86 amount condition).

## 44.12 Two settlors for CGT s.86 charge

The s.86 charge only applies to disposals of settled property "originating from the settlor". This expression is defined in TCGA Sch 5 para 8: see 69.3.5 (CGT s.86 definition of "settlor").

### 44.12.1 *Two direct settlors: A adds property to B's trust*

The position is straightforward if one individual ("A") creates a trust and another ("B") adds property to it. A and B are both settlors. If A is UK resident and B is non-resident, then A is not subject to CGT under s.86 and B is subject to tax on gains from the funds originating from B.

The same applies if B adds value indirectly to A's trust (eg by a gift to a company held by the trust). B is a "settlor" for s.86 purposes: see 69.14 (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. It relates to s.77 TCGA (repealed 2008) but would still be applicable to s.86:

> **34893. Multiple settlors**
> Section 79 provides that trust gains are only to be attributed to each settlor to the extent that those gains accrue on property originating from that person. Where the assets provided by two or more settlors are managed as separate funds, there should be no difficulty in determining to which settlor the gains on the disposal of particular items of property should be attributed. Where the assets provided by different settlors are not appropriated into separate funds, the legislation provides for a just apportionment as between the settlors.
> **34894. Multiple settlors** [August 2007]
> If HMRC Trusts Head Office Bootle or Financial Intermediaries and Claims Office (formerly Claims Branch) have given advice on apportionment for Income Tax purposes, this should be followed for CGT. Otherwise, if settlors together make the settlement, the gains in such a case should be apportioned according to the amounts each put in. If a settlor adds to a settlement, then the amount put in should be compared with the value of the settlement at that time. Trust Offices should endeavour to reach a fair and easily worked solution.
> **34895. Multiple settlors**
> If one settlor is within Section 79 and the other is not, the gains are apportioned on the lines suggested, but those relating to the settlor who is outside Section 79 are assessed on the trustees in the normal way after deducting the trustees' annual exempt amount.
> **34900. Example 1** [April 2010]
> A and B each settle ordinary shares in X Limited on a trust under which both Mrs A and Mrs B have an interest as defined by the new provisions. A settles

500 such shares and B 1500. It is accepted that there is only one settlement for CGT purposes and the shares are not appropriated into separate funds.
In 1988-89 there is a gain of £2,000 on the sale of some of the shares, a loss of £400 on the sale in 1989/90 of further shares and in 1990-91 a gain of £500 on the sale of shares in Y Limited acquired with the sale proceeds of the shares in X Limited.
In 1988-89, as A and B settled property in the proportion 1:3, there is, on a just apportionment, a chargeable gain of £500(2000×1/4) accruing to A.
Similarly a gain of £1500 is treated as accruing to B. Each is assessed as appropriate.
The loss of £400 in 1989-90 is apportioned £100 to A and £300 to B.
The gain of £500 in 1990-91 is apportioned £125 to A and £375 to B.
The loss of £100 in respect of the property provided by A is set against the gain of £125, leaving a net gain of £25 to be attributed to A. Similarly the loss of £300 in respect of the property provided by B is set against the gain of £375 on the property provided by him, leaving a net gain of £75 assessable on B.
**34901. Example 2** [April 2010]
The facts are as in Example 1 except that by a deed executed during 1988-89 Mrs B irrevocably excludes herself from the class of beneficiaries. The gains of that year are apportioned and attributed as before because Mrs B had an interest in the settlement at some time during the year. The losses of 1989-90 and the gains of 1990-91 are apportioned in the same way, and the net gains of £25 for 1990-91 are attributed to A.
There can be no attribution to B in 1990-91 because neither he nor his spouse has an interest in the settlement in that year. Accordingly the gains on the assets deriving from the property provided by B are assessable on the trustees and the trustees can claim the annual exemption due to them. If this exceeds the gains of 1990-91 (£375), the losses brought forward of £300 do not need to be set against those gains, see CG18030. The losses of £300 will instead be carried forward and set against subsequent gains accruing on disposals of the settled property which derives from B, again making a just apportionment of the trust gains.

### 44.12.2 *Direct and indirect settlors*

The position is less clear where there is an arrangement under which:
(1) A makes a gift of property to B, and
(2) B gifts the property to a trust.
It seems at first that there are two settlors, an indirect settlor ("A") and a direct settlor ("B").[7] Both have provided the *same* property. No issue arises if A and B are both non-resident. What is the position if they are both UK resident? There is no clear provision how to apportion the gains between A and B and, since the gains cannot be subject to tax twice, it is

7 See 69.4 (Gift from A to B followed by gift to trust by B).

considered 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. The best solution to the problem is to identify a "real" settlor (presumably B) and infer that A is not to be regarded as the settlor.

If A is UK resident and B is not (or *vice versa*) there is no double charge, but the argument just about still runs that A (the UK settlor) cannot be taxed; though in these circumstances the argument is less meritorious and one would not like to rely on it.

This issue usually arises in the context of failed tax planning of the kind discussed at 69.33 (Planning to create trust with foreign domiciled settlor).

If A is not UK resident and B is UK resident there is no double charge. B might argue that B is not the "real" settlor. In practice this factual situation should not arise.

## 44.13 Interaction of ss.86 and 87 TCGA

In the absence of relief, a gain accruing to a trust may be attributed to the settlor under s.86(4) and a s.2(2) amount under s.87(2). Section 87(4)(b) TCGA provides relief for s.87 and so prevents double taxation:

> (4) The section 2(2) amount for a settlement for a tax year for which this section applies to the settlement is—
> (a) the amount upon which the trustees of the settlement would be chargeable to tax under section 2(2) for that year if they were resident and ordinarily resident in the UK in that year, or
> (b) if section 86 applies to the settlement for that year, the amount mentioned in paragraph (a) minus the total amount of chargeable gains treated under that section as accruing in that year.

I refer to this as "**s.86 current year credit**". In short, s.86 in principle has priority over s.87.

## 44.14 Corporate settlor

It is considered that s.86 TCGA does not apply to a company even if it does create a settlor-interested settlement and is the settlor. The context suggests that only individuals are intended to be caught. It appears that

HMRC may not accept this view.[8] The issue rarely arises in practice. In these cases HMRC may instead look to see if the shareholders are settlors.[9]

## 44.15 Role of non-resident trusts from 2008

Non-resident trusts may be useful where:

(1) s.86 TCGA does not apply; and
(2) the trust holds:
  (a) UK situate property; or
  (b) companies within s.13 TCGA which hold UK situate property.

For if the trust property is held by beneficiaries directly, disposals of the UK situate property are chargeable on an arising basis; if the same property is held on a trust, disposals by the trustees are taxable on a capital payments basis.

## 44.16 UK resident trust

A UK resident trust is in principle subject to CGT even if the settlor is a foreign domiciliary. This applies even if the assets are not situated in the UK. The remittance basis does not apply as that only applies to "individuals"; trustees are not individuals.

One might avoid this problem for the future by exporting the trust (appointing non-resident trustees) but there may in principle be a migration charge.[10]

One solution may be to transfer assets from the trust to foreign domiciled beneficiaries absolutely. Although this involves a disposal by the trustees,

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8 The CG Manual provides:

> "**35020. Trusts for employees**
>
> There is nothing in Section 77 [TCGA] itself to prevent it being applied to a company. In particular, where a company has set up a settlement for its employees, the deed may provide that if all the trusts fail, the property may revert to the company. The most common cases are share option schemes and unapproved pension schemes."

Section 77 TCGA was repealed in 2008, the issue for s.86 is similar. For a further discussion, see Kessler & Brown, *Taxation of Charities and Non-Profit Organisations*, (8th ed, 2011) para 20.2.2 (Loan by company).

9 See 69.32 (Trust made by company: are shareholders settlors?).

10 See 7.5 (Liability of trustees for exit charge).

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.

## 44.17 Rates of tax on s.86 charge

Para 21 Sch 1 F(No.2) A 2010 provides:

> Chargeable gains treated as accruing to a settlor under section 86(4)(a) of TCGA 1992 (attribution of gains to settlors with interest in non-resident or dual resident settlements) in the tax year 2010-11 are to be treated for the purposes of this Schedule as accruing before 23 June 2010.

This preserves the 18% rate for the whole of 2010/11. I am not quite sure why when in most other cases the year is divided into gains accruing before or after 23 June 2010, but settlors of settlor-interested non-resident trusts will not complain.

CHAPTER FORTY FIVE

# GAINS OF NON-RESIDENT TRUSTS: S.87

## 45.1 The s.87 charge – Introduction

This chapter considers the CGT charge on beneficiaries under s.87 TCGA, which I call the "**s.87 charge**". The charge is supplemented by a further charge in s.89 TCGA but I use the expression "s.87 charge" loosely to refer to both charges.

The FA 2008 rewrote the s.87 charge. In the following discussion the "**pre-2008 s.87**" means the section as it was before the 2008 amendments.

"**HMRC s.87 guidance note**" means the 54 page guidance note, first published 8 May 2009, 2nd version October 2009, entitled "FA 2008 changes to the CGT charge on beneficiaries of non-resident settlements".

### 45.1.1 *Cross references*

For s.87 gains accruing to charity, see Kessler & Brown, *Taxation of Charities and Non-Profit Organisations* (8th ed, 2011), Chap. 30 (Payments to charity from non-resident trusts).

For losses, see 48.6 (Disallowance of personal losses against s.87 gains) and 48.5 (Loss accruing to non-resident trustees).

For OIG s.87, see 32.12 (OIG s.87 charge).

For DT issues, see 50.19 (DT reliefs: s.87 TCGA).

## 45.2 "Settlement" and "trustee"

### 45.2.1 *"Settlement"*

Section 97(7) TCGA provides:

> In sections 86A to 96 and Schedule 4C and in this section—

> "settlement" has the meaning given by section 620 of ITTOIA 2005, and
> "settled property" and references (however expressed) to property comprised in a settlement shall be construed accordingly.

"Settlement" here means settlement-arrangement.

The estate of a deceased person is not a settlement-arrangement.[1]

In practice one is normally concerned with trusts in the classic sense. That is just as well, as the problems raised by other types of settlement (which I call **"non-trust settlement-arrangements"**) such as a foundation, have not been fully thought through.

### 45.2.2 *"Trustee" of non-trust settlement-arrangement*

A problem arises for an entity which is a settlement-arrangement (and so a settlement for s.87 purposes) but which (not being a classic settlement) has no trustees in the normal (trust law) sense of the word. For s.87 purposes one needs to identify trustees because:

(1) one needs to ascertain trustee residence;[2]
(2) one needs to identify s.2(2) amounts (trust gains), which are the amounts on which "the trustees of the settlement" would be chargeable to tax under s.2(2) if they were resident in the UK.

Accordingly s.97(7A) TCGA provides:

> [a] In this section, sections 86A to 96 and Schedule 4C "trustee", in relation to a settlement in relation to which there would be no trustees apart from this subsection, means any person in whom the settled property or its management is for the time being vested ... [3]

When this extended sense applies, I use the word "trustees" (using scare quotation marks).

An example is a Liechtenstein stiftung (foundation). The "trustees" are (a) the foundation itself (a body corporate in which the "settled property"

1 See 67.6.1 (Is an estate a "settlement" within s.87 TCGA?).
2 See 45.3 (Non-resident settlement condition).
3 There is a similar definition for IHT. Section 45 IHTA provides:
"In this Act "trustee", in relation to a settlement in relation to which there would be no trustees apart from this section, means any person in whom the settled property or its management is for the time being vested."

is vested) or (b) the members of the board of management (in whom its management is vested).

What about a civil law usufruct? There is no need for the s.87 rules: under ordinary principles the gain can come into charge on a disposal by the usufructuary or by the encumbered owner but since a usufruct is in principle a settlement-arrangement, what reason can one find that s.87 does not apply? The answer is that there is nothing which one can identify as "settled property". There are two items of property, one belonging to the usufructuary and the other belonging to the bare owner. So it is considered that there are no "trustees" and a usufruct is not within the scope of s.87.

### 45.2.3 *2006 transitional rules?*

Section 97(7A) was introduced by para 15 Sch 12 FA 2006. Para 15(3) provides:

> This paragraph shall come into force on 6th April 2006 (in relation to settlements whenever created).

This raises the interesting possibility that s.87 did not apply to a foundation[4] before 2006 as a foundation has no "trustees" in the normal (trust law) sense. But it is suggested that the context shows that the word "trustee" should be construed widely enough to include a foundation (bear in mind that the word "settlement" is given the wide and artificial meaning of settlement-arrangement). Section 97(7A) is only for the avoidance of doubt and the law before 2006 was the same as now.

## 45.3 Non-resident settlement condition

Section 87(1) TCGA sets out the fundamental condition for the application of s.87:

> This section applies to a settlement for a tax year ("the relevant tax year") if the trustees are neither resident nor ordinarily resident in the UK in that year.

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4 Or any other settlement-arrangement which was not a classic settlement and so had no trustees in the strict sense.

Statute often refers to a settlement "to which s.87 applies"; from 1998/99 this means (in short) a non-resident settlement. In full, it means:

(1) a non-resident settlement; or
(2) a dual resident (more accurately, domestic-law UK resident treaty non-resident) settlement.[5]

### 45.3.1 *Residence of "trustee" of non-trust settlement-arrangement*

Section 97(7A) TCGA provides:

> [a] ... "trustee", in relation to a settlement in relation to which there would be no trustees apart from this subsection, means any person in whom the settled property or its management is for the time being vested
> [b] (and a person who is treated as a trustee of the settlement by virtue of this subsection shall be treated as a trustee of the settlement for the purposes of section 69).

The effect of s.97(7A)[b] is that the s.69 trustee test of residence applies.
In the case of a foundation, the "trustees" are (a) the foundation itself or (b) the members of the board of management. The residence of (a) and (b) will normally be the same so there is no need to consider the analysis if they were resident in different places but one would presumably look to the foundation itself, as that is the person (a body corporate) to which gains accrue on a disposal of foundation property.

## 45.4 The s.87 charge

Section 87(2) TCGA provides:

> [a] Chargeable gains are treated as accruing in the relevant tax year to a beneficiary of the settlement
> [b] who has received a capital payment from the trustees in the relevant tax year or any earlier tax year
> [c] if all or part of the capital payment is matched (under s.87A as it applies for the relevant tax year) with the s.2(2) amount for the relevant tax year or any earlier tax year.

5 See 45.17 (Dual resident trust).

The key terms here are "capital payment" "s.2(2) amount" and "matching". I refer to gains treated as accruing as "**deemed s.87 gains**".

A deemed s.87 gain accrues in the year that a capital payment is matched with a s.2(2) amount. That may be later than the year that the capital payment is made.

Section 87 is not strictly a charging section, it feeds into s.2 TCGA which imposes the charge. It is nevertheless convenient to use the expression "s.87 charge" as a shorthand.

## 45.5 Section 2(2) amount

Section 87(4) TCGA provides:

> The s.2(2) amount for a settlement for a tax year for which this section applies to the settlement is—
> (a) the amount upon which the trustees of the settlement would be chargeable to tax under s.2(2) for that year if they were resident and ordinarily resident in the UK in that year, or
> (b) if s.86 applies to the settlement for that year, the amount mentioned in para (a) minus the total amount of chargeable gains treated under that section as accruing in that year.

The term "s.2(2) amount" has more or less the same meaning as the term "trust gains" in the pre-2008 s.87. The old terminology was clearer, and EN FB 2008 itself uses the term "trust gains." It is usually better to adopt statutory terminology, rather than using a different term with the same meaning as a statutory defined term. However "s.2(2) amount" is so opaque that I sometimes clarify it by using the phrase *"s.2(2) amounts (trust gains)."* Some practitioners use the term "stockpiled gains" or describe a trust as having a pool of s.2(2) amounts.

There is a s.2(2) amount *for a tax year*: ie each s.2(2) amount must be linked to a specific tax year. The expression "s.2(2) amounts" (in the plural) is used to refer to the case where there are s.2(2) amounts for more than one tax year.

Section 87(4)(b) TCGA deals with the interaction of ss.86 and 87. Gains treated as accruing to the settlor under s.86 are deducted in computing the s.2(2) amount. This avoids double taxation.

Section 87(5) TCGA provides:

> The s.2(2) amount for a settlement for a tax year for which this section does not apply to the settlement is nil.

This makes sense, of course, since if s.87 does not apply the trustees must be UK resident and within the scope of CGT.

### 45.5.1 *Annual exemption*

HMRC say:

> The trustees compute gains as if they were resident in the UK. Any exemptions and reliefs due to resident trustees are included in this computation. But no annual exempt amount is available...[6]

The last sentence is wrong, as s.3 TCGA (extended to trustees by sch 1 TCGA) provides that trustees "shall not be chargeable to CGT" on the exempt amount. So "the amount upon which the trustees would be chargeable to tax under s.2(2) for that year if they were resident" is reduced by the exempt amount. The Courts might disapply the plain words if the result were absurd, but it is not absurd. One could even say it was sensible. Of course, there is not much tax at stake here.

### 45.5.2 *s.2(2) amount of foundation or other non-trust settlement-arrangement*

A foundation is in principle a settlement-arrangement and so a settlement for s.87 purposes. What is the s.2(2) amount, ie the amount on which the "trustees" of the settlement would be chargeable under s.2(2) if they were UK resident? If the "trustees" are the members of the board of the foundation, the amount is nil as no gains accrue to them. Assuming (which is a better analysis) the "trustees" are the foundation itself, the position would be that the foundation would be subject to CT and so at first sight, the amount chargeable under s.2(2) would be nil! The answer is that s.97(7A)[b][7] applies s.69 TCGA, which deems the "trustees" to be

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6 "HMRC Residency: Non-resident trusts" published online at *www.hmrc.gov.uk/cnr/nr_trusts.htm* on 1 April 2008. The document is referring to the pre-2008 legislation (it became out of date 5 days after publication) but the current legislation is the same on this point.

7 See 45.3.1(Residence of "trustee" of non-trust settlement-arrangement).

a separate person which not a company; though one could reach the same result by construction even without reference to that provision.[8]

## 45.6 Capital payment

### 45.6.1 *Definition of capital payment*

"Capital payment" is defined in s.97(1) TCGA:

> In sections 86A to 96 and Schedule 4C and this section "capital payment" —
> (a) means
> [i] any payment which is not chargeable to income tax on the recipient
> [ii] or, in the case of a recipient who is neither resident nor ordinarily resident in the UK, any payment received otherwise than as income...[9]

### 45.6.2 *"Chargeable to income tax"*

What is the position if a remittance basis taxpayer receives income from a non-resident discretionary trust which is not remitted? It is considered that the income is "chargeable" to income tax even if no tax is paid because of the remittance basis.[10] Otherwise there could be double

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8 *de Rothschild v Lawrenson* 67 TC 300.

9 As to what is an income/capital receipt from a trust, see 22.8 (Payment from discretionary trust: income or capital?).

10 Before 2005 the former s.65 ICTA drew a distinction between a "charge" and a "computation;" unremitted income was described as "chargeable" even though ignored in the computation of the charge. This is still the case: ITTOIA imposes a charge on all RFI and the remittance basis only affects the amount on which the charge is made. See 9.12 (Nature of charge on remitted RFI).
It was assumed by the drafter of s.37 TCGA (consideration chargeable to tax on income) that unremitted foreign income is "charged" to income tax. Otherwise there would be a charge to CGT on unremitted income of an asset to which the RFI remittance basis applies but the CGT remittance basis does not apply. That would apply to a UK domiciled and resident but not ordinarily resident individual. Another example would be income accruing to a foreign domiciliary from an asset which was UK situate for CGT purposes, but a foreign income source for income tax purposes. It is true that the word "chargeable" takes its meaning from the context, and in some contexts unremitted income is not regarded as chargeable to IT. But the context

taxation, a s.87 deemed gain and an IT charge on remittance of the income. Also whenever a trust distributed income to a UK resident foreign domiciliary before 2008/09 it made a "capital payment" (and reduced s.2(2) amounts); that would be very odd.

Similarly a benefit which is within s.731, or within s.731 subject to the s.731 remittance basis, is not a capital payment.[11]

Similarly, if a settlor within s.624 receives a payment of income from a non-resident discretionary trust, that is not a capital payment. There is no income on receipt of the payment, but the sum is treated for all purposes of income tax to be the income of the settlor and that deeming should be applied in order to determine whether the payment is chargeable to income tax for the purposes of the definition of capital payment.

Similarly, if a settlor within the s.624 remittance basis receives a payment of income from a non-resident discretionary trust, (applying the mixed fund rules to determine what is income): the payment is taxable on remittance, so is not a capital payment.

Similarly, if a transferor within s.720 receives a payment of income taxable under s.720, or if a transferor within the s.720 remittance basis receives a payment of income (applying the mixed fund rules to determine what is income): the payment is taxable on remittance, so is not a capital payment. (This issue arises in the exceptional case of a trust within s.720 and not within s.624, and in the more common case of a payment from a company held by the trust.)

### 45.6.3 *"Payment"*

Section 97(2) TCGA provides:

> In subsection (1) above references to a payment include references to
> [a] the transfer of an asset and
> [b] the conferring of any other benefit, and to
> [c] any occasion on which settled property becomes property to which s.60 applies.

The issues overlap with s.731 ITA so for the meaning of "benefit" see 27.4 (Benefit) and for valuation see 27.5 (Valuation of benefits).

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shows that is not the case here.

11 See 27.11 (Is a benefit within s.731 a capital payment?).

### 45.6.4 *Arm's length transaction*

Section 97(1) TCGA provides:

> In sections 86A to 96 and Schedule 4C and this section "capital payment"—
> (b) does not include a payment under a transaction entered into at arm's length if it is received on or after 19th March 1991.

It is considered that a transaction at arm's length could not be a capital payment at all, and this provision was inserted only for the avoidance of doubt; even if (contrary to my view) it were a capital payment, the amount of the payment would normally be nil. But the issue now will not often arise.

### 45.6.5 *Termination of settlement*

The termination of a settlement constitutes a capital payment, so any s.2(2) amounts at that time will be attributed to the beneficiaries who become entitled to the trust property: s.97(2)[c] TCGA. This rule should not, in practice, affect well drafted settlements, whose life may extend for a century or more. If action is taken in time it will generally be possible to extend the life of poorly drafted settlements by appropriate exercise of trustees' powers. Trustees should if appropriate diarise the date when the settlement may come to an end so as to take action beforehand.

## 45.7 Receipt from the trustees

The s.87 charge applies where a beneficiary has received a capital payment from the trustees. There are two requirements here: a *receipt,* and a receipt *from the trustees.*

Section 97(5) TCGA expands on both these concepts:

> For the purposes of sections 86A to 90 and Schedule 4C a capital payment shall be regarded as received by a beneficiary from the trustees of a settlement if—
> (a) he receives it from them directly or indirectly, or
> (b) it is directly or indirectly applied by them in payment of any debt of his or is otherwise paid or applied for his benefit, or
> (c) it is received by a third person at the beneficiary's direction.

On the general meaning of "receipt" see 27.6 (Who is the recipient of a benefit?).

### 45.7.1 *Indirect receipt from trustees*

In *Herman v HMRC* [2007] STC (SCD) 571 there was an arrangement under which:

(1) Trust 1 transferred funds to trust 2.

(2) Trust 2 transferred the funds to a beneficiary ("B").

The Special Commissioner held that B had received funds directly from trust 2[12] *and* indirectly from trust 1. This is an unsatisfactory decision, because parts of the reasoning are obviously flawed;[13] because of its casual disregard of double taxation; but most of all because no attempt was made to explain where a capital payment is or is not received indirectly from trustees, thus leaving taxpayers (and indeed HMRC) none the wiser in other cases:

> 21 The right approach, I think, is to make an enquiry, using whatever signposts appropriate to the circumstances are available, and to determine whether the receipts of [B] can *properly* be linked to the disposition from [trust 1] as their indirect source.

Of course this begs the question of what is meant by the evaluative term *properly.*

> An obvious *signpost* will be the existence of a plan, if there is one. In the present circumstances the appointment by the trustees of [trust 1] was in pursuance of a scheme ...; it will be relevant to the enquiry to determine whether the plan as a whole envisaged that [B] should receive the amounts that they did. If the relevant receipt resulted by accident or on account of circumstances not envisaged by the scheme, then the linkage *may* not be there.

This is too tentative. A plan of the kind found in *Herman* is not the signpost but the end of the matter; conversely if the receipt resulted by accident (assuming trusts have accidents) then the linkage cannot be there.

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12 [2007] STC (SCD) 571 at [17].

13 In particular, the reliance on *West v Trennery* at [17]; see below.

> The second signpost is to analyse the trust law and determine whether [trust 2] "served as a vehicle to receive and continue the act of bounty effected by" the trustees[14] of [trust 1] (see the words of Lord Walker in para 41 of *West v Trennery*)...

This is misconceived, for *all* transferee trusts "serve as a vehicle to receive and continue the act of bounty" effected by the settlor of the transferor trust.

The better view is that *Herman* was wrongly decided. If however it is regarded as right (and adopting the jurisprudence of legal realism, the temptation to knock down the tax avoidance scheme involved may prove irresistible) there is no point in looking to the decision to find the test of when a payment from trust 2 should also be regarded as an indirect payment from trust 1. The guidance is not there. We are therefore thrown back to first principles. On that basis it is considered that the concept of indirect receipt should be limited to cases where there is a tightly drawn up scheme (as in *Herman*) under which (in the absence of the most unlikely changes of circumstances) payments are inevitably to be made from trust 1 to trust 2, and from trust 2 to the beneficiary. The scheme of s.90 TCGA (and the double taxation consequences from any other view) show that this is the case.

## 45.8 Capital payments from companies

Section 96(1) TCGA provides:

> Where a capital payment is received from a qualifying company which is controlled by the trustees of a settlement at the time it is received, for the purposes of sections 87 to 90 and Schedule 4C it shall be treated as received from the trustees.

This is perhaps needed because s. 87 only applies if a beneficiary receives a capital payment from the trustees. It might perhaps have been argued that receipt from the company is not receipt indirectly from the trustees though if the trustees controlled the company, the argument seems somewhat implausible.

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14 "Trustees" is a slip for settlor, for the trustees do not confer any bounty.

### *45.8.1 Qualifying company*

Section 96(6) TCGA provides:

> For the purposes of subsection (1) above a qualifying company is a close company or a company which would be a close company if it were resident in the UK.

### *45.8.2 Controlled by the trustees*

Section 96 TCGA provides:

> (7) For the purposes of subsection (1) above a company is controlled by the trustees of a settlement if it is controlled by the trustees alone or by the trustees together with a person who (or persons each of whom) falls within subsection (8) below.
> (8) A person falls within this subsection if—
> (a) he is a settlor in relation to the settlement, or
> (b) he is connected with a person falling within paragraph (a) above.

### 45.8.3 *"Control"*

Section 96(10) TCGA defines control with a slightly non-standard meaning:

> (10) For the purposes of this section—
> (a) the question whether a company is controlled by a person or persons shall be construed in accordance with sections 450 and 451 of CTA 2010, but in deciding that question for those purposes no rights or powers of (or attributed to) an associate or associates of a person shall be attributed to him under section 451(4) to (6) of CTA 2010 if he is not a participator[15] in the company;

## 45.9 Capital payments to companies

Section 96(2) TCGA provides:

15 "Participator" has the standard meaning. Section 96(10) TCGA provides: "For the purposes of this section ... (b) 'participator' has the meaning given by section 454 of CTA 2010."

> Where a capital payment is received from the trustees of a settlement (or treated as so received by virtue of subsection (1) above) and it is received by a non-resident qualifying company, the rules in subsections (3) to (6) below shall apply for the purposes of sections 87 to 90 and Schedule 4C.

The rules in ss. (3)-(6) depend on whether
(1) the company is controlled by one person alone.
(2) the company is controlled by 2 or more persons (taking each one separately).
(3) the company is controlled by 2 or more persons (taking them together).
Section 96 provides:

> (3) If the company is controlled by one person alone at the time the payment is received, and that person is then resident or ordinarily resident in the UK, it shall be treated as a capital payment received by that person.
> (4) If the company is controlled by 2 or more persons (taking each one separately) at the time the payment is received, then—
> (a) if one of them is then resident or ordinarily resident in the UK, it shall be treated as a capital payment received by that person;
> (b) if 2 or more of them are then resident or ordinarily resident in the UK ("the residents") it shall be treated as being as many equal capital payments as there are residents and each of them shall be treated as receiving one of the payments.
> (5) If the company is controlled by 2 or more persons (taking them together) at the time the payment is received-
> (a) it shall be treated as being as many capital payments as there are participators in the company at the time it is received, and
> (b) each such participator (whatever his residence or ordinary residence) shall be treated as receiving one of the payments, quantified on the basis of a just and reasonable apportionment,
> but where (by virtue of the preceding provisions of this subsection and apart from this provision) a participator would be treated as receiving less than one-twentieth of the payment actually received by the company, he shall not be treated as receiving anything by virtue of this subsection.

### *45.9.1 Non-resident qualifying company*

Section 96(9) TCGA provides:

> For the purposes of subsection (2) above a non-resident qualifying company is a company which is not resident in the UK and would be a close company if it were so resident.

### 45.9.2 *Interaction with temporary non-residence rules*

Section 96 TCGA provides:

> (9A) For the purposes of this section an individual shall be deemed to have been resident in the United Kingdom at any time in any year of assessment which in his case is an intervening year for the purposes of section 10A.
> (9B) If—
> (a) it appears after the end of any year of assessment that any individual is to be treated by virtue of subsection (9A) above as having been resident in the United Kingdom at any time in that year, and
> (b) as a consequence, any adjustments fall to be made to the amounts of tax taken to have been chargeable by virtue of this section on any person,
>
> nothing in any enactment limiting the time for the making of any claim or assessment shall prevent the making of those adjustments (whether by means of an assessment, an amendment of an assessment, a repayment of tax or otherwise).

### 45.9.3 *Disregard of capital payments to companies*

These are odd rules, to say the least. As often happens, the anomalies may favour the taxpayer. Section 87C TCGA was brought in to counteract this. It provides:

> (1) For the purposes of sections 87 and 87A as they apply in relation to a settlement, no account is to be taken of a capital payment (or a part of a capital payment) within subsection (2).
> (2) A capital payment is within this subsection if (and to the extent that) it is received (or treated as received) in a tax year from the trustees of the settlement by a company that—
> (a) is not resident in the UK in that year, and

(b) would be a close company if it were resident in the UK,
(and is not treated under any of subsections (3) to (5) of section 96 as received by another person).

SP 5/92 para 18 provides:

> In general, transactions between trustees and companies which they, directly or indirectly, wholly own, or between such companies, are … not treated as capital payments within TCGA 1992 s 97.

The paragraph sets out a commonsense definition of "wholly owned" and concludes with a qualification:

> This approach may not, however, be taken where, on the facts of a particular case, it appears that the transaction has been entered into solely or mainly for the purposes of obtaining a UK tax advantage.

## 45.10 Matching

### 45.10.1 *Why does matching matter?*

The matching of capital payments with s.2(2) amounts is important for many reasons:

(1) *Time of charge:* The deemed s.87 gains accrue in the year that a capital payment is matched with a s.2(2) amount.
(2) *Amount of charge:* The amount of the s.87 deemed gain is the amount of the capital payment or the amount matched, if less.
(3) *Which beneficiaries come into charge:* if
 (a) more than one beneficiary receives capital payments, and
 (b) there are not enough s.2(2) amounts to match all the capital payments
 the question which capital payment is matched with a s.2(2) amount makes all the difference as to which beneficiary receives deemed s.87 gains.
(4) *Which capital payments come into charge:* if
 (a) one beneficiary receives more than one capital payment, some in and some outside the UK; and
 (b) there are not enough s.2(2) amounts to match all the capital payments

the question which capital payment is matched with a s.2(2) amount matters for the remittance basis. If a UK benefit is matched, there is a charge; if a non-UK benefit is matched, the s.87 remittance basis offers a defence to the charge.

(5) *The interest surcharge,* which depends on the time gap between a capital payment and the s.2(2) amount with which it is matched.

(6) *2008 transitional relief,* which applies where post-2008 capital payments are matched to pre-2008 s.2(2) amounts.

Matching is carried out on a LIFO (last in first out) basis. EN FB 2008 provides a summary:

> 452. Where the s.2(2) amount is equal to or greater than the capital payments then all the capital payments are matched:
> [1] any surplus s.2(2) amount is carried back to the year preceding the current tax year and any unmatched capital payments of that earlier year are matched to the surplus s.2(2) amount;
> [2] any surplus s.2(2) amount is carried back to the preceding year and matched with unmatched capital payments of that year, and so on, until the s.2(2) amount has been reduced to nil or there are no unmatched capital payments left in any earlier year; and
> [3] any surplus s.2(2) amount left after matching to previous years is available to match against future capital payments.
> 453. Where the amount of capital payments for the latest relevant tax year is greater than the s.2(2) amount for that year, then the surplus capital payments are carried back in the same way as surplus s.2(2) amounts, matching the surplus capital payments against the unmatched trust gains of each earlier year, starting with the latest year first and only moving back to an earlier year where there are no unmatched trust gains left in the later year. Any capital payments that remain unmatched are carried forward from the current tax year to be matched against the s.2(2) amounts of future years. ...
> 455. Note that:
> [1] the matching rules are modified by new subs.(4) of s.762 ICTA in relation to offshore income gains; and
> [2] capital payments are matched to trust gains within a given tax year on a pro rata basis, not on a daily basis.

The rules changed from a FIFO to a LIFO basis in 2008. HMRC did not state why they made this change. I surmise that it was done to minimise the benefit of 2008 transitional relief, which applies if post-2008 capital payments are matched with pre-2008 s.2(2) amounts. The old rule would have maximised the benefit of the relief, so that very large trusts with substantial s.2(2) amounts may have been free of CGT for a substantial period of time. Had the reason been given, there might have been some debate about whether the benefit justified the change, but as it was, there was none. But there it is.

### 45.10.2 *The statute*

Section 87A TCGA provides:

> (1) This section supplements s.87.
> (2) The following steps are to be taken for the purposes of matching capital payments with s.2(2) amounts.
> *Step 1*
> Find the s.2(2) amount for the relevant tax year.
> *Step 2*
> Find the total amount of capital payments received by the beneficiaries from the trustees in the relevant tax year.

Armed with these figures we proceed to the matching rule:

> *Step 3*
> The s.2(2) amount for the relevant tax year is matched with—
> (a) if the total amount of capital payments received in the relevant tax year does not exceed the s.2(2) amount for the relevant tax year, each capital payment so received, and
> (b) otherwise, the relevant proportion of each of those capital payments.
> "The relevant proportion" is the s.2(2) amount for the relevant tax year divided by the total amount of capital payments received in the relevant tax year.

I refer to a case within (a) as a "**surplus s.2(2) amount**" and a case within (b) as a "**surplus capital payment**".

The next step is a recomputation of the s.2(2) amount and of the amount of capital payments

> *Step 4*
> [1] If para (a) of Step 3 applies—

That is, if there is a surplus s.2(2) amount—

(a) reduce the s.2(2) amount for the relevant tax year by the total amount of capital payments referred to there, and
(b) reduce the amount of those capital payments to nil.

I refer to the s.2(2) amount after this reduction as "**the unmatched s.2(2) amount**".

[2] If para (b) of that Step applies—

That is the case of a surplus capital payment—

(a) reduce the s.2(2) amount for the relevant tax year to nil,
and
(b) reduce the amount of each of the capital payments referred to there by the relevant proportion of that capital payment.

I refer to the amount of the capital payments after this deduction as "**the unmatched capital payments**".

Then one starts again at the beginning, but with modifications:

*Step 5*
[1] Start again at Step 1 (unless subs.(3) applies).
[2] If the s.2(2) amount for the relevant tax year (as reduced under Step 4) is not nil, read references to capital payments received in the relevant tax year as references to capital payments received in the latest tax year which—
(a) is before the last tax year for which Steps 1 to 4 have been undertaken, and
(b) is a tax year in which capital payments (the amounts of which have not been reduced to nil) were received by beneficiaries.

I again refer to a case within step 5[2] (where there is an unmatched s.2(2) amount) as a "**surplus s.2(2) amount**".

Amended as step 5[2] directs, Steps 1-4 become:

*Step 1*
Find the s.2(2) amount for the relevant tax year [ie the unmatched s.2(2) amount].
*Step 2*
Find the total amount of capital payments received by the beneficiaries from the trustees ~~in the relevant tax year~~ *in the latest tax year which—*

(a) *is before the last tax year for which Steps 1 to 4 have been undertaken, and*

(b) *is a tax year in which capital payments (the amounts of which have not been reduced to nil) were received by beneficiaries.*

*Step 3*

The s.2(2) amount for the relevant tax year is matched with—

(a) if the total amount of capital payments received ~~in the relevant tax year~~ *in the latest tax year which—*

*(a) is before the last tax year for which Steps 1 to 4 have been undertaken, and*

*(b) is a tax year in which capital payments (the amounts of which have not been reduced to nil) were received by beneficiaries.*

does not exceed the [unmatched ] s.2(2) amount for the relevant tax year, each capital payment so received, and

(b) otherwise, the relevant proportion of each of those capital payments.

"The relevant proportion" is the [remaining] s.2(2) amount for the relevant tax year divided by the total amount of capital payments received ~~in the relevant tax year~~ *in the latest tax year which—*

*(a) is before the last tax year for which Steps 1 to 4 have been undertaken, and*

*(b) is a tax year in which capital payments (the amounts of which have not been reduced to nil) were received by beneficiaries.*

*Step 4*

If para (a) of Step 3 applies—

(a) reduce the [unmatched] s.2(2) amount for the relevant tax year by the total amount of capital payments referred to there, and

(b) reduce the amount of those capital payments to nil.

If para (b) of that Step applies—

(a) reduce the [unmatched] s.2(2) amount for the relevant tax year to nil, and

(b) reduce the [unmatched] amount of each of the capital payments referred to there by the relevant proportion of that capital payment.

Eventually the unmatched s.2(2) amount is reduced to nil (ie all the s.2(2) amount is matched). Then step 5[2] ceases to apply. The journey then takes us to step 5[3]:

*Step 5*

[3] If the s.2(2) amount for the relevant tax year (as so reduced) is nil, read references to the s.2(2) amount for the relevant tax year as the s.2(2) amount for the latest tax year—

(a) which is before the last tax year for which Steps 1 to 4 have been undertaken, and

(b) for which the s.2(2) amount is not nil.

I refer to a case within step 5[3] as a "**surplus capital payment**". This is a case where:

(1) there is no unmatched s.2(2) amount for the relevant year;

(2) there is a s.2(2) amount for an earlier year.

Amended as step 5[3] directs, steps 1-4 become:

> *Step 1*
>
> Find the s.2(2) amount ~~for the relevant tax year~~ *for the latest tax year —*
>
> *(a) which is before the last tax year for which Steps 1 to 4 have been undertaken, and*
>
> *(b) for which the s.2(2) amount is not nil.*
>
> *Step 2*
>
> Find the total amount of capital payments received by the beneficiaries from the trustees in the relevant tax year.
>
> *Step 3*
>
> The s.2(2) amount ~~for the relevant tax year~~ *for the latest tax year—*
>
> *(a) which is before the last tax year for which Steps 1 to 4 have been undertaken, and*
>
> *(b) for which the s.2(2) amount is not nil*
>
> is matched with—
>
> (a) if the total amount of capital payments received in the relevant tax year does not exceed the s.2(2) amount ~~for the relevant tax year~~, *for the latest tax year—*
>
> *(a) which is before the last tax year for which Steps 1 to 4 have been undertaken, and*
>
> *(b) for which the s.2(2) amount is not nil.*
>
> each capital payment so received, and
>
> (b) otherwise, the relevant proportion of each of those capital payments.
>
> "The relevant proportion" is the s.2(2) amount ~~for the relevant tax year~~ *for the latest tax year—*
>
> *(a) which is before the last tax year for which Steps 1 to 4 have been undertaken, and*
>
> *(b) for which the s.2(2) amount is not nil.*
>
> divided by the total amount of capital payments received in the relevant tax year.
>
> *Step 4*
>
> If para (a) of Step 3 applies—
>
> (a) reduce the s.2(2) amount ~~for the relevant tax year~~ *for the latest tax year—*
>
> *(a) which is before the last tax year for which Steps 1 to 4 have been undertaken, and*
>
> *(b) for which the s.2(2) amount is not nil.*
>
> by the total amount of capital payments referred to there, and
>
> (b) reduce the amount of those capital payments to nil.
>
> If para (b) of that Step applies—
>
> (a) reduce the s.2(2) amount ~~for the relevant tax year~~ *for the latest tax year—*
>
> *(a) which is before the last tax year for which Steps 1 to 4 have been undertaken, and*

> *(b) for which the s.2(2) amount is not nil.*
>
> to nil, and
>
> (b) reduce the amount of each of the capital payments referred to there by the relevant proportion of that capital payment.

## 45.10.3 *When to stop*

Section 87A(3) TCGA (incorporated at step 5[1]) states when one can stop repeating these steps:

> This subsection applies if—
>
> (a) all of the capital payments received by beneficiaries from the trustees in the relevant tax year or any earlier tax year have been reduced to nil, or
>
> (b) the s.2(2) amounts for the relevant tax year and all earlier tax years have been reduced to nil.

That is, one stops when there are no unmatched capital payments or s.2(2) amounts.

Section 87A(4) TCGA provides:

> The effect of any reduction under Step 4 of subsection (2) is to be taken into account in any subsequent application of this section.

That seems self-evident.

## 45.10.4 *HMRC example: surplus s.2(2) amount*

EN FB 2008 provide two examples. *Text in italics represents HMRC comments:*

> ***56. Section 87A: Example 1: section 2(2) amount is greater than the total amount of capital payments for latest tax year:***
>
> The facts assumed in the example are as follows:
>
> *2008-09: no surplus trust gains or surplus capital payments*

| ***Year*** | ***Capital payment*** | ***s.2(2) amount*** |
|---|---|---|
| *2009-10:* | *£100k* | *nil* |
| *2010-11:* | *£200k* | *nil* |
| *2011-12:* | *£500k* | *nil* |
| *2012-13:* | *£500k* | *£2m* |

I set out the text of the relevant steps in the analysis.

> *Step 1*
> Find the s.2(2) amount for the relevant tax year.
> *Step 2*
> Find the total amount of capital payments received by the beneficiaries from the trustees in the relevant tax year.

The relevant tax year is 2012/13 and we can take the figures from the table.

We move on to step 3. There is (in my terminology) a surplus s.2(2) amount, because "the total amount of capital payments received in the relevant tax year" (£500k) does not exceed "the s.2(2) amount for the relevant year" (£2m). Accordingly:

> *Step 3*
> The s.2(2) amount for the relevant tax year is matched with—
> (a) ... each capital payment so received,

Thus step 3 states that £2m (the s.2(2) amount for 2012/13) is matched with the £500k capital payment. There are two difficulties with this. First, the charge in s.87(2) requires us to ask whether the *capital payment* is matched with the s.2(2) amount, and step 3 tells us that the *s.2(2) amount* is matched with the capital payment. The answer is that matching is by implication a reflexive operation, ie if A is matched with B, then B is matched with A.

Secondly, applying step 3 literally, the capital payment (£500k) is matched with the *entire* s.2(2) amount (£2m). This does not matter because s.87(3) TCGA restricts the charge to the amount of the capital payment. In order to follow s.87(3) one needs to read it together with s.87(2):

> (2) Chargeable gains are treated as accruing in the relevant tax year to a beneficiary of the settlement who has received a capital payment from the trustees in the relevant tax year or any earlier tax year if all or part of the capital payment is matched (under s.87A as it applies for the relevant tax year) with the s.2(2) amount for the relevant tax year or any earlier tax year.
> (3) The amount of chargeable gains treated as accruing is equal to—
> (a) the amount of the capital payment, or

(b) if only part of the capital payment is matched, the amount of that part.

But the HMRC analysis is as follows:

*Match as follows:*
*a. 2012-13 capital payments £500,000 match to £500,000 gains.*

The HMRC analysis (wisely) does not try to refer to the statutory steps which authorise this conclusion. (Indeed, there is no reason to think that the author of the HMRC example read the legislation.) But the end result is the same.

We move on to step 4. Ours is a surplus capital payment case, so step 4 provides:

*Step 4*
If para (a) of Step 3 applies—
(a) reduce the s.2(2) amount for the relevant tax year by the total amount of capital payments referred to there, and
(b) reduce the amount of those capital payments to nil.

So our revised table becomes:

| ***Year*** | ***Capital payment*** | ***s.2(2) amount*** |
|---|---|---|
| *2009-10:* | *£100k* | *nil* |
| *2010-11:* | *£200k* | *nil* |
| *2011-12:* | *£500k* | *nil* |
| *2012-13:* | *£0 ~~£500k~~* | *£1.5 ~~£2m~~* |

The HMRC analysis is as follows:

*[1] 2012-13 capital payments reduced to nil.*
*[2] Unmatched 2012-13 trust gains reduced to £1.5 million.*
*[3] Refer unmatched trust gains to preceding year.*

Point [1] is correct. Points [2] and [3] are a fair paraphrase.

Our journey takes us to step 5:

*Step 5*
[1] Start again at Step 1 (unless subsection (3) applies).
[2] If the s.2(2) amount for the relevant tax year (as reduced under Step

> 4) is not nil, read references to capital payments received in the relevant tax year as references to capital payments received in the latest tax year which—
> (a) is before the last tax year for which Steps 1 to 4 have been undertaken, and
> (b) is a tax year in which capital payments (the amounts of which have not been reduced to nil) were received by beneficiaries.

There is still a surplus s.2(2) amount (the s.2(2) amount for the relevant tax year is not nil, it is now £1.5m).

We revert to step 2 which now reads:

> *Step 2*
> Find the total amount of capital payments received by the beneficiaries from the trustees ~~in the relevant tax year~~ *in the latest tax year which—*
> *(a) is before the last tax year for which Steps 1 to 4 have been undertaken, and*
> *(b) is a tax year in which capital payments (the amounts of which have not been reduced to nil) were received by beneficiaries*

The "latest tax year" is now 2011-12 and we can take the figures from the revised table.

We move on to step 3. This is a surplus s.2(2) amount case, because "the total amount of capital payments received in the latest tax year" (£500k) does not exceed "the s.2(2) amount for the relevant year" (£1.5m). Accordingly:

> *Step 3*
> The s.2(2) amount for the relevant tax year is matched with—
> (a) ... each capital payment so received,

Thus step 3 states that £1.5m (the unmatched s.2(2) amount) is matched with the £500k capital payment. But the HMRC analysis is as follows:

> *b. 2011-12 unmatched capital payments £500,000 match to £500,000 gains.*

As noted, this is a loose paraphrase of step 3, but it does not matter.

We move on to step 4. Ours is a step 3(a) case, so step 4 provides:

> *Step 4*
> If para (a) of Step 3 applies—
> (a) reduce the s.2(2) amount for the relevant tax year by the total amount of capital payments referred to there, and
> (b) reduce the amount of those capital payments to nil.

So:
(a): reduce the s.2(2) amount for the relevant year thus: £1.5m-£500k = £1m.
(b): reduce the capital payment for the latest year [2011-12] to nil.
The HMRC analysis is as follows:

> *2011-12 capital payments reduced to nil.*
> *Unmatched 2012-13 trust gains reduced to £1 million.*
> *Refer unmatched trust gains to preceding year.*

The process repeats once again, but "the latest tax year" now becomes 2009-10. It is not necessary to set out the steps. The reader will by now have the idea. The HMRC analysis (or paraphrase) is as follows:

> *2010-11 unmatched capital payments £200,000 match to £200,000 gains.*
> *2010-11 capital payments reduced to nil.*
> *Unmatched 2012-13 trust gains reduced to £800,000.*
> *Refer unmatched trust gains to preceding year.*

The process repeats once again, but "the latest tax year" now becomes 2009-10. It is not necessary to set out the steps. The HMRC analysis (or paraphrase) is as follows:

> *d. 2009-10 unmatched capital payments £100,000 match to £100,000 gains.*
> *2010-11 capital payments reduced to nil.*
> *Unmatched 2012-13 trust gains reduced to £700,000.*
> *Refer unmatched trust gains to preceding year.*

At this point s.87A(3) TCGA applies because "all of the capital payments received by beneficiaries from the trustees in the relevant tax year or any earlier tax year have been reduced to nil". Accordingly the steps come to an end. The HMRC analysis is:

*e. No unmatched capital payments in 2008-09 or earlier years.*

Lastly, the HMRC analysis provides:

*Carry forward unmatched trust gains of 2012-13 of £700,000 to be matched against capital payments of 2013-14 and subsequent years.*

This is a reference to step 1 as amended by step 5[3] but the point does not actually arise under the facts of the HMRC example.

It is noteworthy that in order to deal with the facts of the HMRC example (which is a simplication of the facts of a typical case in real life because there is only one s.2(2) amount) one has to carry out 15 steps.

### 45.10.5 *HMRC example: surplus capital payment*

HMRC's second example is as follows

***57. Section 87A: Example 2: capital payments are greater than section 2(2) amount for latest tax year: The facts assumed in the example are as follows:***

*2008-09: no surplus trust gains or surplus capital payments*

| ***Year*** | ***Capital payment*** | ***s.2(2) amount*** |
|---|---|---|
| *2009-10:* | *nil* | *£100k* |
| *2010-11:* | *nil* | *£200k* |
| *2011-12:* | *nil* | *£500k* |
| *2012-13:* | *£2m* | *£500k* |

I set out the text of the relevant steps in the analysis.

*Step 1*
Find the s.2(2) amount for the relevant tax year.
*Step 2*
Find the total amount of capital payments received by the beneficiaries from the trustees in the relevant tax year.

The relevant tax year is 2012/13 and we can take the figures from the table.

We move on to step 3. There is (in my terminology) a surplus capital payment because "the total amount of capital payments received in the relevant tax year" (£2m) does exceed "the s.2(2) amount for the relevant year" (£500k). Accordingly:

> *Step 3*
> The s.2(2) amount for the relevant tax year is matched with—
> (b) ... the relevant proportion of each of those capital payments.

"The relevant proportion" is the s.2(2) amount for the relevant tax year (£500k) divided by the total amount of capital payments received in the relevant tax year (£2m) = 0.25.

Thus step 3 states that £500k (the s.2(2) amount) is matched with one quarter of the capital payment = £500k. As noted, the charge in s.87(2) requires us to ask whether the *capital payment* is matched with the s.2(2) amount, and step 3 tells us that the *s.2(2) amount* is matched with the capital payment. The solution is that matching is a reflexive operation, ie if A is matched with B, then B is matched with A.

The HMRC analysis is as follows:

> *Match as follows:*
> *a. 2012-13 capital payments £500,000 match to £500,000 gains.*

We move on to step 4. Ours is a surplus capital payment case, so step 4 provides:

> *Step 4*
> [2] If para (b) of that Step [step 3] applies—
> (a) reduce the s.2(2) amount for the relevant tax year to nil, and
> (b) reduce the amount of each of the capital payments referred to there by the relevant proportion of that capital payment.

So our revised table becomes:

| **Year** | **Capital payment** | **s.2(2) amount** |
|---|---|---|
| 2009-10: | nil | £100k |
| 2010-11: | nil | £200k |
| 2011-12: | nil | £500k |
| 2012-13: | £1.5 ~~£2m~~ | £0 ~~£500k~~ |

The HMRC analysis is as follows:

*Unmatched 2012-13 capital payments reduced to £1.5 million.*
*Refer unmatched capital payments to preceding year.*

Our journey takes us to step 5.

> *Step 5*
> [1] Start again at Step 1 (unless subs.(3) applies)....
> [3] If the s.2(2) amount for the relevant tax year (as so reduced) is nil, read references to the s.2(2) amount for the relevant tax year as the s.2(2) amount for the latest tax year—
> (a) which is before the last tax year for which Steps 1 to 4 have been undertaken, and
> (b) for which the s.2(2) amount is not nil.

This is a surplus capital payment case, (the s.2(2) amount for 2012–13 is now nil).

We revert to step 3 which now reads:

> *Step 3*
> The s.2(2) amount ~~for the relevant tax year~~ *for the latest tax year—*
> *(a) which is before the last tax year for which Steps 1 to 4 have been undertaken, and*
> *(b) for which the s.2(2) amount is not nil*
> is matched with—
> (a) if the total amount of capital payments received in the relevant tax year does not exceed the s.2(2) amount ~~for the relevant tax year~~, *for the latest tax year—*
> *(a) which is before the last tax year for which Steps 1 to 4 have been undertaken,*
> *(b) for which the s.2(2) amount is not nil.*
> each capital payment so received, and
> (b) otherwise, the relevant proportion of each of those capital payments.
> "The relevant proportion" is the s.2(2) amount ~~for the relevant tax year~~ *for the latest tax year*
> *(a) which is before the last tax year for which Steps 1 to 4 have been undertaken,*
> *(b) for which the s.2(2) amount is not nil*
> divided by the total amount of capital payments received in the relevant tax year.

The "latest tax year" is now 2011-12. This is a surplus capital payment case because "the total amount of capital payments received in the relevant tax year" (now £1.5m) does exceed "the s.2(2) amount for the latest year" (£500k). Accordingly:

> *Step 3*
> The s.2(2) amount for the latest tax year is matched with—
> (b) ... the relevant proportion of each of those capital payments.

The relevant proportion is one third.

The process repeats again and again. It is not necessary to set out the steps. The reader will by now have the idea. The HMRC analysis (or paraphrase) is as follows:

> *2012-13 trust gains reduced to nil.*
> *b. 2011-12: match 2012-13 capital payments £1.5 million to £500,000 gains.*
> *2011-12 trust gains reduced to nil.*
> *Unmatched 2012-13 capital payments reduced to £1 million.*
> *Refer unmatched capital payments to preceding year.*
> *c. 2010-11: match 2012-13 capital payments £200,000 to £200,000 gains.*
> *2010-11 trust gains reduced to nil.*
> *Unmatched 2012-13 capital payments reduced to £800,000.*
> *Refer unmatched capital payments to preceding year.*
> *d. 2009-10: match 2012-13 capital payments £100,000 to £100,000 gains. 2010-11 trust gains reduced to nil.*
> *Unmatched 2012-13 capital payments reduced to £700.000.*
> *Refer unmatched capital payments to preceding year.*
> *e. No unmatched trust gains in 2008-09 or earlier years.*
> *Carry forward unmatched capital payments of 2012- 13 of £700,000 to be matched against trust gains of 2013-14 and subsequent years.*

It is noteworthy that in order to deal with the facts of the HMRC example (which is a simplication of the facts of a typical case in real life for there is only one capital payment in five years) one has to carry out 15 steps.

### 45.10.6 *Year of death of beneficiary*

If a beneficiary dies in a tax year, all gains accruing to the trustees in that year are s.2(2) amounts, which can be matched to capital payments made to the beneficiary, even post-death gains. However gains of a subsequent tax year cannot be matched. Section 87 does not say so expressly but the beneficiary could not be subject to CGT on s.87 deemed gains, as the charge is limited to UK residents (s.2 TCGA) and a deceased person is not resident in the UK. That has to be the rule: otherwise it could happen that an estate of a beneficiary who received capital payments could not be completely administered, as there might be a possibility of gains accruing at any time in the future.

Contrast the rule for s.86 which does not apply to gains accruing to the trustees in the year that the settlor dies, even pre-death gains.[16] Perhaps the reason for the s.87 rule is that it works (slightly) more fairly when two beneficiaries receive capital payments in a tax year and one of them dies during that year.

### 45.10.7 *Commentary: step-based drafting*

The pre-2008 s.87 provided:

> *(4) Subject to the following provisions of this section, the trust gains for a year of assessment shall be treated as chargeable gains accruing in that year to beneficiaries of the settlement who receive capital payments from the trustees in that year or have received such payments in any earlier year.*
> *(5) The attribution of chargeable gains to beneficiaries under subsection (4) above shall be made in proportion to, but shall not exceed, the amounts of the capital payments received by them.*
> *(6) A capital payment shall be left out of account for the purposes of subsections (4) and (5) above to the extent that chargeable gains have by reason of the payment been treated as accruing to the recipient in an earlier year.*

No reader who labouriously works through the almost endless iterative steps of s.87A will consider the new style of wording is an improvement on the old. I first speculated whether the legislation was drafted by someone who trained to write computer programs rather than legislation. The correct explanation seems to be that "step-based drafting" was an innovation of the tax law rewrite project in the search for new and clearer methods of drafting; the drafter of the FA 2008 sought to adopt the same technique, but in more clumsy hands the technique delivered obscurity rather than clarity.

16 See 44.8 (Year of death of settlor).

This does not necessarily mean that step-based drafting is a bad technique, but it certainly demonstrates how it can be used to bad effect. Finance Bills are generally drafted in a hurry (the FA 2008 was a mad panic) and clarity was a victim of the process.

The fundamental problem however is not the drafting, but the need to match capital payments with trust gains for a year.

## 45.11 Planning by matching

Matching is a rough and ready rule and trustees need to plan carefully to avoid unfairness.

### 45.11.1 *Planning to obtain remittance basis*

Suppose:

(1) Years 1–10: A beneficiary ("B") occupies a UK house held by a trust. This is a capital payment.

(2) Year 11: The house is sold for £1m gain and a s.2(2) amount arises.

In principle the s.2(2) amount in year 11 is matched with the capital payments in years 1–10. The deemed s.87 gain is taxed on an arising basis of the benefit received in the UK. If B is UK resident in year 11, this is an expensive matter. Suppose:

(3) Year 11: The trustees make a capital payment of £1m to B outside the UK.

The s.2(2) amount is matched with the £1m capital payment and the deemed s.87 gain is taxed on the remittance basis.

### 45.11.2 *Planning to avoid interest surcharge*

Since the surcharge matches on a LIFO basis, the charge can be avoided by realising gains in the year that any capital payment is made, so as to frank any capital payment with current year gains. If gains are not actually realised, the rules in schedule 4B TCGA make it fairly easy to realise deemed gains which will do just as well.[17]

17 See 46.1 (Borrowing by non-resident trust: Sch 4B TCGA).

## 45.12 Capital payment received by non-beneficiary

Chargeable gains are treated as accruing in the relevant tax year to *a beneficiary of the settlement* who has received a capital payment from the trustees.

One might think that the charge only applies to beneficiaries so if a capital payment is made to a non-beneficiary there is no charge. However, s.97(8) TCGA provides:

> In a case where—
>
> (a) at any time on or after 19th March 1991 a capital payment is received from the trustees of a settlement or is treated as so received by virtue of section 96(1),
>
> (b) it is received by a person, or treated as received by a person by virtue of section 96(2) to (5),
>
> (c) at the time it is received or treated as received, the person is not (apart from this subsection) a beneficiary of the settlement, and
>
> (d) subsection (9) or (10) below does not prevent this subsection applying,
>
> for the purposes of sections 86A to 90 and Schedule 4C the person shall be treated as a beneficiary of the settlement as regards events occurring at or after that time.

The drafting is clumsy: the charge applies to a beneficiary but every person is treated as a beneficiary: it would have been easier just to say that the charge applies to a person! One can identify four permutations:

| Case No. | Time of capital payment | Time deemed gain accrues |
|---|---|---|
| 1 | B | B |
| 2 | NB | B |
| 3 | B | NB |
| 4 | NB | NB |

Key: B: Beneficiary
NB: Non-beneficiary

Case 1 (beneficiary status at all times) is caught by s.87(2) directly.

Cases 2 and 4 (not a beneficiary at time of capital payment) are caught by s.87(8). This leaves case 3: the individual is a beneficiary at the time of the capital payment but not when the s.87 deemed gain accrues.

Section 97(8) does not apply because the condition in s.97(8)(a) does not apply. It is considered that s.87(2) should be construed widely so as to catch this case, otherwise there would be a strange anomaly in the legislation.

### 45.12.1 *Exceptions*

There are two exceptions to the rule in s.97(8). Section 97(9) TCGA provides:

> Subsection (8) above shall not apply where a payment mentioned in para
> (a) is made in circumstances where it is treated (otherwise than by subsection (8) above) as received by a beneficiary.

I cannot understand this.

Section 97(10) provides:

> Subsection (8) above shall not apply so as to treat—
> (a) the trustees of the settlement referred to in that subsection, or
> (b) the trustees of any other settlement,
> as beneficiaries of the settlement referred to in that subsection.

## 45.13 Interest surcharge

Section 91(1) TCGA provides:

> This section applies if—
> (a) chargeable gains are treated under s.87 or 89(2) as accruing to a beneficiary by virtue of the matching (under s.87A) of all or part of a capital payment with the s.2(2) amount for a tax year ("the relevant tax year"),
> (b) the beneficiary is charged to tax by virtue of that matching, and
> (c) the capital payment was made more than one year after the end of the relevant tax year.

It is not enough that chargeable gains to accrue to a beneficiary, and that the beneficiary is charged to tax; this must be "by virtue of the matching". But since gains never accrue unless there is matching, and the beneficiary is never charged unless there is matching, the words appear to be otiose. Section 91 continues to deal with part matching:

> (1A) Where part of a capital payment is matched, references in subsections (2) and (3) to the capital payment are to the part matched.

We then turn to the tax increase:

> (2) [a] The tax payable by the beneficiary in respect of the payment shall be increased by the amount found under subsection (3) below,
> [b] except that it shall not be increased beyond the amount of the payment;
> [c] and an assessment may charge tax accordingly.

Para 2[b] stops the Treasury increasing the rate of tax beyond 100%. One would hope it is not necessary.

Para 2[c] is otiose.

Section 91 continues to set out the amount of the increase:

> (3) The amount is one equal to the interest that would be yielded if an amount equal to the tax which would be payable by the beneficiary in respect of the payment (apart from this section) carried interest for the chargeable period at the rate of 10 per cent per annum.

Thus we have a notional 10% interest – the rate bears no relation to actual interest rates – for a period called a chargeable period.

> (4) The chargeable period is the period which—
> (a) begins with the later of the 2 days specified in subsection (5) below, and
> (b) ends with 30th November in the year of assessment following that in which the capital payment is made.
> (5) The 2 days are—
> (a) 1st December in the tax year immediately after the relevant tax year, and
> (b) 1st December falling 6 years before 1st December in the year of assessment following that in which the capital payment is made.

Thus the chargeable period cannot exceed 6 years and the maximum surcharge is 60% of the tax. As the top CGT rate is 28% the maximum rate of tax on a capital payment is therefore 44.8%.

I call this the "**interest surcharge.**" It is not in fact interest but the wording is designed to give it the some of the appearance of interest.

For completeness, the Treasury may alter the rules;[18] but they have never done so.

What is the position if the s.87 remittance basis applies? Section 12(2) TCGA (applied by s.87B TCGA, discussed below) provides:

> Chargeable gains are treated as accruing to the individual in any tax year in which any of the foreign [deemed, s.87] chargeable gains are remitted to the UK.

One might argue that there is no interest surcharge, because the gains are not charged to tax by virtue of matching; they are charged by virtue of the remittance. But the better view is the charge applies (by reference to the year of capital payment, not by reference to the year of remittance), and this is the HMRC view: see 45.15.1 (HMRC examples).

### 45.13.1 *Commentary*

What is the reason for the interest surcharge? It is to counter the perceived advantage that UK trusts pay CGT on an arising basis, but non-resident trusts (outside s.86) pay CGT on a capital payments basis, which is more favourable. But it works very oddly and unfairly, particularly after the extension of s.87 to foreign domiciled settlors and beneficiaries in 2008. For instance, consider a trust set up some years ago by an Australian for Australian beneficiaries; one beneficiary comes to the UK and receives a capital payment here. Why should there be a surcharge?

Following the 2008 reforms the surcharge is not likely to bring in sufficient tax to justify the complications that it causes. The case for repeal of the rule is very strong.

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18 Section 91 TCGA continues:

"(6) The Treasury may by order substitute for the percentage specified in subsection (3) above (whether as originally enacted or as amended at any time under this subsection) such other percentage as they think fit.

(7) An order under subsection (6) above may provide that an alteration of the percentage is to have effect for periods beginning on or after a day specified in the order in relation to interest running for chargeable periods beginning before that day (as well as interest running for chargeable periods beginning on or after that day)."

## 45.14 Non-resident beneficiary

It does not matter that s.87 deemed gains accrue to a beneficiary who is non-resident (unless the temporary non-residence rules apply) since the gains are not subject to CGT. But the time which matters is when the gains accrue, so the matching rules need to be considered and pose something of a trap.

Suppose:

(1) Year 1: A capital payment is made to a beneficiary ("B") when B is non-resident. There are no s.2(2) amounts so that the capital payment is not matched.

(2) Year 2: A s.2(2) amount accrues when B is UK resident.

The capital payment is matched in year 2, so the s.87 deemed gain is chargeable (subject to the s.87 remittance basis).

### 45.14.1 *Planning for beneficiary coming to UK*

This problem arises if a beneficiary has an unmatched capital payment before coming to the UK. In this situation the trustees should trigger gains in year 1. The capital payment will then be matched in year 1, and will not come into charge in year 2.

### 45.14.2 *Commentary*

It is suggested that (subject to the temporary non-residence rules) a gain accruing to a non-resident should not come into charge. The charge only affects those who fail to take the necessary planning, and in many of those cases it is likely that it will be overlooked or tacitly ignored by non-compliant taxpayers.

## 45.15 Section 87 remittance basis

Before 2008/09 a beneficiary who is not domiciled in the UK was altogether exempt from the s.87 charge regardless of their residence and regardless of the domicile of the settlor. This rule was abolished from 2008/09. Section 87B TCGA provides a relief which I call the "**s.87 remittance basis**". Section 87B(1) provides:

> This section applies if—
> (a) chargeable gains are treated under s.87 as accruing to an individual in a tax year,
> (b) s.809B, 809D or 809E (remittance basis) applies to the individual for that year, and
> (c) the individual is not domiciled in the UK in that year.

In short, the relief applies to remittance basis taxpayers. Section 87B(2) provides the relief:

> The chargeable gains are foreign chargeable gains within the meaning of s.12 (non-UK domiciled beneficiaries to whom remittance basis applies).

The effect of s.87B(2) is to incorporate the ITA remittance basis. Section 87B continues:

> (3) For the purposes of Chapter A1 of part 14 of ITA 2007 (remittance basis) treat relevant property or benefits as deriving from the chargeable gains.
> (4) For the purposes of subsection (3) property or a benefit is "relevant" if the capital payment by reason of which the chargeable gains are treated as accruing consists of—
> (a) the payment or transfer of the property or its becoming property to which s.60 applies, or
> (b) the conferring of the benefit.

A rule of this kind is needed because deemed s.87 gains (being fictional) could not be remitted. The drafting of s.87B(4) is somewhat clumsy because a capital payment will always fall within (a) or (b) so every capital payment gives rise to relevant property or benefits. But it does not matter.

A capital payment still reduces the s.2(2) amount even though the payment is (un)taxed under the s.87 remittance basis. This is sensible because other beneficiaries (and the trustees) could not know what the position was.

It does not matter whether the s.2(2) amounts arise on disposals of UK or foreign assets. All that matters is whether the capital payment is remitted to the UK. HMRC agree. FAQ Residence & Domicile – NR trusts provides:

> **Does it make any difference if the assets in the non-resident trust or underlying non-resident company owned by the trust are UK situated?**
> There is no difference in the Capital Gains Tax treatment of UK situated vs foreign situated assets when these are owned by a non-resident trust or underlying non-resident company. However, as under current law, any UK source income produced by the trust or company will be taxed on the UK resident settlor or transferor on an arising basis irrespective of whether he has received any benefit if he has power to enjoy such income at the date it arises.

HMRC s.87 guidance provides:

> 43. The remittance basis applies to the section 87 gain not the gain that created the section 2(2) amount. For example, trustees dispose of an asset held outside the UK creating a section 2(2) amount. In the same year they make a capital payment outside the UK to a non-domiciled beneficiary. The capital payment is matched against the section 2(2) amount. A section 87 gain accrues to the beneficiary who has claimed the remittance basis for that year. The trustees apply the proceeds of the disposal in buying investments in the UK. This remittance of the gain which created the section 2(2) amount is not treated as a remittance of the section 87 gain by the beneficiary.

A capital payment may be remitted to the UK in a year before the s.87 deemed gains accrue, due to the quirky matching rules. Suppose:
(1) Year 1: a beneficiary receives a benefit; there are no s.2(2) amounts so the benefit is not matched and no s.87 deemed gains accrue.
(2) Year 2: the beneficiary remits the benefit to the UK. There is still not tax charge.
(3) Year 3: s.2(2) amounts accrue to the trustees and a deemed s.87 gain accrues to the beneficiary.
This gain is deemed to be remitted in the year it arises (year 3) and not before.[19]

### 45.15.1 *HMRC examples*

HMRC s.87 guidance note provides:

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19 See 10.27 (Remittance before income or gains arise).

**Example 8 – New section 87B - remittance of capital payment: payment**
A is a UK resident and domiciled beneficiary of a non-UK resident settlement. B is a UK resident but non-UK domiciled beneficiary of the same settlement. The settlement owns shares in X Inc. X Inc is an American company registered on the New York Stock Exchange.[20]
In 2008-09 the trustees sell shares in X Inc for $120,000 when the spot rate is £1 = $1.50. The acquisition cost of the shares was $20,000 when spot was also £1 = $1.50. This creates a section 2(2) amount of £66,666 for 2008-09, ie $100,000 @ 1.50.
In 2010-11 the trustees make capital payments of $40,000 into the US bank accounts of each beneficiary. The spot rate of the US dollar at the date of the payment is £1 = $1.75. Chargeable gains of £22,857 accrue to each beneficiary under section 87 in 2010-11 in respect of these capital payments. $40,000 @ $1.75 = £22,857.
At the time of writing the annual exempt amount and rate of Capital Gains Tax are not known for 2010-11 and 2012-13. This example assumes the rate of Capital Gains Tax is 18% for both years and the annual exempt amount was £10,000 in 2010-11 and £11,000 in 2012-13.
Beneficiary A has other gains in 2010-11. The overall position is as follows.

- Section 87 gains £22,857
- Other personal gains £40,000
- Other personal losses £20,000
- Annual exempt amount £10,000

The amount on which Capital Gains Tax is chargeable is £32,857. The personal losses can be set only against the other personal gains but the annual exempt amount is allocated first to the section 87 gain leaving £12,857 of that part of the gain chargeable at 18%. The tax due on £12,857 is £2,314 (£12,857 @ 18%). This is increased by £462 (£2,314 @ 20%) because there is a delay of over one year in making the capital payment.
Beneficiary B claims the remittance basis for 2010-11 and leaves the $40,000 in the US bank account. B also has other gains in 2010-11. These gains and losses arise on the disposal of assets situated in the UK. The overall position is as follows.

- Section 87 gains £22,857
- Other personal gains on UK assets £40,000
- Other personal losses on UK assets £20,000

B does not have an annual exempt amount in 2010-11 because they have claimed the remittance basis. B is not liable to Capital Gains Tax on the section 87 gain of £22,857 because of section 87B. B is liable to CGT at 18% on the full amount of the other net personal gains £20,000.
Because B has claimed the remittance basis they also have to decide whether or not to make an election under section 16ZA TCGA. The effect of that election is allow losses on the disposal of assets situated outside the UK to be set-off against gains, either foreign chargeable gains or gains on the disposal of assets

20 This sentence is irrelevant, as the situs of the asset does not matter for s.87 purposes.

> situated in the UK. Unless the election is made the foreign losses will be lost. An effect of the election is that the annual exempt amount cannot be set foreign chargeable gains remitted to the UK, section 16ZB(4). B makes a valid election within the time limit, 31 January 2017.
> In 2012-13 B remits \$30,000 of the \$40,000 from the US bank to their UK bank where it is converted to sterling at a rate of £1 = \$2.00 ie £15,000. B is not a remittance basis user in 2012-13. The rate of Capital Gains Tax is 18%. The annual exempt amount is £11,000. The remittance is a disposal of foreign currency in the US bank account giving a loss of £2,142 [\$30,000 @ \$2.00 = £15,000 - \$30,000 @ 1.75 = £17,142].
> B is liable to Capital Gains Tax in 2012-13 on the following elements.
> The section 87 gain is a foreign chargeable gain. Section 12(2) and (3) TCGA provides this chargeable gain is treated as accruing in 2012-13 equal to the full amount of the gains remitted in 2012-13. B has remitted 75% of the £22,857 chargeable gain (30,000/40,000×£22,857) = £17,142. Section 2(4) TCGA prevents the personal losses, £2,142, being set against this gain. Because of the election under s16ZA neither can the annual exempt amount be set against this part of the gain. Tax is due at 18% on £17,142 = £3,085. This tax is subject to the increase in section 91 TCGA. This is calculated by reference to the year the gain was matched ie 2010-11 not the year the gain was remitted. The rate charged, 20%, will be the same that applied to beneficiary A. The total tax charged on this part of the gain is £3,085 + £617 = £3,702.
> If B had not made the election under s16ZA the annual exempt amount could be set against the remitted gains reducing the amount liable to the increase under s91. But they would lose the benefit of losses on any assets situated the UK.
> Additionally for 2012-13 B has other personal gains on UK assets of £18,000. Because of the election under s16ZA the personal losses £2,142 can be set against these gains as can the annual exempt amount £11,000. With a tax rate of 18% the total tax charged on the net gains of £4,858 is £971. The total Capital Gains Tax payable for 2012-13 is £4,673 (£3,702 + £971).

The next example concerns capital payments which take the form of benefits (use of accommodation) rather than transfer of cash. Omitting irrelevant detail, the example is as follows:[21]

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21 The example in full, including its irrelevant detail, is as follows:

> "C is a UK resident but non-UK domiciled beneficiary of a non-UK resident settlement. C claims the remittance basis. The settlement owns 100% of the issued share capital of a Gibraltarian holding company which in turn owns 100% of the issued share capital of a Gibraltarian company. That company owns a property in Spain. Both companies are non-UK resident.
> The company sells the property in Spain creating a section 2(2) amount of £120,000 through section 13 TCGA. The company invests some of the proceeds in the purchase of a smaller property in Spain. C is allowed to use the property rent-free. C is also allowed rent-free use of a cottage in Devon owned by the settlement."

*Example 9 - New section 87B - Remittance of capital payment: benefit*
C is a UK resident but non-UK domiciled beneficiary of a non-UK resident settlement. C claims the remittance basis. The settlement has s.2(2) amounts.
The trustees (or underlying companies) allow C to use rent-free:
(1) a property outside the UK and
(2) a property in the UK.

The HMRC analysis is as follows:

The use of both properties by C gives rise to a capital payment equal to the value of the benefit. These capital payments are matched against the section 2(2) amount and a section 87 chargeable gain accrues to C. Section 87B(2) TCGA provides this is a foreign chargeable gain.
The use of the UK property meets condition A in section 809L. Because section 87B(3) TCGA provides the benefits derive from the chargeable gains the use of that property also meets condition B in section 809L(3)(b) ITA 2007. C is treated as remitting the capital payment created [by] the use of the Devon property to the UK and C is liable to CGT on that payment.
The use of the property outside the UK is not treated as a remittance to the UK and C is not liable to CGT on that payment.

## 45.16 Migrant settlements

### 45.16.1 *UK resident trust becomes non-resident*

Section 89(1) TCGA provides:

Where a period of one or more years of assessment for which s.87 applies to a settlement (“a non-resident period”) succeeds a period of one or more years of assessment for each of which s.87 does not apply to the settlement (“a resident period”), a capital payment received by a beneficiary in the resident period shall be disregarded for the purposes of sections 87 and 87A if it was not made in anticipation of a disposal made by the trustees in the non-resident period.

### 45.16.2 *Non-resident trust becomes UK resident*

Section 89 TCGA provides:

(1A) Subsection (2) applies to a settlement if—
(a) a non-resident period is succeeded by a resident period, and
(b) in relation to the last tax year in the non-resident period ("the last non-resident tax year"), s.87A(3) applied by virtue of para (a) of that provision (exhaustion of capital payments).[22]
(2) Chargeable gains are treated as accruing in a tax year (in the resident period) to a beneficiary of the settlement who receives a capital payment from the trustees in that year if all or part of the capital payment is matched (under s.87A as it applies for that year) with the s.2(2) amount for the last non-resident tax year or any earlier tax year.
(3) Section 87(3) and (4) and ss.87A to 87C apply for the purposes of subsection (2) as if the relevant tax year were the tax year mentioned in subsection (2).
(4) Section 87B (remittance basis) applies in relation to chargeable gains treated under subsection (2) as accruing as it applies in relation to chargeable gains treated under s.87 as accruing.

## 45.17 Dual resident trust – s.88 TCGA

In the context of s.88 TCGA, **"dual resident"** is used as a shorthand to describe a trust which is:
(1) domestic-law UK resident; and
(2) treaty-resident in a state with a DTA which has an article conferring CGT relief.

This is a slightly artificial use for the term "dual resident", which would naturally be used with a slightly wider meaning[23] but it is difficult to think of a better term and no difficulty arises as long as one bears that meaning in mind.

A dual resident trust would not be within s.87.[24] This gap is filled by s.88 TCGA:

**88 Gains of dual resident settlements**
(1) Section 87 also applies to a settlement for any year of assessment beginning on or after 6th April 1991 if—
(a) the trustees are resident and ordinarily resident in the UK during any

22 See 45.10.3 (When to stop).
23 On the terminology see 50.2.1 (Types of residence).
24 See 45.3 (Non-resident settlement condition).
For trusts which are not domestic law UK resident but which are treaty non-resident, see 50.19 (DT reliefs: s.87 TCGA).

part of the year, and

(b) at any time of such residence and ordinary residence they fall to be regarded for the purposes of any double taxation relief arrangements[25] as resident in a territory outside the UK.

### 45.17.1 *Revised definition of s.2(2) amount*

The usual definition of s.2(2) amount would not work for a dual resident trust, so s.88 TCGA provides:

> (2) The section 2(2) amount for a tax year for which section 87 applies by virtue of this section is what it would be if the amount mentioned in section 87(4)(a) were the assumed chargeable amount.
> (3) For the purposes of subsection (2) above the assumed chargeable amount in respect of a year of assessment is the lesser of the following 2 amounts—
> (a) the amount on which the trustees would be chargeable to tax for the year under section 2(2) on the assumption that the double taxation relief arrangements did not apply;
> (b) the amount on which, by virtue of disposals of protected assets, the trustees would be chargeable to tax for the year under section 2(2) on the assumption that those arrangements did not apply.

### 45.17.2 *Protected Assets*

Section 88 TCGA provides:

> (4) For the purposes of subsection (3)(b) above assets are protected assets if—
> (a) they are of a description specified in the double taxation relief arrangements, and
> (b) were the trustees to dispose of them at any 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.
> (5) For the purposes of subsection (4) above—
> (a) the assumption specified in subsection (3)(b) above shall be ignored;
> (b) a relevant time is any time, in the year of assessment concerned, when the trustees fall to be regarded for the purposes of the arrangements as resident in a territory outside the UK;

25 For the meaning of this term, see 8.4.3 ("DTR arrangements" – CGT).

(c) if different assets are identified by reference to different relevant times, all of them are protected assets.

45.17.3 *Commentary*

It is best to avoid dual resident (ie, UK domestic law resident, treaty non-resident) trusts because they involve tax in the UK (so far as the treaty does not provide relief), tax in the treaty jurisdiction, and tax liabilities under s.87. In practice such trusts only arise by accident.

## 45.18 Four basic strategies for the s.87 charge

In outline the position is as follows:

45.18.1 *Indefinite deferral*

Beneficiaries are only liable to the s.87 charge if they receive a capital payment. But there may be no need for a capital payment to be made. Instead, the capital of the trust fund may be retained. The beneficiaries of the settlement would enjoy a trust fund unreduced by the burden of CGT. In this way the charge may be postponed until further tax planning becomes possible – or indefinitely.

45.18.2 *Non-resident beneficiary*

Section 2(2) amounts are treated as chargeable gains accruing to a beneficiary who receives capital payments. But a beneficiary who is neither resident nor ordinarily resident in the UK is not subject to CGT on those gains. Such a beneficiary may therefore receive capital payments from the trust tax free, just as they can realise capital gains of their own without incurring any tax charge. The temporary non-residence rules need to be considered, see 8.1 (Temporary non-residence).

45.18.3 *Mixed UK and foreign beneficiaries: simple capital payments*

Section 2(2) amounts which have been matched with a capital payment to a beneficiary in an earlier tax year cease to be available for the purpose of the s.87 charge in the following year. This principle applies whether or not the beneficiary was subject to the s.87 charge. Suppose that s.2(2) amounts are matched with capital payments to a non-resident beneficiary and the capital payments equal the total s.2(2) amounts. Those s.2(2) amounts are sometimes said to have been "washed". In subsequent tax years these are not taken into account and a capital payment may be made to a UK beneficiary without incurring any tax charge under s.87. Careful timing is essential. The payment to the exempt beneficiary must be made in one tax year and the payment to a UK beneficiary must be postponed until the following tax year. Section 2(2) amounts accruing in a subsequent tax year may be taxed on the UK beneficiary.

### 45.18.4 *Mixed UK and foreign beneficiaries: capital payment/resettlement*

If one or more of the beneficiaries of the settlement are not UK resident, the trustees might consider advancing trust capital to those beneficiaries absolutely. The beneficiaries might then independently resettle the property and may gain additional inheritance tax advantages. The CGT position would be substantially improved for the other beneficiaries by washing s.2(2) amounts equal to the advancement. But successfully implementing arrangements of this kind is easier said than done. See 69.33 (Planning to create trust with foreign domiciled settlor).

## 45.19 Transfer between trusts

Section 90(1) TCGA provides:

> This section applies if the trustees of a settlement ("the transferor settlement") transfer all or part of the settled property to the trustees of another settlement ("the transferee settlement").

In short, s.90 applies on a transfer between trusts.

The section only applies on a transfer of trust capital: if trustees of a discretionary trust distribute trust income to another trust, it is suggested that s.90 does not apply, because the income is not "settled property".

Section 90 TCGA provides:

> (3) Treat the s.2(2) amount for the transferee settlement for any tax year

> (not later than the year of transfer)[26] as increased by—
> (a) the s.2(2) amount for the transferor settlement for that year (as reduced under s.87A as it applies in relation to that settlement for the year of transfer and all earlier tax years), or
> (b) if part only of the settled property is transferred, the relevant proportion of the amount mentioned in para (a).
> (4) "The relevant proportion" is—
> (a) the market value of the property transferred, divided by
> (b) the market value of the property comprised in the transferor settlement immediately before the transfer.

Section 90(5) TCGA provides corresponding relief for the transferor settlement:

> Treat the s.2(2) amount for the transferor settlement for any tax year as reduced by the amount by which the s.2(2) amount for the transferee settlement for that year is increased under subs.(3).
> ...
> (7) The increase under subs.(3) has effect for the year of transfer and subsequent tax years.
> (8) The reduction under subs.(5) has effect for tax years after the year of transfer.

It is interesting to compare the technique of s.81 IHTA (deeming transferred property to remain in the original trust). While that is not without its problems, it is a more effective anti-avoidance rule. The reason may be that s.90 is not (or not just) an anti-avoidance provision. It is intended to facilitate inter-trust transfers. Such transfers may be desirable for family reasons or to avoid unfairness which otherwise follows from the operation of s.87. Suppose trustees hold a trust fund worth £2m with s.2(2) amounts of £1m and they wish to make a capital payment of £1m to beneficiary A. If they do so then a subsequent distribution to beneficiary B would be tax free, and that would not be fair as between A and B. A transfer of one half of the trust fund to a separate trust, followed by a capital payment to A, solves this unfairness: A pays tax on one half of the s.2(2) amounts and B in due course may pay tax on the other half.

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26 Section 90(2) TCGA gives this term a commonsense definition: "In this section 'the year of transfer' means the tax year in which the transfer occurs."

Section 90(6) TCGA deals with a transfer to a UK resident settlement:

> If neither s.87 nor s.89(2) would otherwise apply to the transferee settlement for the year of transfer—
> (a) s.89(2) to (4) apply to the settlement for that year (and subsequent tax years), and
> (b) for this purpose, references there to the last non-resident tax year are to be read as the year of transfer.

Amended as s.90(6) directs, s.89(2) to (4) provides:

> (2) Chargeable gains are treated as accruing in a tax year (in the resident period) to a beneficiary of the settlement who receives a capital payment from the trustees in that year if all or part of the capital payment is matched (under section 87A as it applies for that year) with the section 2(2) amount for the ~~last non-resident tax year~~ *year of transfer* or any earlier tax year.
> (3) Section 87(3) and (4) and sections 87A to 87C apply for the purposes of subsection (2) as if the relevant tax year were the tax year mentioned in subsection (2).
> (4) Section 87B (remittance basis) applies in relation to chargeable gains treated under subsection (2) as accruing as it applies in relation to chargeable gains treated under section 87 as accruing.

Section 90(9) TCGA deals with valuation:

> When calculating the market value of property for the purposes of this section or s.90A in a case where the property is subject to a debt, reduce the market value by the amount of the debt.

A transfer between trusts triggers the deadline for a rebasing election.[27]

### 45.19.1 *Transfer for consideration*

Section 90A TCGA provides:

> (1) Section 90 does not apply to a transfer of settled property made for consideration in money or money's worth if the amount (or value) of

27 See 45.28 (Rebasing: the election).

that consideration is equal to or exceeds the market value of the property transferred.

(2) The following provisions apply if—

(a) s.90 applies to a transfer of settled property made for consideration in money or money's worth, and

(b) the amount (or value) of that consideration is less than the market value of the property transferred.

(3) If the transfer is of all of the settled property, for the purposes of s.90 treat the transfer as being of part only of the settled property.

(4) Deduct the amount (or value) of the consideration from the amount of the market value referred to in s.90(4)(a).

Section 90 does not apply to a loan from trust 1 to trust 2 on commercial terms. It does not apply to an interest free loan repayable on demand, because the promise to repay is full consideration.

### 45.19.2 *Interaction with schedule 4B*

Section 90(10) TCGA provides:

This section does not apply to—

(a) a transfer to which Schedule 4B applies, or

(b) any s.2(2) amount that is in a Schedule 4C pool (see para 1 of Schedule 4C).

See 46.1 (Borrowing by non-resident trust: Sch 4B TCGA).

## 45.20 1981 transitional relief

Para 116 Sch 7 FA 2008 provides:

For the purposes of sections 87 and 87A of TCGA 1992, no account is to be taken of—

(a) any capital payment received before 10 March 1981, or

(b) any capital payment received on or after that date but before 6 April 1984, so far as it represents a chargeable gain which accrued to the trustees before 6 April 1981.

All capital payments before 10 March 1981 are disregarded. Capital payments before 6 April 1984 are disregarded if they represent a chargeable gain which accrued to the trustees before 6 April 1981. How does one decide whether a capital payment represents a pre-1981 gain? Fortunately this problem will not often arise now.

## 45.21 1998 transitional relief

Para 118 Sch 7 FA 2008 provides:

> (1) This paragraph applies if—
> (a) s.87 of TCGA 1992 applies to a settlement for the tax year 2008-09 or any subsequent tax year ("the tax year"),
> (b) the settlement was made before 17 March 1998,
> (c) none of the settlors fulfilled the residence requirements when the settlement was made, and
> (d) none of the settlors fulfils the residence requirements in the tax year.
> (2) For the purposes of that section as it applies to the settlement for the tax year, no account is to be taken of—
> (a) any gains or losses accruing to the trustees of the settlement before 17 March 1998, or
> (b) any capital payments received before that date.
> (3) A settlor "fulfils the residence requirements" when the settlor is—
> (a) resident or ordinarily resident in the UK, and
> (b) domiciled in any part of the UK.

I refer to this as "**1998 transitional relief**". In principle, (inter alia) for foreign domiciled settlor settlements, one disregards gains and capital payments before 17 March 1998. But if in any year there is a UK resident and domiciled settlor, even only one of several, the relief is lost in that year. Thus, the "tainting" principle applies. A small, even nominal contribution from a UK resident and domiciled settlor will forfeit the transitional relief for all years that that settlor is UK resident and domiciled.

One can envisage a case where it is better that this relief does not apply, in which case it would be possible to arrange to forfeit the relief, but this will not be common and in practice it might never arise.

## 45.22 Ascertaining s.2(2) amounts as at end 2007/8

The concept of s.2(2) amount was introduced in the FA 2008 with effect from 2008/9 but it is necessary to compute the s.2(2) amount for earlier years in order to know what s.2(2) amount is carried forward to 2008/09 and subsequently.

Para 120 Sch 7 FA 2008 provides:

> (1) This paragraph applies to a settlement if s.87 or s.89(2) of TCGA 1992 applied to it for the tax year 2007–08 or any earlier tax year.
> (2) The following steps are to be taken for the purposes of calculating the s.2(2) amount for the settlement for the tax year 2007-08 and earlier tax years.
> *Step 1*
> Calculate (in accordance with s.87 and, where appropriate, s.88) the s.2(2) amount for the settlement for the tax year 2007-08 and earlier tax years.
> For this purpose, references in s.87(4) and (5) of TCGA 1992 (as substituted) to s.87 of that Act applying to a settlement for a tax year are to be read as references to s.87 of that Act (as it had effect before that substitution) applying to a settlement for a tax year.
> *Step 2*
> Find the total amount of chargeable gains treated under s.87 or 89(2) as accruing to beneficiaries of the settlement in the tax year 2007-08 or any earlier tax year ("the total deemed gains").
> *Step 3*
> Find the earliest tax year for which the s.2(2) amount is not nil.
> If the s.2(2) amount for that year is less than or equal to the total deemed gains, reduce that s.2(2) amount to nil.
> Otherwise, reduce that s.2(2) amount by the amount of the total deemed gains.
> *Step 4*
> Reduce the total deemed gains by the amount by which the s.2(2) amount was reduced under Step 3.
> *Step 5*
> If the total deemed gains is not nil, start again at Step 3.
> For this purpose, read references to the earliest tax year for which the s.2(2) amount is not nil as references to the earliest tax year—
> (a) which is after the last tax year for which Steps 3 and 4 have been undertaken, and
> (b) for which the s.2(2) amount is not nil.

EN FB 2008 provides an example:

> 60. Example: determining the s.2(2) amount for years preceding

> 2008-09:
> The s.2(2) amounts of a settlement were:
> 2004-05: £100,000
> 2005-06: £50,000
> 2006-07: £200,000
> 2007-08: £200,000
> Total deemed gains were £450,000.
> a. Subtract the s.2(2) (£100,000) amount for the earliest year from the total deemed gains. Section 2(2) amount for 2004-05 reduces to nil. Total deemed gains reduced to £350,000.
> b. Subtract the s.2(2) (£50,000) amount for the next earliest year from the total deemed gains carried forward. Section 2(2) amount for 2005-06 reduces to nil. Total deemed gains reduced to £300,000.
> c. Subtract the s.2(2) (£200,000) amount for the next earliest year from the total deemed gains carried forward. Section 2(2) amount for 2006-07 reduces to nil. Total deemed gains reduced to £100,000.
> d. Subtract the s.2(2) (£200,000) amount for the next earliest year from the total deemed gains carried forward. Section 2(2) amount for 2007-08 reduces to £100,000. Total deemed gains reduced to nil.
> The s.2(2) amount for the settlement for 2007-08 is therefore £100,000.

In short, pre-2008 deemed gains are deducted from pre-2008 s.2(2) amounts on a FIFO basis (first in first out). It is expressed in just about the most obscure way possible.[28]

Para 120(3) provides for Schedule 4B cases, though the drafter does not try very hard:

> If, before 6 April 2008, the trustees of the settlement made a transfer of value to which Schedule 4B to TCGA 1992 applied, sub-para (2) has effect subject to such modifications as are just and reasonable on account of Schedule 4C to that Act having applied in relation to the settlement.

### 45.22.1 *Pre-2008 OIG amounts*

Para 99 Sch 7 FA 2008 applies the same rule to OIG amounts:

28 For a discussion of the drafting technique, see 45.10.7 (Commentary: Step-based drafting).

Paragraphs 120 and 121 apply in relation to offshore income gains as if—

(a) references to section 2(2) amounts were to OIG amounts,
(b) references to chargeable gains were to offshore income gains, and
(c) Step 1 of paragraph 120(2) provided that OIG amounts are to be calculated in accordance with—
  (i) section 762(2) of ICTA (the reference in the second sentence of that Step to section 87(4) of TCGA 1992 being read as a reference to section 762(2) of ICTA), or
  (ii) section 87(5) of TCGA 1992 as applied by section 762(3) of ICTA.

Section 762 ICTA is now repealed. The OFTR should have updated the references but somewhat negligently failed to do so. It is considered that the slip can be corrected by construction, ie references to the new provisions should be implied.

## 45.23 Pre-2008 inter-trust transfer

Para 120(4) Sch 7 FA 2008 disapplies the rules in para 120 where there was an inter-trust transfer before 2008/09[29] and para 121 Sch 7 FA 2008 sets out its own set of rules:

> (1) If s.90 of TCGA 1992 (as originally enacted) applied to a transfer of settled property made before 6 April 2008, this paragraph applies in relation to the transferor settlement and the transferee settlement.
> (2) In this paragraph "the year of transfer" means the tax year in which the transfer occurred.
> (3) The following steps are to be taken for the purpose of calculating the s.2(2) amount for the transferor and transferee settlements for the tax year 2007-08 and earlier tax years.
> *Step 1*
> Take the steps in para 120(2) for the purpose of calculating the s.2(2) amount (at the end of the year of transfer) for the transferor settlement for the year of transfer and earlier tax years.
> For this purpose, read references there to the tax year 2007-08 as references to the year of transfer.

29 Para 120(4) provides:
This paragraph does not apply if s.90 of TCGA 1992 applied to a transfer of settled property by or to the trustees of the settlement that was made before 6 April 2008 (see para 121).

*Step 2*
Take the steps in para 120(2) for the purpose of calculating the s.2(2) amount (before the year of transfer) for the transferee settlement for the tax year before the year of transfer and earlier tax years.
For this purpose, read references there to the tax year 2007-08 as references to the tax year before the year of transfer.
*Step 3*
Calculate the s.2(2) amount for the transferee settlement for the year of transfer.
*Step 4*
Treat the s.2(2) amount for the transferee settlement for the year of transfer or any earlier tax year (as calculated under Step 2 or 3) as increased by—
(a) the s.2(2) amount for the transferor settlement for that year (as calculated under Step 1), or
(b) if part only of the settled property was transferred, the relevant proportion of the amount mentioned in para (a).
"The relevant proportion" here has the same meaning as in s.90(4) of TCGA 1992 (as substituted by this Schedule).
*Step 5*
Treat the s.2(2) amount for the transferor settlement for any tax year as reduced by the amount by which the s.2(2) amount for the transferee settlement for that year is increased under Step 4.
*Step 6*
Take the steps in para 120(2) for the purpose of calculating the s.2(2) amount for the transferor settlement for the tax year 2007-08 and earlier tax years.
For this purpose—
(a) treat the s.2(2) amount for the year of transfer or any earlier tax year as the amount calculated by taking Steps 1 and 5 above, and
(b) reduce the total deemed gains by the amount of the total deemed gains calculated by taking Step 1 above.
*Step 7*
Take the steps in para 120(2) for the purpose of calculating the s.2(2) amount for the transferee settlement for the tax year 2007-08 and earlier tax years.
For this purpose—
(a) treat the s.2(2) amount for the year of transfer or any earlier tax year as the amount calculated by taking Steps 2 to 4 above, and
(b) reduce the total deemed gains by the amount of the total deemed gains calculated by taking Step 2 above.

The drafter felt something should be done about multiple transfers, and Sch 4B, but did not know what:

(4) This paragraph applies with any necessary modifications in relation to a settlement as respects which more than one relevant transfer was made.
(5) In sub-para (4) "relevant transfer" means a transfer—
(a) made before 6 April 2008, and
(b) to which s.90 of TCGA 1992 applied.

(6) If, before 6 April 2008, the trustees of the transferor or transferee settlement made a transfer of value to which Schedule 4B to TCGA 1992 applied, this paragraph has effect subject to such modifications as are just and reasonable on account of Schedule 4C to that Act having applied in relation to the settlement.

Para 99 Sch 7 FA 2008[30] applies the same rules for OIG amounts.

## 45.24 Pre-2008 capital payments

In order to follow the present legislation, one needs to have in mind the original terms of s.87(6) TCGA and in order to follow that, one needs to read all of the pre-2008 s.87(4)-(6) TCGA:

*(4) Subject to the following provisions of this section, the trust gains for a year of assessment shall be treated as chargeable gains accruing in that year to beneficiaries of the settlement who receive capital payments from the trustees in that year or have received such payments in any earlier year.*
*(5) The attribution of chargeable gains to beneficiaries under subsection (4) above shall be made in proportion to, but shall not exceed, the amounts of the capital payments received by them.*
*(6) A capital payment shall be left out of account for the purposes of subsections (4) and (5) above to the extent that chargeable gains have by reason of the payment been treated as accruing to the recipient in an earlier year.*

Para 122 Sch 7 FA 2008 provides:

(1) If all of a capital payment would (in the tax year 2008-09) have been left out of account by virtue of s.87(6) of TCGA 1992 as originally enacted, the amount of that capital payment is reduced to nil.
(2) If part of a capital payment would (in the tax year 2008-09) have been left out of account by virtue of s.87(6) of TCGA 1992 as originally enacted, the amount of that capital payment is reduced by the amount of that part.

The point of this is to prevent double counting of a capital payment: it is set against s.2(2) amounts under para 120 and not a second time.

30 Set out at 45.22.1 (Pre-2008 OIG amounts).

(3) If—
(a) chargeable gains were treated under s.87 or 89(2) of, or para 8 of Schedule 4C to, TCGA 1992 as accruing in the tax year 2007-08 or any earlier tax year to a beneficiary,
(b) more than one capital payment that the beneficiary had received was taken into account for the purposes of determining the amount of chargeable gains treated as accruing to the beneficiary, and
(c) the amount of those chargeable gains was less than the total amount of capital payments taken into account,
for the purposes of this paragraph treat s.87(6) of TCGA 1992 as originally enacted as having effect in relation to earlier capital payments before later ones.

Para 122 then imposes the same rules for OIGs:

(4) References in this paragraph to s.87(6) of TCGA 1992 include that provision as it would (but for the amendments made by this Schedule) have applied by virtue of s.762(3) of ICTA (offshore income gains).
(5) References in this paragraph to chargeable gains include offshore income gains.

Section 762 ICTA is now repealed. The OFTR should have updated the reference but (somewhat negligently) failed to do so. It is considered that the slip can be corrected by construction, ie references to the new provisions should be implied.

## 45.25 Pre-2008 trust immigration

In order to follow the present legislation, one needs to have in mind the original terms of s.89(2) TCGA and in order to follow that it needs to be read with s.89(1):

*(1) Where a period of one or more years of assessment for which section 87 applies to a settlement ("a non-resident period") succeeds a period of one or more years of assessment for each of which section 87 does not apply to the settlement ("a resident period"), a capital payment received by a beneficiary in the resident period shall be disregarded for the purposes of section 87 if it was not made in anticipation of a disposal made by the trustees in the non-resident period.*
*(2) Where*
*(a) a non-resident period is succeeded by a resident period, and*

> *(b) the trust gains for the last year of the non-resident period are not (or not wholly) treated as chargeable gains accruing in that year to beneficiaries,*
>
> *then, subject to subsection (3) below, those trust gains (or the outstanding part of them) shall be treated as chargeable gains accruing in the first year of the resident period to beneficiaries of the settlement who receive capital payments from the trustees in that year; and so on for the second and subsequent years until the amount treated as accruing to beneficiaries is equal to the amount of the trust gains for the last year of the non-resident period.*

Para 123 Sch 7 FA 2008 provides:

> Section 89(2) of TCGA 1992 as substituted applies to a settlement for the tax year 2008-09 (and subsequent tax years) if s.89(2) of that Act as originally enacted would (but for the amendments made by this Schedule) have applied to the settlement for the tax year 2008-09.

## 45.26 Matched pre-2008 capital payments/s.2(2) amounts: Non-Dom relief

Para 124 Sch 7 FA 2008 provides:

> (1) This paragraph applies if—
> (a) chargeable gains are treated under s.87 or 89(2) of TCGA 1992 as accruing to an individual in the tax year 2008-09 or any subsequent tax year, and
> (b) the individual is not domiciled in the UK in that year.
> (2) The individual is not charged to capital gains tax on the chargeable gains if and to the extent that they are treated as accruing by reason of—
> (a) a capital payment received (or treated as received) by the individual before 6 April 2008, or
> (b) the matching of any capital payment with the s.2(2) amount for the tax year 2007-08 or any earlier tax year.

Para (2)(a) provides relief for pre-2008 capital payments to foreign domiciliaries. Para (2)(b) provides relief for post 2008 capital payments matched with pre-2008 s.2(2) amounts.

EN FB 2008 summarises the matter this way:

> 440. The overall effect of these new rules is that: ...
> [1] there will be no charge to tax in respect of capital payments made

to non-UK domiciled beneficiaries who:

[a] receive capital payments before 6 April 2008 that are matched to trust gains accruing on or after 6 April 2008; or

[b] receive capital payments on or after 6 April 2008 that are matched to trust gains accruing before 6 April 2008.

This will be so irrespective of whether the non-UK domiciled beneficiary is a remittance basis user;

### 45.26.1 *Pre-2008 capital payments and pre-2008 OIG amounts*

Para 100 Sch 7 FA 2008 provides the same rules for OIG amounts:

> (1) This paragraph applies if—
> (a) by virtue of section 87 or 89(2) of, or Schedule 4C to, TCGA 1992 as applied by regulation 20 of the Offshore Funds (Tax) Regulations 2009 (S.I. 2009/3001), income is treated under such regulations (regulation 17 of those Regulations[)] as arising to an individual in the tax year 2008–09 or any subsequent tax year, and
> (b) the individual is not domiciled in the UK in that year.
> (2) The individual is not charged to income tax on the income if and to the extent that it is treated as arising by reason of—
> (a) a capital payment received (or treated as received) by the individual before 6 April 2008, or
> (b) the matching of any capital payment with the OIG amount for the tax year 2007–08 or any earlier tax year.

### 45.26.2 *Capital payments between 12 March and 5 April 2008*

Para 125 Sch 7 FA 2008 provides a special rule for these capital payments:

> (1) This paragraph applies in relation to a settlement for the tax year 2008-09 or any subsequent tax year ("the relevant tax year") if—
> (a) an individual who was resident or ordinarily resident, but not domiciled, in the UK in the tax year 2007-08 received a capital payment from the trustees of the settlement on or after 12 March 2008 but before 6 April 2008, and
> (b) the individual is resident or ordinarily resident, but not domiciled, in the UK in the relevant tax year.
> (2) For the purposes of sections 87 to 89 of TCGA 1992 as they apply in relation to the settlement for the relevant tax year, no account is to be

taken of the capital payment.

One might refer to capital payments made between 12 March and 5 April 2008 as post-budget 2008 capital payments. There is no matching for post-budget 2008 capital payments, so such payments do not reduce s.2(2) amounts.

January 2009 Qs & As provides:

> **Q4**: Paragraph 125(2) appears to disregard payments between 12 March and 5 April altogether, which is different to the treatment proposed in the Budget documentation published on 12 March.
> **A**: The original intention set out in the Budget documentation of 12 March and legislation was to allow the matching of capital payments between 12 March 2008 and 5 April 2008 with any gains relating to the period up to 5 April 2008 arising to the trustees after 5 April 2008. However, this proposal was dropped because it would have introduced additional and unnecessary complexity to the legislation.

This rule is not extended to offshore income gains. It is not clear if that was deliberate or an accident.

## 45.27 Rebasing - introduction

Paragraph 126 Sch 7 FA 2008 provides a relief which I call "**rebasing**". HMRC s.87 guidance note provides:

> 80. The election is commonly known as a "rebasing" election ... But it is not rebasing as that term applies to section 35 TCGA and assets held at 31 March 1982. There is no across the board revaluation of the assets in the trust fund as at 6 April 2008.

## 45.28 Rebasing: the election

### 45.28.1 *Need for rebasing election*

Para 126 Sch 7 FA 2008 provides:

> (1) The following provisions apply to a settlement if—
> (a) s.87 applies to the settlement for the tax year 2008-09, and
> (b) the trustees of the settlement have made an election under this

> subparagraph. ...
> (5) An election under sub-para (1) is irrevocable.

EN FB 2008 provides:

> 63. The provisions of para [126] are subject to an election rather than being mandatory because:
> [1] depending on the assets comprised in the settlement as at 6 April 2008 it may not be advantageous for the paragraph to apply; and
> [2] the trustees will be required to provide additional information to HMRC about trust assets. Trustees of non-resident settlements have been assured in a letter from the Acting Chairman of HMRC, Dave Hartnett, dated 12 February 2008 that in applying the provisions set out in this Schedule, HMRC will not require any additional disclosure.

As far as [1] is concerned, it can never be disadvantageous for para 126 to apply (the election cannot in any circumstances increase the tax liability). HMRC s.87 guidance note provides:

> 79. The election ... cannot increase the tax payable by a beneficiary. Whether it improves the position of the beneficiary depends on the history of the assets disposed of.

Subject to point [2] (confidentiality) an election should be made in every case where it might be useful, which is generally the case where there are or might be UK resident foreign domiciled beneficiaries. I understand however that an election in relation to a trust unknown to HMRC will generally lead to protracted enquiries.

### 45.28.2 *Requirements for valid rebasing election*

HMRC s.87 guidance note provides:

> 82. The election can be made only if the settlement was non-UK resident throughout 2008-09.

This follows from para 126(1)(a). The guidance note continues:

> Paragraph 126(1) requires that the election be made by the trustees of the

settlement. It must be made by all the trustees or by a majority of them if they are permitted to act through a majority. It cannot be made by a beneficiary. If the beneficiary's Self Assessment tax return is taken up for enquiry an election may require additional disclosure to HMRC about assets held by the trustees in order to agree the valuation.

Para 126(6) sch 7 FA 2008 provides:

> An election under that sub-paragraph must be made in the way and form specified by the Commissioners for HMRC.

The HMRC s.87 guidance note provides:

> 89. The election must be made in the way and form specified by HMRC, paragraph 126(6). HMRC have provided a form RBE1 to satisfy this requirement and all elections must be made on that form. The form asks for the name of the settlement and the date it was created. The date is used to distinguish between settlements with similar names in particular those created by settlors with a prevalent surname. The form also asks the trustees to identify if and when a trigger event has occurred. The RBE1 can be downloaded from the HMRC website[31] or can be ordered by phoning HM Revenue and Customs CAR Residency on 0151 472 6384 or +44 151 472 6384 if you are calling from abroad.
> 90. Some trustees may have made the election by writing to CAR Residency before the form was available. That election remains valid and there is no need to make a further election on the form.

### 45.28.3 *Time limit for election*

Para 126(2) sch 7 FA 2008 provides:

> An election under sub-para (1) may only be made on or before the first 31 January to occur after the end of the first tax year (beginning with the tax year 2008-09) in which an event within either of the following paragraphs occurs—
> (a) a capital payment is received (or treated as received) by a

31 Accessible *www.hmrc.gov.uk/cnr/rbe1.pdf.*

beneficiary of the settlement,[32] and the beneficiary is resident in the UK in the tax year in which it is received, and

(b) the trustees transfer all or part of the settled property to the trustees of another settlement, and s.90 of TCGA 1992 applies in relation to the transfer.

The time limit is crucial. HMRC s.87 guidance note provides:

> 83. The relief is given only to individuals, paragraph 126(7), but the time limit is triggered if a capital payment is received by any UK resident beneficiary.

"Capital payment" is not defined in sch 7. The term is of course defined in s.97 TCGA but only "for the purposes of s.86A to 97 (and sch 4C)". Strictly that definition does not apply for the purposes of sch 7. It is considered however that the context shows that the usual definition is intended to be incorporated, notwithstanding the absent-minded omission of a provision to that effect. If that is right, a benefit within s.731 is not a capital payment so does not trigger the deadline for an election. It is well arguable that a benefit within the scope of OIG s.87 (which is chargeable to income tax) is not a "capital payment" for the purposes of para 126,[33] but it would be best not to rely on that point and to make the election in good time.

The December 2008 Qs & As provide:

> The earliest deadline for trustees to make an election for rebasing will be 31 January 2010 where a trigger such as a capital payment is made to a UK resident beneficiary in 2008-09 or the trustees transfer property in another settlement.

The HMRC s.87 guidance note provides:

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32 Para 126 expands on this in Sch 4C cases:

"(3) For a tax year as respects which the settlement has a Schedule 4C pool, the reference in sub-para (2)(a) above to a capital payment received (or treated as received) by a beneficiary of the settlement is to be read as a capital payment received (or treated as received) by a beneficiary of a relevant settlement from the trustees of a relevant settlement.

(4) Para 8A of that Schedule (relevant settlements) applies for the purposes of sub-para (3) above."

33 See 32.12.3 ("Capital payment").

> 87. An election may be made before a triggering event happens.

This is important as it is convenient and (in offshore fund cases, may be necessary) to make the election before there is any capital payment. The HMRC s.87 guidance note continues:

> There is no requirement that the beneficiary receiving the payment was a beneficiary of the settlement as at 6 April 2008. The recipient may become a beneficiary at some later time. The time limit in paragraph 126(2) of Schedule 7 runs from the time the trustees first make a capital payment to a UK resident beneficiary. If the trustees make such a payment and do not make the election they may be out of time for making the election if they make a payment to a UK-resident but non-domiciled beneficiary at a later time. The election can be made even if there are no non-UK domiciled beneficiaries when the payment is made.
> 88. Any election made late will be considered in accordance with the guidance in paragraph 13801 onwards in HMRC's Capital Gains Tax manual [*recte* Capital Gains Manual].

**45.29 Rebasing: the relief**

Assuming an election has been made, we can move on to consider the relief. Para 126 Sch 7 FA 2008 provides:

> (7) Sub-para (8) applies if—
> (a) by virtue of the matching of a capital payment with the s.2(2) amount for the settlement for the tax year 2008-09 or any subsequent tax year ("the relevant tax year"), chargeable gains are treated under s.87 or 89(2) of, or para 8 Schedule 4C to, TCGA 1992 as accruing to an individual in a tax year, and
> (b) the individual is resident, but not domiciled, in the UK in that year.
> (8) The individual is not charged to capital gains tax on so much of the chargeable gains as exceeds the relevant proportion of those gains.

EN FB 2008 provides:

> 64. It should be noted that para [126] does not affect the computation of the s.2(2) amount under s.87 for a year. It simply provides a mechanism for identifying an amount of the chargeable gain treated as accruing to a non-UK domiciled beneficiary that is not chargeable to tax because an

element of the underlying s.2(2) amounts are attributable to the period before 6 April 2008, when non-UK domiciled beneficiaries were not chargeable to tax in respect of chargeable gains attributed to them under s.87.
65. Para [126] applies to all non-UK domiciled beneficiaries of a settlement, the trustees of which have made a valid election. The non-UK domiciled beneficiary does not need to be a remittance basis user. Only once the provisions of para [126] have been applied is it necessary to see whether the amount of tax that is left in charge is chargeable on the arising basis, in the year in which the gains are treated as having accrued to the beneficiary, or on the remittance basis where one of s.809B, [809D or 809E] applies.
66. ... Although there is only one s.87 pool for each tax year, where an election has been made under para [126](1) trustees will need to keep track of the separate elements of gains attributed to the period before and after 6 April 2008 within the pool.
67. There are no special rules to deal with assets where the market value as at 6 April 2008 was either higher or lower than both the cost of acquisition of the asset and the disposal proceeds....
81. The election has no effect on the matching of capital payments to section 2(2) amounts or the reduction of capital payments and section 2(2) amounts. It has no effect on gains accruing to UK domiciled beneficiaries.

### 45.29.1 *Relevant proportion*

Para 126(9) Sch 7 FA 2008 provides:

> The relevant proportion is A÷B where—
> A is what would be the s.2(2) amount for the settlement for the relevant tax year, if immediately before 6 April 2008 every relevant asset had been sold by the trustees (or the company concerned) and immediately re-acquired by them (or it) at the market value at that time, and
> B is the s.2(2) amount for the settlement for the relevant tax year.

In short, rebasing relief applies to relevant assets.

### 45.29.2 *Relevant asset*

Para 126(10) provides:

> For the purposes of sub-para (9) an asset is a "relevant asset" if—
> (a) by reason of the asset, a chargeable gain or allowable loss accrues to the trustees in the relevant tax year, and
> (b) the asset has been comprised in the settlement from the beginning of 6 April 2008 until the time of the event giving rise to the chargeable gain or allowable loss.

HMRC s.87 guidance provides:

> 79. ... It is not possible to make the election only in respect of assets which have increased in value since 6 April 2008...
> 97. You consider only the assets whose disposal gave rise to the section 2(2) amount. Any assets held at 6 April 2008 which are not disposed of are not included in the comparison. This means that assets held at 6 April 2008 need be valued only when they are disposed of.

Para 126(11) extends rebasing relief to assets held by companies held by trusts:

> For those purposes, an asset is also a "relevant asset" if—
> (a) by reason of the asset, chargeable gains are treated under s.13 of TCGA 1992 as accruing to the trustees in the relevant tax year,
> (b) the company to whom the chargeable gains actually accrue has owned the asset from the beginning of 6 April 2008 until the time of the event giving rise to those chargeable gains, and
> (c) had the company disposed of the asset at any time in the relevant period,[34] part[35] of the chargeable gains (if any) accruing on the disposal would have been treated under s.13 of TCGA 1992 as accruing to the trustees.

A company's asset is not a relevant asset if a loss accrues on the disposal. But a trust asset can be a relevant asset even if a loss accrues on the disposal. It follows that one can envisage cases where the fraction A/B is greater than 1 (because an asset which gives rise to a loss on an actual disposal may be such that a gain would arise if the asset had been disposed of on 6/4/2008). However it does not matter if this is so. The relief is that:

34 Para 126(12) provides: "In sub-para (11)(c) "the relevant period" means the period beginning at the beginning of 6 April 2008 and ending immediately before the event giving rise to the chargeable gains."

35 The context shows that this must mean: *all or* part...

The individual is not charged to capital gains tax on so much of the chargeable gains as exceeds the relevant proportion of those gains.

So if the relevant proportion is greater than one, no relief applies but the tax charge is not increased.

## 45.30 Rebasing - HMRC examples

EN FB 2008 provides some examples. Example 1 is relatively straightforward.

68. *Example 1: basic mechanism of para [126(8)(9)]*:
The trustees of a settlement make an election under para [126](1).
In 2009-10 the trustees dispose of a property for £10 million. The chargeable gain accruing to the trustees is £8 million.
The chargeable gain that would have accrued to the trustees if the gain had been computed using the market value of the property as at 6 April 2008 as the cost of acquisition is £1 million.
The trustees make a capital payment to beneficiaries X and Y of £4 million each.
X and Y are both resident in the UK but X is also domiciled in the UK whereas Y is not.
There are no unmatched capital payments or trust gains relating to earlier years.

The HMRC analysis is as follows:

a. Match the capital payments to the s.2(2) amount for the year. Capital payments total £8 million and match to the s.2(2) amount of £8 million.
Chargeable gains of £4 million are treated as accruing to X and Y for 2009-10.
X is chargeable to CGT in 2009-10 under s.87 on the gains of £4 million.
Y is non-UK domiciled so para [126](1) applies to determine how much of the chargeable gains of £4 million is chargeable to tax.
b. The s.2(2) amount for 2009-10 is £8 million ("B" in para [126(9)].
c. The s.2(2) amount that would have applied if the trustees had sold the property and reacquired it immediately before 6 April 2008 is £1 million ("A" in para [126(9)].
d. A/B is 1/8.
e. Apply A/B to the chargeable gains of £4 million accruing to Y: the amount of the gains that is chargeable to tax under para [126(8)] is £4 million/8, i.e. Y is chargeable to capital gains tax on £500,000. If Y is a remittance basis user there will be no charge to tax until Y remits gain to the UK.
There are no surplus capital payments or trust gains for 2009-10.

Example 2 is more challenging.

69. *Example 2: matching capital payments across years and s.13 gains*
The trustees of a settlement make an election under para [126](1)]. The beneficiaries of the settlement are X, who is UK domiciled, and Y, who is not. Both X and Y are resident in the UK.
There are no unmatched trust gains or capital payments relating to earlier years.
In 2010-11 the trustees dispose of two assets:
a. the chargeable gains are £8 million: the pre 6 April 2008 gains are £7 million and the post 5 April 2008 gains are £1 million;
b. the overall loss is £5 million: the pre 6 April 2008 gain is £1 million and the post 5 April 2008 loss is £6 million.
A capital payment of £5 million is made to beneficiary Y.
In 2011-12 the trustees dispose of an asset. The chargeable gain is £5 million: the pre 6 April 2008 gain is £4 million and the post 5 April 2008 gain is £1 million.
Capital payments are made to beneficiaries X and Y of £2 million each.
In 2012-13 an underlying company within s.13 wholly owned by the trustees disposes of an asset.[36] The loss on the asset is £2 million.[37] But substituting the market value as at 6 April 2008 creates a post 5 April gain of £1 million. The trustees also dispose of an asset. The chargeable gain is £3 million: the pre 6 April 2008 gain is £2 million and the post 5 April 2008 gain is £1 million.
Capital payments are made to beneficiaries X and Y of £2 million each.

The EN sets out a table to summarise these facts which for ease of reference I set out here slightly expanded. It is easier to follow the example with the fuller spreadsheet which is available on *www.kessler.co.uk* (not set out here because it requires an A4 sheet).

| | **Pre 6/4/08 gain/loss** | **Post 5/4/08 gain/loss** | **"A"** | **s.2(2) amount "B"** | **A/B** | **Cap P't to X** | **Cap P't to X** |
|---|---|---|---|---|---|---|---|
| 2010-11 | £8m | (£5m) | £0 | £3m | 0 | - | £5m |
| 2011-12 | £4m | £1m | £1m | £5m | 1/5 | £2m | £2m |
| 2012-13 | £2m | £2m | £2m(?) | £3m | 2/3(?) | £2m | £2m |

The HMRC analysis is as follows:

***2010-11***
The s.2(2) amount is £3 million. Match capital payment of £5 million against trust gains of £3 million: chargeable gains of £3 million treated as accruing to Y. But Y is not UK domiciled so para [126] applies.

36 The example confusingly adds that the disposal is for £5m. But that is irrelevant, as what matters for tax is the gain or loss on the disposal, not the amount of the sale proceeds.
37 [Author's Footnote] This loss is not allowable; careful planning might have avoided that result.

Only £3 million×(A÷B) of the matched capital payment is chargeable to tax. However, the s.2(2) amount based on the market value of the assets as at 6 April 2008 is £0. Therefore A÷B is zero and none of the chargeable gains treated as accruing to Y is chargeable to tax.

2010-11: £2 million unmatched capital payments to Y.

***2011-12***

The s.2(2) amount is £5 million. Match capital payments of £4 million in the year against trust gains of £5 million; chargeable gains of £2 million treated as accruing to each of X and Y.

There are £1 million trust gains of 2011-12 unmatched. Step 5 of s.87A(2) applies.

Match 2011-12 £1 million trust gains to unmatched capital payments of £2 million to Y of 2010-11.

Chargeable gains of £1 million treated as accruing to Y. Unmatched capital payment to Y of 2010-11 reduced to £1 million.

X is chargeable to tax on £2 million in respect of 2012-13.

Y has chargeable gains of £3 million in respect of 2012-13. But Y is not UK domiciled so para [126] applies.

Under para [126(8)(9)]£3 million×(A÷B) of the matched capital payment is chargeable to tax.

A÷B is 1/5 so £600,000 of the chargeable gains treated as accruing to Y in 2011-12 are taxable.

£1 million unmatched capital payments to Y originating from 2010-11 to carry forward.

***2012-13***

The s.2(2) amount is £3 million. The disposal of the asset by the underlying company does not form part of the s.2(2) amount because only s.13 gains are brought into s.87. However, by applying the market values to the assets as at 6 April 2008 there is a gain attributable to the disposal of the asset by the company.

Match the capital payments of £4 million to the s.2(2) amount. Chargeable gains are treated as accruing to X and Y of £1.5 million each under part (b) of Step 3 of s.87A(2).

X is chargeable to tax on £1.5 million in respect of 2012-13.

Y has chargeable gains of £1.5 million in respect of 2012-13. But Y is not UK domiciled so para [126] applies.

*Under para [126(8)(9)], £1.5 million×(A÷B) of the matched capital payment is chargeable to tax. A÷B is 2/3 so £1 million of the chargeable gains treated as accruing to Y in 2012-13 are taxable. While the kink in the value of the company's asset has increased the proportion of gains on which Y is chargeable to tax, Y is still better off than if no election had been made.*

This assumes that the company's asset is a "relevant asset". However it is not a relevant asset, as it is not the case that "by reason of the asset, chargeable gains are treated under s.13 TCGA as accruing to the trustees in the relevant tax year." The correct figure for A/B is 1/3 and not 2/3 and the taxable gain after rebasing relief is £0.5m and not £1m.

There are £1.5m unmatched capital payments to Y to carry forward - £1m from 2010-11 and £0.5m from 2012-13.
There are £0.5m unmatched capital payments to X to carry forward all originating from 2012-13.

70. *Example 3: keeping track of pre 6 April and post 5 April gains and losses.* The trustees of a settlement make an election under para [126](1). The beneficiaries of the settlement are X, who is UK domiciled, and Y, who is not. Both X and Y are resident in the UK. There are no unmatched trust gains or capital payments relating to earlier years.
In 2010-11 the trustees dispose of an asset. The chargeable gain is £8 million: the pre 6 April gain is £7 million and the post 5 April 2008 gain is £1 million.
A capital payment of £2 million is made to each of beneficiaries X and Y.
In 2011-12 the trustees make a further capital payment to X and Y of £2 million each.

The example may be easier to follow if the facts are set out in a table:

| | **Pre 6/4/08 gain/loss** | **Post 5/4/08 gain/loss** | **"A"** | **s.2(2) amount "B"** | **A/B** | **Cap P't to X** | **Cap P't to X** |
|---|---|---|---|---|---|---|---|
| 2010-11 | £7m | £1m | £1m | £8m | 1/8 | £2m | £2m |
| 2011-12 | 0 | 0 | n/r | £5m | n/r | £2m | £2m |

The HMRC analysis is as follows:

***2010-11***

The s.2(2) amount is £8 million.
Match capital payments of £4 million in the year against trust gains of £8 million: chargeable gains of £2 million treated as accruing to each of X and Y. X is chargeable to tax on £2 million in respect of 2010-11.
Y has chargeable gains of £2 million in respect of 2010-11. But Y is not UK domiciled so para [126] applies.
Under para [126(8)(9)] £2 million×(A÷B) of the matched capital payment is chargeable to tax.
A÷B is 1/8 so £250,000 of the chargeable gains treated as accruing to Y in 2010-11 are taxable.
The reduced s.2(2) amount for 2010-11 for the purposes of matching with future capital payments is £4m.

***2011-12***

There is no s.2(2) amount for the year. Apply s.87A matching rules to earlier year.
Match capital payments of £4 million in 2011-12 to s.2(2) amount (as reduced) for 2010-11 of £4m:
chargeable gains of £2 million treated as accruing to each of X and Y.

X is chargeable to tax on £2m in respect of 2011-12.
Y has chargeable gains of £2 million in respect of 2011-12. But Y is not UK domiciled so para [126] applies.
Under para [126(7)(8)] £2 million×(A÷B) of the matched capital payment is chargeable to tax.
A÷B is 0.5/4 so £250,000 of the chargeable gains treated as accruing to Y in 2011-12 are taxable.
The table below shows how the s.2(2) amount for the year and the underlying gains (or losses) relating to the period before and after 6 April 2008 are matched.

| **2010-11 matching of capital payments** | **Pre 6 April gain/loss** | **Post 5 April gain/loss** | **Total trust gains (section 2(2) amount)** |
|---|---|---|---|
| 2010-2011 | £7m | £1m | £8m |
| Less matched to capital payment in 2010-11 | £3.5m | £500,000 | £4m |
| Unmatched in 2010-11 | £3.5m | £500,000 | £4m |
| Less matched to capital payments in 2011-12 | £3.5m | £500,000 | £4m |
| Unmatched in 2011-12 | £0 | £0 | £0 |

## 45.31 Rebasing - supplementary provisions

Para 126(13) Sch 7 FA 2008 extends the relief where one asset is derived from another asset; this will not be very common:

If— (a) by reason of an asset which would not otherwise be a relevant asset ("the new asset"), chargeable gains or allowable losses accrue, or are treated under s.13 as accruing, to the trustees in the relevant tax year,
(b) the value of the new asset derives wholly or in part from another asset ("the original asset"), and
(c) s.43 of TCGA 1992 applies in relation to the calculation of the chargeable gains or allowable losses,
the new asset (or part of that asset) is a "relevant asset" if the condition in sub-para (10)(b) or the conditions in sub-para (11)(b) and (c) would be met were the references there to the asset to be read as references to the new asset or the original asset.

Para 126(14)(15) extends the relief where there is an inter-group transfer:

(14) If—
(a) on or after 6 April 2008, a company ("company A") disposes of an

asset to another company ("company B"), and

(b) s.171 of TCGA (transfers within groups) (as applied by s.14(2) of that Act) applies in relation to the disposal,

for the purposes of sub-para (11) (and this sub-paragraph) treat company B as having owned the asset throughout the period when company A owned it.

(15) If an asset is a relevant asset by virtue of sub-para (14), for the purposes of sub-para (9)—

(a) treat the chargeable gains as having accrued to the company which owned the asset at the beginning of 6 April 2008, and

(b) treat the proportion of those chargeable gains attributable under s.13 of TCGA 1992 to the trustees as being the proportion of the chargeable gains actually accruing that are so attributable.

Para 126(16) to (18) deals with the situation where an asset is held by a company, and the trustees have held different interests in the company at different times:

(16) If—

(a) an asset would otherwise be a "relevant asset" within sub-para (11), and

(b) the proportion of chargeable gains treated under s.13 of TCGA 1992 as accruing to the trustees by reason of the asset ("the relevant proportion") is greater than the minimum proportion,

for the purposes of sub-para (9) treat the appropriate proportion of the asset as a relevant asset and the rest of the asset as if it were not a relevant asset.

(17) "The minimum proportion" is the smallest proportion of chargeable gains (if any) that would have been attributable to the trustees on a disposal of the asset at any time in the relevant period (as defined by sub-para (12)).

(18) "The appropriate proportion" is the minimum proportion divided by the relevant proportion.

This does not work. Suppose for example a trust held 50% of the shares in a non resident company, T Ltd before 2008, and later acquired all the shares. T Ltd realises a gain of £100 on an asset (the company's asset) held before 2008. The gain is deemed to accrue to the trust under s.13. The terms of subpara 16 are met:

(a) the company's asset would otherwise be a "relevant asset" within sub-para (11), and

(b) the proportion of chargeable gains treated under s.13 of TCGA 1992 as accruing to the trustees by reason of the asset ("the relevant proportion" - 100%) is greater than the minimum proportion (which under the definition in 126(17) is 50%.

So subpara 16 directs:

> for the purposes of sub-para (9) treat the appropriate proportion of the asset as a relevant asset and the rest of the asset as if it were not a relevant asset.

We need to ascertain the appropriate proportion. That is one half divided by the relevant proportion. So we need to know the relevant proportion. That is:

> A÷B where—
> A is what would be the s.2(2) amount for the settlement for the relevant tax year, if immediately before 6 April 2008 every relevant asset had been sold by the trustees (or the company concerned) and immediately re-acquired by them (or it) at the market value at that time, and
> B is the s.2(2) amount for the settlement for the relevant tax year.

B is £100. In order to work out A we need to know what is the relevant asset, but we do not know what is a relevant asset until we have applied subpara 16. Presumably we are to ignore the subpara 16 reduction, in which case the company asset is the relevant asset. Assume that the company asset was worth £50 on 6 April 2008, so the relevant proportion is one half. Then the appropriate proportion is one half divided by one half, = one. I suspect that the drafter has confused "divided" with "multiplied". What a shambles! But there it is. Fortunately the problem may not often arise.

## 45.32 Rebasing – OIG amounts

Paragraph 101 Sch 7 FA 2008 provides equivalent rebasing relief for OIGs:

> (1) This paragraph applies if—
> (a) the trustees of a settlement have made an election under paragraph

126(1) (re-basing election),

(b) income is treated under regulation 17 of the Offshore Funds (Tax) Regulations 2009 (S.I. 2009/3001) as arising to an individual in the tax year 2008–09 or any subsequent tax year ("the relevant tax year") by reason of the matching, under section 87A of TCGA 1992 as applied by regulation 20 of those Regulations, of an OIG amount with a capital payment received by the individual from the trustees, and

(c) the individual is resident or ordinarily resident, but not domiciled, in the UK in the relevant tax year.

(2) The individual is not charged to income tax on so much of the income as exceeds the relevant proportion of that income.

(3) Sub-paragraphs (9) to (18) of paragraph 126 (meaning of "the relevant proportion") apply for the purposes of sub-paragraph (2) above as if—

(a) references to section 2(2) amounts were to OIG amounts,

(b) references to chargeable gains were to offshore income gains,

(c) references to allowable losses were omitted, and

(d) references to anything accruing were to it arising (and similar references were read accordingly).

Amended as para 101(3) requires, para 126(9) to (13) provide:

(9) The relevant proportion is A÷B where—

A is what would be the ~~section 2(2) amount~~ <u>OIG amount</u> for the settlement for the relevant tax year, if immediately before 6 April 2008 every relevant asset had been sold by the trustees (or the company concerned) and immediately re-acquired by them (or it) at the market value at that time, and

B is the ~~section 2(2) amount~~ <u>OIG amount</u> for the settlement for the relevant tax year.

(10) For the purposes of sub-paragraph (9) an asset is a "relevant asset" if—

(a) by reason of the asset, ~~a chargeable gain or allowable loss accrues~~ <u>an offshore income gain arises</u> to the trustees in the relevant tax year, and

(b) the asset has been comprised in the settlement from the beginning of 6 April 2008 until the time of the event giving rise to the chargeable gain or allowable loss.

(11) For those purposes, an asset is also a "relevant asset" if—

(a) by reason of the asset, ~~chargeable gains~~ <u>offshore income gains</u> are treated under section 13 of TCGA 1992 as ~~accruing~~ <u>arising</u> to the trustees in the relevant tax year,

(b) the company to whom the ~~chargeable gains~~ offshore income gains actually accrue has owned the asset from the beginning of 6 April 2008 until the time of the event giving rise to those ~~chargeable gains~~ offshore income gains, and

(c) had the company disposed of the asset at any time in the relevant period, part of the ~~chargeable gains~~ offshore income gains (if any) accruing on the disposal would have been treated under section 13 of TCGA 1992 as ~~accruing~~ arising to the trustees.

(12) In sub-paragraph (11)(c) "the relevant period" means the period beginning at the beginning of 6 April 2008 and ending immediately before the event giving rise to the ~~chargeable gains~~ offshore income gains.

(It is not necessary to set out the rest of para 126, as amended).

## 45.33 Rebasing - transfers between trusts

Para 127(1) Schedule 7 FA 2008 provides:

This paragraph applies if—

(a) in the tax year 2008-09 or any subsequent tax year, the trustees of a settlement ("the transferor settlement") transfer all or part of the settled property to the trustees of another settlement ("the transferee settlement"),

(b) s.90 of TCGA 1992 applies in relation to the transfer,

(c) the trustees of the transferor settlement have made an election under para 126(1),

(d) by virtue of the matching of a capital payment with the s.2(2) amount for the transferee settlement for the tax year 2008-09 or any subsequent tax year ("the relevant tax year"), chargeable gains are treated under s.87 or 89(2) of, or para 8 of Schedule 4C to, TCGA 1992 as accruing to an individual in a tax year, and

(e) the individual is resident, but not domiciled, in the UK in that year.

### 45.33.1 *Transferee trust makes rebasing election*

Para 127(2) Sch 7 FA 2008 provides:

If the trustees of the transferee settlement have made an election under para 126(1), para 126(7) to (9) have effect in relation to the transferee settlement for that year as if the reference in para 126(9) to relevant assets included relevant assets within the meaning of this paragraph.

### 45.33.2 *Transferee trust does not make rebasing election*

Para 127 Sch 7 FA 2008 provides:

> (3) If the trustees of the transferee settlement have not made an election under para 126(1), the individual is not charged to capital gains tax on so much of the chargeable gains mentioned in sub-para (1)(d) above as exceeds the relevant proportion of those gains.
> (4) The relevant proportion is—
> where—
> A is what would be the s.2(2) amount for the transferee settlement for the relevant tax year, if immediately before 6 April 2008 every relevant asset had been sold by the company concerned and immediately re-acquired by it at the market value at that time, and
> B is the s.2(2) amount for the transferee settlement for the relevant tax year.
> (5) For the purposes of this paragraph an asset is a "relevant asset" if—
> (a) by reason of the asset, chargeable gains are treated under s.13 of TCGA 1992 as accruing to the trustees of the transferee settlement in the relevant tax year,
> (b) the company to whom the chargeable gains actually accrue has owned the asset from the beginning of 6 April 2008 until the time of the event giving rise to those chargeable gains,
> (c) had the company disposed of the asset at any time in the relevant period, part of the chargeable gains (if any) accruing on the disposal would have been treated under s.13 of TCGA 1992 as accruing to—
> (i) the trustees of the transferor settlement (if the disposal had been made before the transfer), or
> (ii) the trustees of the transferee settlement (if it had not).
> (6) In sub-para (5)(c) "the relevant period" means the period beginning at the beginning of 6 April 2008 and ending immediately before the event giving rise to the chargeable gains.
> (7) Sub-paras (13) to (18) of para 126 apply for the purposes of this paragraph (with such modifications as are necessary) as they apply for the purposes of that paragraph.

January 2009 Qs & As provides:

**Q7** In applying the allocation rules to transfers between settlements, the transferor trust gains carried across will be treated as having accrued to the transferee trust in the year in which they in fact accrued to the transferor trust. Those gains that have been matched with capital payments out of transferor trust in the year of transfer or previous years will be left out of account. Gains carried across will be allocated to a capital payment from the transferee trust on a 'last in first out' (LIFO) basis. Gains on such assets will be governed by whether or not the transferor trust has made a rebasing election under paragraph 126 sch 7 FA 2008.

If the transferor settlement has made a rebasing election by the time of the transfer of the transferee settlement, then pre and post April 2008 gains which are deemed to have accrued on the actual disposal of an asset go across *pro rata*.

If the transferor settlement has not made a rebasing election by the 31 January following the year of the transfer, then even if no capital payment has yet been made, the right to rebase is lost in relation to the transferred assets and any assets retained in the transferor trust.

However, it should be noted that any transfers between settlements made prior to 6 April 2008 will not trigger a time limit on rebasing and any assets moving over to the transferee settlement as a result of a transfer made prior to 6 April 2008 will not be affected by any subsequent election for rebasing made by the transferor trust. If the asset appointed over to the transferee settlement before 6 April 2008 includes shares in a company within s.13 TCGA 1992, then the transferee settlement may wish to elect for rebasing in its own right. An election made by the transferee settlement may cover gains made by such a company – see para 127 Sch 7 FA 2008. Transferee settlements which receive property on or after 6 April 2008 cannot elect for rebasing in relation to the transferred assets – the decision is solely that of the transferor settlement.

Example

Trust 1 –- £300,000 gains made

Capital payment made of £10,000 to a remittance basis user.

Election for rebasing made: 90% (£270,000) of gains relate to the period pre 6 April 2008 and 10% (£30,000) post 5 April 2008.

The capital payment is matched only to post 5 April 2008 gains and taxed on remittance basis. £290,000 gain carried forward (£270,000 pre 6 April and £20,000 post 5 April 2008). So now 6.90% is post 5 April 2008 gain and 93.10% is pre 6 April 2008 gain.

Trust 1 appoints cash to Trust 2 of £2.5m at a time when Trust 1 is worth £20m (i.e. 12.5% of fund). £36,250 gains are transferred to

Trust 2 (12.5% of £290,000). 93.1% of these relate to the period pre 6 April 2008 and 6.9% after.

Trust pool in Trust 1 reduced to £253,750 (93.1% pre 6 April and 6.9% post 5 April 2008).

### 45.33.3 *Transfer between trusts: OIG amounts*

Para 102 Sch 7 FA 2008 provides equivalent rules for OIG amounts:

(1) This paragraph applies if—

(a) in the tax year 2008–09 or any subsequent tax year, the trustees of a settlement ("the transferor settlement") transfer all or part of the settled property to the trustees of another settlement ("the transferee settlement"),

(b) section 90 of TCGA 1992 applies in relation to the transfer,

(c) the trustees of the transferor settlement have made an election under paragraph 126(1),

(d) by virtue of the matching (under section 87A of TCGA 1992 as applied by regulation 20 of the Offshore Funds (Tax) Regulations 2009 (S.I. 2009/3001)) of a capital payment with an OIG amount of the transferee settlement, income is treated under such regulations (regulation 17 of those Regulations [)] as arising to an individual in a tax year ("the relevant tax year"), and

(e) the individual is resident or ordinarily resident, but not domiciled, in the UK in the relevant tax year.

(2) If paragraph 101 applies in relation to the transferee settlement, paragraph 126(9) as applied by paragraph 101(3) has effect as if the reference there to relevant assets included relevant assets within the meaning of paragraph 127(4) (as modified by sub-paragraph (4)(b) below).

(3) If paragraph 101 does not apply in relation to the transferee settlement, the individual is not charged to income tax on so much of the income mentioned in sub-paragraph (1)(d) above as exceeds the relevant proportion of that income.

(4) Sub-paragraphs (4) to (7) of paragraph 127 (meaning of "the relevant proportion") apply for the purposes of sub-paragraph (3) above as if—

(a) references section 2(2) amounts were to OIG amounts,

(b) references to chargeable gains were to offshore income gains, and

(c) references to anything accruing were to it arising.

## 45.34 Record keeping

HMRC s.87 guidance note provides:

> 133. Before 6 April 2008 trustees of non-UK resident settlements that have no UK domiciled beneficiaries, or beneficiaries who may become UK domiciled, will not have had to consider the possible UK Capital Gains Tax liabilities of the beneficiaries. From 6 April 2008 they will have to consider the possibility that a charge under section 87 or Schedule 4C TCGA may accrue to UK resident but non-UK domiciled beneficiaries.
> 134. In relation to pre 6 April 2008 transactions HMRC recognise that in such cases trustees
> - May not have kept sufficient records to calculate precisely the post 5 April 2008 Capital Gains Tax liabilities that may accrue on UK resident but non-UK domiciled beneficiaries, or
> - May not want to incur the expense of searching through old records to obtain all the necessary information to calculate precise Capital Gains Tax liabilities.
>
> 135. In such cases HMRC will consider any reasonable solution suggested to them. Usually proposed solutions will have to be considered on a case by case basis.

The guidance note concludes:

> One solution that HMRC will accept generally is that all assets held by trustees or underlying companies at midnight on 5 April 2008 are treated as having a zero acquisition cost. Provided the trustees make a valid election under paragraph 126 of Schedule 7 there will be no disadvantage to the beneficiaries. This is because the chargeable gain is restricted to the growth in the value of asset since 6 April 2008.

If a rebasing election is made, historic gain does not often matter, but there are situations in which it does.

## 45.35 CGT planning aspects of non-resident trusts

When are non-resident trusts advantageous? One situation is to maximise use of losses, but no-one *plans* to realise losses so that is not generally a planning point.

### 45.35.1 *Where capital payment basis better than arising basis*

Non-resident trusts are in principle better than absolute ownership of UK situate property by UK resident foreign domiciled individuals. Suppose:

(1) s.86 TCGA does not apply (eg settlor foreign domiciled, non-resident or dead);
(2) The trust holds:
    (a) UK situate property; or
    (b) Companies within s.13 TCGA which hold UK situate property.

If the trust property is held by foreign domiciled beneficiaries directly, disposals of the UK situate property are chargeable on an arising basis; if the same property is held in a non-resident trust, disposals by the trustees are taxable on a capital payments basis.

For beneficiaries who are arising basis taxpayers, similar points apply regardless of the situs of the trust property.

### 45.35.2 *Where capital payment basis better than remittance basis*

Non-resident trusts may be better than absolute ownership of foreign situate property by remittance basis taxpayers as they may avoid the application of the mixed fund rule.

*Example 1 (trust better than absolute ownership)*
Suppose a foreign situate asset is acquired for £1m, sold for £2m, giving a gain of £1m. If the asset is held by a remittance basis taxpayer (T) who remits £1m, there is a CGT charge on £1m as the remitted sum is all gain. By contrast, suppose:

(1) the asset is held in a non-resident trust.
(2) the trust makes a capital payment of £1m to T offshore.
(3) in the following year, the trust makes a capital payment of £1m to T onshore.

The offshore payment has reduced the s.2(2) amount to nil, so the second payment is free of CGT.

However to take advantage of this requires careful timing of gains and payments that is often not practical. Often, the remittance basis will be better than the capital payments basis.

*Example 2 (trust worse than absolute ownership)*
Suppose 3 foreign situate assets are each acquired for £1m, sold for £2m,

giving a gain of £1m each. If the assets are held by a remittance basis taxpayer (T) who remits the £2m proceeds of one of the assets, there is a CGT charge on £1m only. (Assume the proceeds are not paid into a singe account, ie are not mixed.)

By contrast, suppose:

(1) the assets are held in a non-resident trust.

(2) the trust makes a capital payment of £2m in the UK.

There is then a CGT charge on £2m.

### 45.35.3 *Where non-resident trusts not desirable*

Non-resident trusts are not desirable where the settlor is non-UK resident, since trust gains are s.2(2) amounts and gains accruing to the settlor are in principle CGT free.

### 45.35.4 *Should trustees hold assets through a trust subsidiary?*

Trustees may hold trust assets directly or through a wholly owned non-resident company (here called "a trust subsidiary"). Which is better?

For CGT a trust company has no CGT advantage and some disadvantages as there may be a double CGT charge:

(1) Gains accruing to the company are attributed to the trustees under s.13[38] and so constitute s.2(2) amounts.

(2) In addition, there may be a chargeable gain when the offshore trustees dispose of the company's shares and so further s.2(2) amounts.

There is normally no relief for that double charge.[39]

Losses of the trust company are restricted and easily lost altogether.

If the property is a residence, CGT private residence relief is lost by use of a company.[40]

So a company should not be used unless there is some good reason (which might be IT or IHT or some other reason.)[41]

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38 See 47.1 (Gains of non-resident companies).

39 There are some reliefs: see 47.18 (Company distribution relief). However these only help the person who pays tax under s.13, so would only be relevant to a settlor-interested trust within s.86.

40 See 47.24 (Private residence relief).

41 See too 29.31 (Transfer of assets from non-resident trust to non-resident trust subsidiary)

CHAPTER FORTY SIX

# BORROWING BY NON-RESIDENT TRUST: SCH 4B TCGA

## 46.1 Flip-flop schemes

This chapter considers sch. 4B and 4C TCGA which are designed to counter a set of tax avoidance schemes popularly known as flip-flop schemes.

In order to understand the law it is helpful to review these schemes, which were designed avoid ss.86, 77 and 87 TCGA.

The s.86 version of the scheme was as follows. Suppose non-resident trustees wished to dispose of an asset on which a gain would accrue within s.86 TCGA. The following steps could be taken:

(1) The trustees borrow money equal to the value of the asset.
(2) They transfer the borrowed money to a second settlement.
(3) The trustees use their powers to exclude the settlor and designated persons from the first settlement so that s.86 ceases to apply to it.
(4) In the following tax year, the trustees of the first settlement sell the asset and realise a gain to which s.86 does not apply. They may then repay the loan.

This scheme was never challenged in court; I infer it was successful (though in practice it was often combined with a payment to the settlor from the second settlement, which turned out to be taxable under s.87.)

The s.77 version of the scheme was designed to avoid s.77 TCGA. It involved the same steps as the s.86 version. In this case however the legislation was (slightly) differently worded, and the scheme was eventually held to be unsuccessful in *West v Trennary* 76 TC 713, where the result (appropriately) flip-flopped through taxpayer success before the Commissioners, failure in the High Court, success in the Court of Appeal, to eventual failure in the House of Lords. Section 77 is now repealed, so this is now of historic interest only, though the background explains one or two features which survive in the present legislation.

The s.87 TCGA version of the scheme was as follows. Suppose non-resident trustees wished:

(1) to dispose of an asset on which a s.2(2) amount (trust gain) would accrue, and
(2) to make a payment to beneficiaries, which would be chargeable under s.87.

The following steps could be taken:

(1) The trustees of the first settlement borrow money equal to the value of the asset.
(2) They transfer the borrowed money to a second settlement.
(3) The trustees of the second settlement made a capital payment to the beneficiary.
(4) In the following tax year, the trustees of the first settlement sell the asset and realise the gain which is not a s.2(2) amount (trust gain) in relation to the second settlement. They may then repay the loan.

This was held to be unsuccessful in *Herman v HMRC*.[1]

It is striking that the majority of these widely marketed schemes eventually failed, contrary (I think) to the general expectation of the profession at the time. What lessons should be learned from that debacle? I leave readers to ponder over that.

The key features of the schemes were trustee borrowing and a transfer of trust property in year 1, followed by a disposal in a subsequent year. Schedule 4B produces a deemed disposal in year 1, which counteracts the s.86 version of the scheme. Schedule 4C contains special rules to tax the gain on beneficiaries, which counteracts the s.87 version.

The provisions were introduced in 2000 and revised in 2003 and 2008.

For the 2008 transitional rules, see 45.22 (Ascertaining s.2(2) amounts as at end 2007/8); 45.23 (Pre-2008 inter-trust transfer). For IHT issues which arise where trustees borrow, see 56.9 (Deduction for debts of trustees).

### 46.1.1 *What about income tax flip-flop schemes?*

Since schedule 4B only applies for CGT and OIG purposes, the reader may wonder if the schemes could work for IT. Suppose non-resident

1 See 45.7.1 (Indirect receipt from trustees).

trustees of a settlor-interested discretionary trust wished to receive income (for instance by surrendering a life policy or receiving dividends) which would fall within s.624 or s.720. Could the following steps be taken:
(1) The trustees borrow money equal to the anticipated income.
(2) They transfer the borrowed money to a second settlement.
(3) The trustees use their powers to exclude the settlor and spouse from the first settlement so that the settlement ceases to be settlor-interested.
(4) In the following tax year, the trustees of the first settlement receive the income and repay the borrowing.

The answer is that the capital payment provisions, s.633 ITTOIA and s.727 ITA, fill that gap.

Similarly, planning of this kind would not work for s.731 as transfers between trusts do not isolate relevant income; see 27.32 (Transfer between trusts).

## 46.2 The key conditions

Para 1 Sch 4B TCGA provides:

> (1) This Schedule applies where trustees of a settlement—
> (a) make a transfer of value (see paragraph 2) in a year of assessment in which the settlement is within section 86 or 87 (see paragraph 3), and
> (b) in accordance with this Schedule the transfer of value is treated as linked with trustee borrowing (see paragraphs 4 to 9).

Thus the three key conditions, or sets of conditions, are:
(1) a Sch4B-transfer of value
(2) trustee borrowing.
(3) the transfer of value is "linked" with trustee borrowing.

## 46.3 Sch4B-transfer of value

The term "transfer of value" is unfortunate. Firstly the term is normally used with a specific IHT meaning. Secondly, the term is artificially defined to include loans and other transactions which do not involve any transfer of value in the normal sense of the term. I therefore use the term **"sch4B-transfer of value"**.

There are three types of sch4B-transfer of value. Para 2(1) Sch 4B TCGA provides:

> For the purposes of this Schedule trustees of a settlement make a transfer of value if they—
> (a) lend money or any other asset to any person,
> (b) transfer an asset to any person and receive either no consideration or a consideration whose amount or value is less than the market value of the asset transferred, or
> (c) issue a security of any description to any person and receive either no consideration or a consideration whose amount or value is less than the value of the security.

The CG Manual does not add much to the statute but I set it out for completeness:

> **35124. Anti-avoidance provisions: Disposals of interests for consideration: Transfer of value**
> Under TCGA 1992, SCH 4B, para 2(1) trustees make a transfer of value if they
> (a) lend money or any other asset, regardless of whether a commercial rate of interest or hire is charged, or
> (b) transfer an asset, including cash, see paragraph 13(1), for no consideration or a consideration less than its market value, or
> (c) issue a security for no consideration or a consideration less than its value.
> **35125. Anti-avoidance provisions: Disposals of interests for consideration: Transfer of value**
> References to transfers of value include everything that is or is treated as a disposal under TCGA 1992, and also include transfers or loans of money, and loans of other assets. Note that this includes disposals of assets such as government stock or a dwelling house occupied as a beneficiary's principal private residence, even though there would be no chargeable gain on the disposal. It also includes the occasion of a beneficiary becoming absolutely entitled as against the trustee but in this context see CG35128.
> Some part disposals involve the creation of a new asset. In this situation any reference in the legislation to the transfer of an asset refers to the (part) disposal of the old asset.
> CG35124(b) above makes it clear that a sale of an asset, whether to an unconnected person or a beneficiary, is not a transfer of value provided it is for full consideration.

### 46.3.1 *Sch4B-transfer of value type (b): actual transfer*

This is the most important type of transfer of value.

RI 259 provides:

> **B1 Paragraph 2(1)(b)—cash distributions which are income**
> Where trustees of a discretionary trust make a distribution which is income of the recipient for UK tax purposes, this is not a "transfer of value" within para 2, which is concerned with capital transactions.

### 46.3.2 *Sch4B-transfer of value type (a): loans*

I cannot see the reason for sch4B transfer of value type (a) (loans). An effective flip-flop scheme would require a transfer which must fall within (b). There is no scope for tax avoidance via a loan. I would be grateful to any reader who could explain.

RI 259 provides:

> **B2 Paragraph 2(1)(a)—beneficiary exercising rights under [TLATA][2] 1996 s 12**
> In certain circumstances a beneficiary's occupation of property, instead of being the consequence of the volition of the trustees, may result from personal rights under Trusts of Land and Appointment of Trustees Act 1996 s 12. Our view is that if the rights of the beneficiary arise as a consequence of the wording of the deed or will, then the occupation does not give rise to a transfer of value. It may be otherwise where the rights have arisen as a consequence of the exercise by the trustees of a power of appointment or advancement.

RI 259 provides:

> **B7 What happens when trustees put money into a conventional current or deposit account at a bank or building society?**
> Although in general law this is regarded as a loan from the customer to the bank, in the context of this legislation we do not consider that this comes within the meaning of "lend" for the purposes of para 2(1)(a). The currency in which the deposit is made is immaterial.

This is purposive, bordering on wishful, thinking; but since it usually suits the taxpayer, it will not usually be challenged.

2 The original refers erroneously to the "Trustee etc Act".

### 46.3.3 *Sch4B-transfer of value type (c): issuing a security*

It is normally companies rather than trustees who issue securities so this is of somewhat theoretical interest. RI 259 provides:

> **B3 Paragraph 2(1)(c)— "issue a security"**
> We have been asked what the expression "issue a security" covers. It caters for those exceptional circumstances where trustees issue to a beneficiary or to the trustees of another trust a document acknowledging liability. Schedule 4B para 13(2) provides that references to the transfer of an asset include everything that is or is treated as a disposal of an asset. The issue of a security is not in itself the disposal or part disposal of an asset. Therefore para 2(1)(b) does not apply to it, and it was necessary to have a specific provision to cover this possibility.

I find the idea that any flip flop scheme could be carried out by issuing a security somewhat implausible. Assuming it was necessary, a neater solution would have been to define transfer to include the creation of an asset (as for the TAA provisions); but it does not do much harm.

### 46.3.4 *Amount of value transferred*

Para 2 Sch 4B TCGA provides:

> (3) In the case of a loan, the amount of value transferred is taken to be the market value of the asset.
> (4) In the case of a transfer, the amount of value transferred is taken to be—
> (a) if any part of the value of the asset is attributable to trustee borrowing, the market value of the asset;
> (b) if no part of the value of the asset is attributable to trustee borrowing, the market value of the asset reduced by the amount or value of any consideration received for it...
> (5) In the case of the issue of a security, the amount of value transferred shall be taken to be the value of the security reduced by the amount or value of any consideration received by the trustees for it.
> (6) References in this paragraph to the value of an asset are to its value immediately before the material time, unless the asset does not exist before that time in which case its value immediately after that time shall be taken.

## 46.4 Settlement "within section 86 or 87"

Para 3 Sch 4B TCGA provides commonsense definitions.

### 46.4.1 *Within s.86*

Para 3 Sch 4B TCGA provides:

> (1) This paragraph explains what is meant in this Schedule by a settlement being "within section 86 or 87" in a year of assessment.
> (3) A settlement is "within section 86" in a year of assessment if, assuming—
> (a) that there were chargeable gains accruing to the trustees by virtue of disposals of any of the settled property originating from the settlor, and
> (b) that the other elements of the condition in subsection (1)(e) of that section were met,
> chargeable gains would, under that section, be treated as accruing to the settlor in that year.
> Expressions used in this sub-paragraph have the same meaning as in section 86.

### 46.4.2 *Within s.87*

Para 3 Sch 4B TCGA, as inserted by s.92(2) FA 2000, used to provide:

> *(4) A settlement is "within section 87" in a year of assessment if, assuming—*
> *(a) there were trust gains for the year within the meaning of subsection (2) of that section, and*
> *(b) that beneficiaries of the settlement received capital payments from the trustees in that year or had received such payments in an earlier year,*
> *chargeable gains would, under that section or section 89(2), be treated as accruing to the beneficiaries in that year.*
> *Expressions used in this sub-paragraph have the same meaning as in section 87.*

Para 3 Sch 4B TCGA was then amended by the para 130 Sch 7 FA 2008:

> In paragraph 3 of Schedule 4B (transfers of value by trustees linked with

> trustee borrowing: settlements), for sub-paragraph (4) substitute—
> "(4) A settlement is "within section 87" for a tax year if—
> (a) section 87 applies to the settlement for that year, or
> (b) chargeable gains would be treated under section 89(2) as accruing in that year to a beneficiary who received a capital payment from the trustees of the settlement in that year.
> (5) The reference in subsection (4)(b) to chargeable gains treated as accruing includes offshore income gains treated as arising."

The drafter absentmindedly repealed the sentence "Expressions used in this sub-paragraph have the same meaning as in section 87".[3] It is considered, however, the context shows that the expressions in para 3(4)(5) are nevertheless to be construed with their s.87 meanings.

## 46.5 Trustee borrowing

Para 4(1) Sch 4B TCGA provides a wide definition of borrowing:

> For the purposes of this Schedule trustees of a settlement are treated as borrowing if—
> (a) money or any other asset is lent to them, or
> (b) an asset is transferred to them and in connection with the transfer the trustees assume a contractual obligation (whether absolute or conditional) to restore or transfer to any person that or any other asset.
> In the following provisions of this Schedule "loan obligation" includes any such obligation as is mentioned in paragraph (b).

A loan to a trust from a company wholly owned by the trust constitutes "trustee borrowing" for the purposes of sch 4B TCGA. RI 259 states that HMRC take this unmeritorious point:

> **B4 Paragraph 4(1): meaning of "borrowing"**
> It is not unusual for the trustees of a non-resident trust to borrow money from a non-resident company which they control. In this situation, if the company were resident in the UK, [s.455 CTA 2010] might well be applicable. It has been suggested that in this situation the trustees are

3 Some databases have failed to notice this (accidental) repeal and include this sentence in para 3 Sch 4B TCGA.

> effectively "borrowing" from themselves and therefore outside para 4(1). We consider this incorrect, particularly in the light of *Chamberlain v IRC*, 25 TC 357. It does not matter whether the borrowing is from a company controlled by the trustees or their associates, or from an entirely unconnected company. What matters is the use to which the borrowing is put.

Sympathetic courts have allowed trustees to avoid the unfairness by setting aside loans made in (understandable) ignorance of these daft rules.[4]

RI 259 continues:

> The fact that money was borrowed before 21 March 2000 does not prevent it from being outstanding trust borrowing.
> Where trustees are presented with a bill, for example for repairs to trust property, bona fide delay in payment would not convert this into a borrowing for the purposes of paragraph 4.

The last paragraph is wrong, since a debt on a bill for *repairs* cannot fall within para 4 at all; para 4 only applies on a loan or transfer of "assets".

### 46.5.1 *Amount borrowed*

Para 4(2) Sch 4B TCGA provides:

> The amount borrowed (the "proceeds" of the borrowing) is taken to be—
> (a) in the case of a loan, the market value[5] of the asset;
> (b) in the case of a transfer [ie a transaction within para 4(1)(b)], the

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4 *Re Leumi Overseas Trust* [2007] JRC 248; *Barclays Private Bank v Chamberlain* 9 ITELR 304. It is an interesting question how offshore courts will react to the decision of the Court of Appeal in *Pitt v Holt* [2011] STC 809 which (more or less) abolishes the rule in *Hastings-Bass* on which these decisions were based.

5 Defined para 4(3):
"References in this paragraph to the market value of an asset are to its market value immediately before the loan is made, or the transfer is effectively completed, unless the asset does not exist before that time in which case its market value immediately after that time shall be taken.
The effective completion of a transfer means the point at which the person acquiring the asset becomes for practical purposes unconditionally entitled to the whole of the intended subject matter of the transfer."

market value of the asset reduced by the amount or value of any consideration received for it.

## 46.6 Transfer of value "linked" with trustee borrowing

### 46.6.1 *Terminology*

The expression "linked with trustee borrowing" is defined in paras 5-8 Sch 4B. These paragraphs employ the following terms:
(1) **"Linked with trustee borrowing"**
(2) **"Outstanding trustee borrowing"**
(3) **"Normal trust purposes"**
(4) **"Ordinary trust assets"**
Each of these four expressions are best regarded as a labels for complex sets of rules. In each case the label is not particularly apt and the definition can be described as artificial; the labels taken literally would be misleading. The cosy expressions conceal the arbitrary and complex nature of the concepts to which they refer. However it is difficult to think of better terms, and for the purposes of discussion it is best to adopt the statutory terminology *faute de mieux*.

### 46.6.2 *"Linked" with trustee borrowing*

Para 5(1) Sch 4B TCGA provides:

> For the purposes of this Schedule a transfer of value by trustees is treated as linked with trustee borrowing if at the material time there is outstanding trustee borrowing.

### 46.6.3 *"Outstanding trustee borrowing"*

Para 5(2) Sch 4B TCGA provides:

> For the purposes of this Schedule there is outstanding trustee borrowing at any time to the extent that—
> (a) any loan obligation[6] is outstanding, and
> (b) there are proceeds of trustee borrowing that have not been either—

6 Defined in para 4(1): see 46.5 (trustee borrowing).

(i) applied for normal trust purposes, or
(ii) taken into account[7] under this Schedule in relation to an earlier transfer of value.

### 46.6.4 *The material time*

Para 2(2) Sch 4B TCGA provides:

> References in this Schedule to "the material time", in relation to a transfer of value, are to the time when the loan is made, the transfer is effectively completed or the security is issued.
> The effective completion of a transfer means the point at which the person acquiring the asset becomes for practical purposes unconditionally entitled to the whole of the intended subject matter of the transfer.

The CG manual provides:

> **35128. Anti-avoidance provisions: Disposals of interests for consideration: The material time**
> The expression 'the material time' is important for two reasons.
> The first is that the test whether the transfer of value is linked with trust borrowing is applied at the material time.
> The second is that the deemed disposal by the trustees occurs at the material time.
> [The Manual sets out para 1(2) and continues] So if say trustees appoint a cash sum to a beneficiary, he would become unconditionally entitled when the money had been transferred to his bank account, not when the cheque was handed to him, for at that stage the trustees might have no funds to meet the cheque.

7 Para 5(3) Sch 4B TCGA provides a commonsense definition:
"An amount of trustee borrowing is "taken into account" under this Schedule in relation to a transfer of value if the transfer of value is in accordance with this Schedule treated as linked with trustee borrowing.
The amount so taken into account is—
(a) the amount of the value transferred by that transfer of value, or
(b) if less, the amount of outstanding trustee borrowing at the material time in relation to that transfer of value."

## 46.7 Normal trust purposes

Para 6(1) Sch 4B TCGA provides:

> For the purposes of this Schedule the proceeds of trustee borrowing are applied for normal trust purposes in the following circumstances, and not otherwise.

There are three types of "normal trust purposes":
(1) Payment for ordinary trust assets
(2) Repayment of loan
(3) Payment of expenses
Para 9 Sch 4B TCGA provides power to amend paras 6-8 by regulation. Presumably HMRC were worried that they might have left some loophole for future tax avoiders. In practice no regulations have been made.

## 46.8 Normal trust purposes: Payment for ordinary trust assets

Para 6(2) Sch 4B TCGA provides:

> They are applied for normal trust purposes if they are applied by the trustees in making a payment in respect of an ordinary trust asset and the following conditions are met—
> (a) the payment is made under a transaction at arm's length or is not more than the payment that would be made if the transaction were at arm's length;
> (b) the asset forms part of the settled property immediately after the material time or, if it does not do so, the alternative condition in paragraph 8 below is met; and
> (c) the sum paid is (or but for section 17 or 39 would be) allowable under section 38 as a deduction in computing a gain accruing to the trustees on a disposal of the asset.

### 46.8.1 *Ordinary trust assets*

Para 7 Sch 4B TCGA provides:

> (1) The following are "ordinary trust assets" for the purposes of this Schedule—

(a) shares or securities;[8]
(b) tangible property, whether movable or immovable, or a lease of such property;
(c) property not within paragraph (a) or (b) which is used for the purposes of a trade, profession or vocation carried on—
  (i) by the trustees, or
  (ii) by a beneficiary who has an interest in possession in the settled property;
(d) any right in or over, or any interest in, property of a description within paragraph (b) or (c).

Thus shares or securities are ordinary trust assets but interests in shares or securities are not. The distinction between securities and interests in securities raises some deep questions, though there is no reason to think that the drafter gave any thought to them.

RI 259 provides:

> **B6 Paragraph 7— "ordinary trust assets"—futures contracts**
> We have been asked to say whether a futures contract relating to commodities is an "ordinary trust asset". Such a contract is not a tangible asset nor does it give the holder an interest in such an asset. Therefore, it is not an "ordinary trust asset".

### 46.8.2 *Grant of lease*

RI 259 provides:

> **B8 What happens when money is borrowed to purchase the freehold interest of a property which is then rented on a commercial basis?**
> ... Under para 13(2) references to the transfer of an asset include references to anything that is a disposal, and under TCGA 1992 s 21(2) references to a disposal include references to a part disposal. Paragraph 13(3) provides that references to a transfer of an asset do not include the transfer of an asset which is created by the part disposal of another asset. The grant of a lease is a part disposal of the freehold interest and therefore the grant of a lease is a transfer of the freehold interest for the purposes of para 2(1)(b) and is not regarded as the transfer simply of the lease. If the freehold interest was bought with borrowed money it meets

8 Defined (after a fashion) in para 7(2): "In sub-paragraph (1)(a) "securities" has the same meaning as in section 132."

the test in para 2(4)(a), and the amount of value transferred equals the market value of the freehold.

Assuming that there is outstanding trustee borrowing at "the material time", which is defined in para 2(2) as the time the transfer is effectively completed, it is then necessary to consider whether the transfer of value is linked with trustee borrowing. Under para 7 tangible property, and any interest in such property falls within the expression "ordinary trust assets". However the property concerned must under para 6(2)(b) either form part of the settled property immediately after the material time, or meet the alternative condition in para 8(1)(b) that it is represented by ordinary trust assets which form part of the settled property immediately after the material time. Paragraph 6(2)(b) and para 8(1)(b) may be looked at together. In this situation we say that the reversion to the lease is still part of the settled property, and the lease itself is represented by the right to the rental stream.

Therefore where trustees borrow money to acquire the freehold interest in a property which is then let commercially and, at the material time, there are no outstanding trustee borrowings other than those which have been applied for normal trust purposes, Sch 4B does not apply. But the position will be different if at that moment there are outstanding trustee borrowings applied for other purposes.

The same considerations apply where trustees acquire a long lease which is sublet, and where the asset in question is a chattel rather than land or buildings.

### 46.8.3 *Asset becoming valueless*

Para 8 Sch 4B TCGA provides:

(1) The alternative condition referred to in paragraph 6(2)(b) in relation to an asset which no longer forms part of the settled property is that—

(a) the asset is treated as having been disposed of by virtue of section 24(1), or

(b) one or more ordinary trust assets which taken together directly or indirectly represent the asset—

  (i) form part of the settled property immediately after the material time, or

  (ii) are treated as having been disposed of by virtue of section 24(1).

(2) Where there has been a part disposal of the asset, the condition in paragraph 6(2)(b) and the provisions of sub-paragraph (1) above may be applied in any combination in relation to the subject matter of the part disposal and what remains.

(3) References in this paragraph to an asset include part of an asset.

## 46.9 Normal trust purposes: Repayment of loan

Para 6(3) Sch 4B TCGA provides:

> They are applied for normal trust purposes if—
> (a) they are applied by the trustees in wholly or partly discharging a loan obligation of the trustees, and
> (b) the whole of the proceeds of the borrowing connected with that obligation (or all but an insignificant amount) have been applied by the trustees for normal trust purposes.

## 46.10 Normal trust purposes: Payment of expenses

Para 6(4) Sch 4B TCGA provides:

> They are applied for normal trust purposes if they are applied by the trustees in making payments to meet bona fide current expenses incurred by them in administering the settlement or any of the settled property.

RI 259 provides:

> **B5 Paragraph 6(4)—application of proceeds to meet current expenses**
> We have been asked whether trustee borrowings to meet payments on account or provision for future or past expenses are covered by the expression "current expenses". One circumstance in which borrowings are applied for "normal trust purposes" (para 6) is where they are applied by the trustees in making payments to meet bona fide current expenses incurred by them.
> One may note that there are three tests to be met—
> – The borrowings have been applied by the moment of the transfer of value (para 5(2)(b)(i)).
> – They have been applied to meet bona fide "current expenses".
> – The expenses are expenses of "administering" the settlement or any of the settled property.
> In the case of borrowing to meet future expenses it is hard to see how the borrowings can be said to have been applied. But the time for making the test is not when the money is borrowed, but the time of the transfer of value (this is "the material time", as defined in para 2(2)). In the case of

payments on account there would be the requisite application and the liability to pay would have been incurred.

We do not regard "current" as restricting qualification to expenditure which for accounting purposes must fall in the year of borrowing, but we should regard it as excluding borrowing to make a provision for future expenditure or to meet expenditure that was incurred long before but left unpaid. In general where contracts for repairs of an ordinary kind have been entered into, we should regard the expenditure anticipated under those contracts to be current expenses at the moment of borrowing. Where trustees as the owner or tenant of a flat are obliged by contract or under the terms of the lease to make payments into a common fund to meet future maintenance or repair expenditure this would be regarded as a current expense.

The expression "administering the settlement or any of the settled property" should be construed widely to cover not only those expenses properly chargeable to income, or which would be so chargeable but for express provisions of the trust deed, but also capital expenditure such as capital taxes in the UK or elsewhere, or legal costs of a reorganisation, in particular the costs of an application under the Variation of Trusts Act. Other capital expenditure would often be expenditure on the asset itself, and therefore qualify under para 6(2). Contributions to the day-to-day running costs of a nominee company controlled by the trustees would also qualify.

### 46.10.1 *Unproductive expenditure*

RI 259 provides:

**B9 What happens when money is spent unproductively, for example on a planning application that fails?**

Under para 6(2) there are three conditions that must be met by a payment in respect of "an ordinary trust asset" if it is to be regarded as applied for normal trust purposes. The third, in para 6(2)(c), is that the sum is allowable under TCGA 1992 s 38 (or would be but for s 17 or 39) as a deduction in computing a gain accruing to the trustees on a disposal of the asset. If an application for planning permission fails, then when the land is actually sold the costs relating to the application are generally not allowable; this is because they are not "reflected in the state or nature of the asset at the time of the disposal". Paragraph 6(2)(c) however must be referring to a notional disposal not to a real one. In the context of para 6 we consider that the reference can only be to a notional disposal taking place at the time when the expenditure is incurred.

> Although one could not lay down as a universal rule that the expenditure would always qualify, the test is whether the existence of the current application for planning permission is reflected in the state or nature of the asset at the time of the notional disposal.

## 46.11 Sch 4B deemed disposal

Para 1(2) Sch 4B TCGA provides:

> Where this Schedule applies the trustees are treated as disposing of and immediately reacquiring the whole or a proportion of each of the chargeable assets that continue to form part of the settled property (see paragraphs 10 to 13).

I refer to this as a **"schedule 4B deemed disposal"**. Para 10 Sch 4B TCGA provides the details

> (1) Where in accordance with this Schedule a transfer of value by trustees is treated as linked with trustee borrowing, the trustees are treated for all purposes of this Act—
> (a) as having at the material time[9] disposed of, and
> (b) as having immediately reacquired,
> the whole or a proportion (see paragraph 11) of each of the chargeable assets that form part of the settled property immediately after the material time ("the remaining chargeable assets").
> (2) The deemed disposal and reacquisition shall be taken—
> (a) to be for a consideration equal to the whole or, as the case may be, a proportion of the market value of each of those assets, and
> (b) to be under a bargain at arm's length.[10]

The key term here is "chargeable asset". Para 10(3) Sch 4B provides:

> For the purposes of sub-paragraph (1) an asset is a chargeable asset if a gain on a disposal of the asset by the trustees at the material time would be a chargeable gain.

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9 See 46.6.4 (The material time).

10 This deeming prevents hold-over relief (relevant to a UK resident trust only).

### 46.11.1 *The extent of the disposal*

Para 11 Sch 4B TCGA provides:

> (1) This paragraph provides for determining whether the deemed disposal and reacquisition is of the whole or a proportion of each of the remaining chargeable assets.
> (2) If the amount of value transferred—
> (a) is less than the amount of outstanding trustee borrowing, and
> (b) is also less than the effective value of the remaining chargeable assets,
> the deemed disposal and reacquisition is of the proportion of each of the remaining chargeable assets given by:
> VT÷EV
> where—
> VT is the amount of value transferred, and
> EV is the effective value of the remaining chargeable assets.
> (3) If the amount of value transferred—
> (a) is not less than the amount of outstanding trustee borrowing, but
> (b) is less than the effective value of the remaining chargeable assets,
> the deemed disposal and reacquisition is of the proportion of each of the remaining chargeable assets given by:
> TB÷EV
> where—
> TB is the amount of outstanding trustee borrowing, and
> EV is the effective value of the remaining chargeable assets.
> (4) In any other case the deemed disposal and reacquisition is of the whole of each of the remaining chargeable assets.
> (5) For the purposes of this paragraph the effective value of the remaining chargeable assets means the aggregate market value of those assets reduced by so much of that value as is attributable to trustee borrowing.
> (6) References in this paragraph to amounts or values, except in relation to the amount of value transferred, are to amounts or values immediately after the material time.

### 46.11.2 *HMRC example computation on part disposal*

RI 259 provides an example (I have slightly amended the layout for enhanced clarity):

**B10 How should we compute the base cost of assets for future disposals?**
... Suppose that an asset cost £600, the trustees are treated as disposing of two thirds of the asset at the material time (paragraph 10(1)), and the respective values of two thirds and one third immediately after that time are £900 and £450.

HMRC compute the sch 4B deemed disposal is:

| | | |
|---|---|---|
| Deemed Proceeds | | 900 |
| Cost | [two thirds of 600] | -400 |
| Gain | | 500 |

HMRC compute the base cost for a future disposal as:

| | | |
|---|---|---|
| Remaining original cost | 600 – 400 | 200 |
| Deemed Acquisition | | 900 |
| Revised base cost | | 1100 |

## 46.12 Value attributable to trustee borrowing

Para 12 Sch 4B TCGA provides:

(1) For the purposes of this Schedule the value of an asset is attributable to trustee borrowing to the extent determined in accordance with the following rules.
(2) Where the asset itself has been borrowed by trustees, the value of the asset is attributable to trustee borrowing to the extent that the proceeds of that borrowing have not been applied for normal trust purposes.
This is in addition to any extent to which the value of the asset may be attributable to trustee borrowing by virtue of sub-paragraph (3).
(3) The value of any asset is attributable to trustee borrowing to the extent that—
(a) the trustees have applied the proceeds of trustee borrowing in acquiring or enhancing the value of the asset, or
(b) the asset represents directly or indirectly an asset whose value was attributable to the trustees having so applied the proceeds of trustee borrowing.
(4) For the purposes of this paragraph an amount is applied by the trustees in acquiring or enhancing the value of an asset if it is applied wholly and exclusively by them—

(a) as consideration in money or money's worth for the acquisition of the asset,
(b) for the purpose of enhancing the value of the asset in a way that is reflected in the state or nature of the asset,
(c) in establishing, preserving or defending their title to, or to a right over, the asset, or
(d) where the asset is a holding of shares or securities that is treated as a single asset, by way of consideration in money or money's worth for additional shares or securities forming part of the same holding.

(5) Trustees are treated as applying the proceeds of borrowing as mentioned in sub-paragraph (4) if and to the extent that at the time the expenditure is incurred there is outstanding trustee borrowing.
(6) In sub-paragraph (4)(d) "securities" has the same meaning as in section 132.

## 46.13 Schedule 4C

Para 1(1) Schedule 4C TCGA provides:

> (1) This Schedule applies where the trustees of a settlement ("the transferor settlement") make a transfer of value to which Schedule 4B applies ("the original transfer")....
> (5) References in this Schedule to a transfer to which Schedule 4B applies include any such transfer, whether or not any chargeable gain or allowable loss accrues under that Schedule by virtue of the transfer.

Schedule 4C repeats (with some differences) the usual s.87 rules.

## 46.14 Schedule 4C pool

Para 1 Schedule 4C TCGA continues:

> (2) The transferor settlement is regarded for the purposes of this Schedule as having a "Schedule 4C pool".
> (3) The Schedule 4C pool contains the section 2(2) amounts for the settlement that are outstanding at the end of the tax year in which the original transfer is made (see paragraph 1A).
> (3A) The section 2(2) amount for that tax year is increased by—
> (a) the amount of Schedule 4B trust gains accruing by virtue of the original transfer (see paragraphs 3 to 7), and

(b) the total amount of any further Schedule 4B trust gains accruing by virtue of any further transfers of value to which that Schedule applies that are made by the trustees in that tax year.

## 46.15 "Outstanding section 2(2) amounts"

Para 1A Sch 4C TCGA provides:

> (1) The following steps are to be taken for the purpose of calculating the section 2(2) amounts for a settlement that are outstanding at the end of a tax year ("the relevant tax year").
> *Step 1* Find the section 2(2) amount for the settlement for the relevant tax year and earlier tax years, as reduced under section 87A as it applies for the relevant tax year and earlier tax years....
> (2) For the purposes of Step 1 of sub-paragraph (1) take into account the effect of section 90 in relation to any transfer of settled property from or to the trustees of the settlement made in or before the relevant tax year.

See 45.5 (Section 2(2) amount).

### 46.15.1 *Capital payment to non-resident beneficiary*

Para 1A(1) Sch 4C TCGA provides:

> *Step 2* This Step applies if, by virtue of the matching of the section 2(2) amount for the settlement for a tax year ("the applicable year") with a capital payment, chargeable gains are treated under section 87 or 89(2) as accruing in the relevant tax year to a beneficiary who is not chargeable to tax for that year.
> Increase the section 2(2) amount for the applicable year (found under Step 1) by the amount of the chargeable gains....
> (3) For the purposes of this Schedule a beneficiary is "chargeable to tax" for a tax year if the beneficiary is resident or ordinarily resident in the UK in that year.

Capital payments to non-residents do not take schedule 4B gains out of the schedule 4C pool. This is different from the usual s.87 rule: contrast 45.18.3 (Mixed UK and foreign beneficiaries: simple capital payments). There is no good reason for this, except a desire to penalise those who make sch.4B deemed disposals.

## 46.16 "Schedule 4B trust gains"

Para 3 Sch 4C TCGA provides:

> (1) This paragraph explains what is meant for the purposes of this Schedule by "Schedule 4B trust gains".
> (2) The Schedule 4B trust gains are computed in relation to each transfer of value to which that Schedule applies.
> (3) In relation to a transfer of value the amount of the Schedule 4B trust gains for the purposes of this Schedule is given by—
> CA -SG -AL
> where—
> CA is the chargeable amount computed under paragraph 4 or 5 below,
> SG is the amount of any gains attributed to the settlor that fall to be deducted under paragraph 6 below, and
> AL is the amount of any allowable losses that may be deducted under paragraph 7 below.

### 46.16.1 *Chargeable amount: non-resident trust*

Para 4 Sch 4C TCGA provides:

> (1) If the transfer of value is made in a year of assessment during which the trustees of the transferor settlement are at no time resident and ordinarily resident in the UK the chargeable amount is computed under this paragraph.
> (2) Where this paragraph applies the chargeable amount is the amount on which the trustees would have been chargeable to tax under section 2(2) by virtue of Schedule 4B if they had been resident and ordinarily resident in the UK in the year (and had made the disposals which Schedule 4B treats them as having made).

The wording is based on the s.87 definition of s.2(2) amount: see 45.5 (Section 2(2) amount).

### 46.16.2 *Dual resident trust*

Para 5 Sch 4C TCGA provides:

> (1) If the transfer of value is made in a year of assessment where—
> (a) the trustees of the transferor settlement are resident and ordinarily

resident in the UK during any part of the year, and
(b) 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,

the chargeable amount is computed under this paragraph.
(2) Where this paragraph applies the chargeable amount is the lesser of—
(a) the amount on which the trustees would be chargeable to tax under section 2(2) by virtue of Schedule 4B on the assumption that the double taxation relief arrangements did not apply (and the disposals which Schedule 4B treats them as having made were made), and
(b) the amount on which the trustees would be so chargeable to tax by virtue of disposals of protected assets.

(3) For this purpose "protected assets" has the meaning given by section 88(4).

The wording is based on the s.87 rules for dual resident trusts: see 45.17 (Dual resident trust).

### 46.16.3 *Gains attributed to settlor*

Para 6(1) Sch 4C TCGA provides:

> For the purposes of this Schedule the chargeable amount in relation to a transfer of value shall be reduced by the amount of any chargeable gains arising by virtue of that transfer of value that—
> (a) are by virtue of section 86(4) treated as accruing to the settlor,

The wording is based on the s.87 rules: see 45.5 (Section 2(2) amount).

> or
> (b) where section 10A applies, are treated by virtue of that section (as it has effect subject to paragraph 12 below) as accruing to the settlor in the year of return.

For the s.87 equivalent rules, see 46.22.1 (Temporarily non-resident settlor: s.86 charge).

### 46.16.4 *Losses of trust within s.86*

Para 6(2) Sch 4C TCGA provides:

> In determining for the purposes of sub-paragraph (1)(a) the amount of chargeable gains arising by virtue of a transfer of value that are treated as accruing to the settlor, there shall be disregarded any losses which arise otherwise than by virtue of Schedule 4B.

This is needed for the case where a trust within s.86 has losses and then realises gains on a sch.4B deemed disposal. The losses are set against the gains, so no gains are treated as accruing to the settlor. This provision is needed to ensure that those gains are not added to the sch.4C pool.

## 46.17 Allowable losses

Para 7 Sch 4C TCGA provides:

> (1) An allowable loss arising under Schedule 4B in relation to a transfer of value by the trustees of a settlement may be taken into account in accordance with this paragraph to reduce for the purposes of this Schedule the chargeable amount in relation to another transfer of value by those trustees.

This would always be the case.

> (2) Any such allowable loss goes first to reduce chargeable amounts arising from other transfers of value made in the same year of assessment.
> If there is more than one chargeable amount and the aggregate amount of the allowable losses is less than the aggregate of the chargeable amounts, each of the chargeable amounts is reduced proportionately.
> (3) If in any year of assessment the aggregate amount of the allowable losses exceeds the aggregate of the chargeable amounts, the excess shall be carried forward to the next year of assessment and treated for the purposes of this paragraph as if it were an allowable loss arising in relation to a transfer of value made in that year.
> (4) Any reduction of a chargeable amount under this paragraph is made after any deduction under paragraph 6.

Why does this matter?
In the HMRC view, if a Sch4B-transfer of value is deliberately made to trigger a loss on a sch.4B deemed disposal, the loss is disallowed under

s.16A TCGA.[11] CG Manual Appendix 9 provides:

> **Example 18 - trustees make a deliberate transfer of value**
> 1. A body of trustees who fall within the terms of Schedule 4B have outstanding borrowing which has not been used for trust purposes (Schedule 4B is a measure introduced to discourage trustees avoiding capital gains tax by incurring debt and advancing funds from the settlement). The trustees intentionally make a transfer of value which triggers off a charge under Schedule 4B, and as they expect this transaction results in a capital loss. The trustees have realised chargeable gains in the same year, and claim to set the loss against those gains.
> 2. It is necessary to look at the arrangements which have been entered into by the trustees to determine whether these have been entered into with a main purpose of securing a tax advantage. There are arrangements in this case, so the question is whether or not those arrangements were entered into with a main purpose of securing a tax advantage, and to decide this it is necessary to take account of all the circumstances surrounding the transactions. It will be relevant to consider what the trustees' overall economic objective was, and whether that objective is being fulfilled in a straightforward way, or whether additional, complex or costly steps have been inserted. It is significant that Schedule 4B is itself anti-avoidance legislation, intended to counter avoidance of tax on gains by contrived arrangements between settlements. The fact that the trustees have deliberately triggered the operation of the schedule is an indicator that one of their main purposes was to secure the advantage of the capital loss. In such a case, the TAAR will apply and the loss will not be an allowable loss.

## 46.18 Subsequent Sch4B-transfer of value

Para 7B Sch 4C TCGA provides:

> (1) This paragraph applies if the trustees of the transferor settlement make a further transfer of value to which Schedule 4B applies in a tax year ("the year of the transfer") after the tax year mentioned in paragraph 1(3).
> (2) If the settlement has a Schedule 4C pool at the beginning of the year of the transfer—
> (a) the section 2(2) amounts in the Schedule 4C pool are increased by

11 Discussed in more detail in 48.12 (Inter-spouse transfer).

the section 2(2) amounts for the settlement that are outstanding at the end of the year of the transfer, and

(b) the section 2(2) amount in the pool for the year of transfer is increased (or further increased) by the amount of Schedule 4B trust gains accruing by virtue of the further transfer.

(3) If the settlement does not have a Schedule 4C pool at the beginning of the year of the transfer, this Schedule applies in relation to the further transfer as it applied in relation to the original transfer.

(4) For the purposes of this paragraph a settlement has a Schedule 4C pool until the end of the tax year in which all section 2(2) amounts in the pool have been reduced to nil.

## 46.19 Attribution of Schedule 4C gains to beneficiaries

Para 8 Sch 4C TCGA[12] provides:

(1) Chargeable gains are treated as accruing in a tax year ("the relevant tax year") to a beneficiary who has received a capital payment from the trustees of a relevant settlement in the relevant tax year or any earlier tax year if all or part of the capital payment is matched (under section 87A as it applies for the relevant tax year) with the section 2(2) amount in the Schedule 4C pool for the relevant tax year or any earlier tax year.

(2) The amount of chargeable gains treated as accruing is equal to—

(a) the amount of the capital payment, or

(b) if only part of the capital payment is matched, the amount of that part.

This is based on the s.87 rules.

(3) Section 87A applies for a tax year for the purposes of matching capital payments received from the trustees of a relevant settlement with section 2(2) amounts in the Schedule 4C pool as if—

(a) references to section 2(2) amounts were to section 2(2) amounts in the Schedule 4C pool,

(b) references to a capital payment received from the trustees by a beneficiary were to a capital payment received from the trustees of a relevant settlement by a beneficiary who is chargeable to tax for that year, and

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12 Flagged (somewhat unnecessarily) in para 1(4): "Paragraphs 8 to 9 provide for the attribution of gains in a settlement's Schedule 4C pool."

(c) for section 87A(3)(b) there were substituted—
"(b) all section 2(2) amounts in the Schedule 4C pool have been reduced to nil."

Amended as para 8 directs, s.87A provides:

(1) This section supplements s.87.
(2) The following steps are to be taken for the purposes of matching capital payments with s.2(2) amounts in the Schedule 4C pool.
*Step 1*
Find the s.2(2) amount in the Schedule 4C pool for the relevant tax year.
*Step 2*
Find the total amount of capital payments received by the beneficiaries who are chargeable to tax for that year from the trustees of a relevant settlement in the relevant tax year.
*Step 3*
The s.2(2) amount in the Schedule 4C pool for the relevant tax year is matched with—
(a) if the total amount of capital payments received in the relevant tax year does not exceed the s.2(2) amount in the Schedule 4C pool for the relevant tax year, each capital payment so received by the beneficiaries who are chargeable to tax for that year from the trustees of a relevant settlement, and
(b) otherwise, the relevant proportion of each of those capital payments.
"The relevant proportion" is the s.2(2) amount in the Schedule 4C pool for the relevant tax year divided by the total amount of capital payments received in the relevant tax year.
*Step 4*
[1] If para (a) of Step 3 applies—
(a) reduce the s.2(2) amount in the Schedule 4C pool for the relevant tax year by the total amount of capital payments referred to there, and
(b) reduce the amount of those capital payments to nil.
[2] If para (b) of that Step applies—
(a) reduce the s.2(2) amount in the Schedule 4C pool for the relevant tax year to nil,
and
(b) reduce the amount of each of the capital payments referred to there by the relevant proportion of that capital payment.
*Step 5*
[1] Start again at Step 1 (unless subs.(3) applies).
[2] If the s.2(2) amount in the Schedule 4C pool for the relevant tax year (as reduced under Step 4) is not nil, read references to capital payments received in the relevant tax year as references to capital payments received in the latest tax year which—
(a) is before the last tax year for which Steps 1 to 4 have been undertaken, and
(b) is a tax year in which capital payments (the amounts of which have not

been reduced to nil) were received by beneficiaries.
(3) This subsection applies if—
(a) all of the capital payments received by beneficiaries who are chargeable to tax for that year from the trustees of a relevant settlement in the relevant tax year or any earlier tax year have been reduced to nil, or
(b) all section 2(2) amounts in the Schedule 4C pool have been reduced to nil. ~~the section 2(2) amounts for the relevant tax year and all earlier tax years have been reduced to nil~~.
(4) The effect of any reduction under Step 4 of subsection (2) is to be taken into account in any subsequent application of this section.

### 46.19.1 *Priority between OIG Sch 4C and CGT Sch 4C*

Para 8 Sch 4C provides:

> (4) Section 87A applies for a tax year by virtue of this paragraph before it applies for that year otherwise than by virtue of this paragraph; but this is subject to sub-paragraph (5).
> (5) If section 87A applies for a tax year by virtue of section 762(3) of the Taxes Act[13] (offshore income gains), it applies for that year by virtue of that provision before it applies for that year by virtue of this paragraph.

## 46.20 "Relevant settlements"

Para 8A Sch 4C TCGA provides:

> (1) This paragraph specifies what settlements are relevant settlements in relation to a Schedule 4C pool.
> (2) The transferor and transferee settlements in relation to the original transfer of value are relevant settlements.
> (3) If the trustees of any settlement that is a relevant settlement in relation to a Schedule 4C pool—
> (a) make a transfer of value to which Schedule 4B applies, or
> (b) make a transfer of settled property to which section 90 applies,
> any settlement that is a transferee settlement in relation to that transfer is also a relevant settlement in relation to that pool.
> (4) If the trustees of a settlement that is a relevant settlement in relation to a Schedule 4C pool make a transfer of value to which Schedule 4B

13 The reference to ICTA is obsolete as the tax law rewrite did not update statutory references in statutory instruments. See 31.1 (Offshore funds – Introduction).

applies, any other settlement that is a relevant settlement in relation to that pool is also a relevant settlement in relation to the Schedule 4C pool arising from the further transfer.

### 46.20.1 *Disregard of certain capital payments*

Para 9 Sch 4C TCGA provides:

> (1) For the purposes of paragraph 8 (and section 87A as it applies for the purposes of that paragraph), no account is to be taken of a capital payment to which any of sub-paragraphs (2) to (4) applies (or a part of a capital payment to which sub-paragraph (4) applies).
> (2) This sub-paragraph applies to a capital payment received before the tax year preceding the tax year in which the original transfer is made.
> (3) This sub-paragraph applies to a capital payment that—
> (a) is received by a beneficiary of a settlement from the trustees in a tax year during the whole of which the trustees—
> (i) are resident and ordinarily resident in the UK, and
> (ii) are not Treaty non-resident,
> (b) was made before any transfer of value to which Schedule 4B applies was made, and
> (c) was not made in anticipation of the making of any such transfer of value or of chargeable gains accruing under that Schedule.
> (4) This sub-paragraph applies to a capital payment if (and to the extent that) it is received (or treated as received) in a tax year from the trustees by a company that—
> (a) is not resident in the UK in that year, and
> (b) would be a close company if it were resident in the UK,
> (and is not treated under any of subsections (3) to (5) of section 96 as received by another person).

### 46.20.2 *Residence of trustees from whom capital payment received*

Para 10(1) Sch 4C TCGA provides:

> Subject to paragraph 9(3), it is immaterial for the purposes of paragraph 8 that the trustees of any relevant settlement are or have at any time been resident and ordinarily resident in the UK.

## 46.21 Remittance basis

Para 8AA Sch 4C TCGA provides:

> Section 87B (remittance basis) applies in relation to chargeable gains treated under paragraph 8 as accruing as it applies in relation to chargeable gains treated under section 87 as accruing.

This incorporates the s.87 remittance basis: see 45.15 (Section 87 remittance basis).

## 46.22 Temporary non-resident rules

### 46.22.1 *Trust within s.86 TCGA*

Para 12 Sch 4C TCGA provides:

> (1) This paragraph applies if—
> (a) by virtue of section 10A, an amount of chargeable gains within section 86(1)(e) that accrued in an intervening year to the trustees of a settlement would be treated as accruing to a person ("the settlor") in the year of return, and
> (b) after paragraph 8 has applied for the year of return, the section 2(2) amount for the intervening year that is in the Schedule 4C pool for the settlement is less than the amount mentioned in paragraph (a).
> (2) The amount of chargeable gains treated as mentioned in sub-paragraph (1)(a) as accruing to the settlor in the year of return is limited to the section 2(2) amount referred to in sub-paragraph (1)(b).
> (4) Where the property comprised in the transferor settlement has at any time included property not originating from the settlor, only so much (if any) of any capital payment taken into account for the purposes of paragraph 8 above as, on a just and reasonable apportionment, is properly referable to property originating from the settlor shall be taken into account in computing the amount charged to beneficiaries.
> (5) Expressions used in this paragraph and section 10A have the same meanings in this paragraph as in that section; and paragraph 8 of Schedule 5 shall apply for the construction of the references in sub-paragraph (4) above to property originating from the settlor as it applies for the purposes of that Schedule.

### 46.22.2 *Trust within s.87*

Para 12A Sch 4C TCGA provides:

> (1) This paragraph applies where by virtue of section 10A an amount of gains would (apart from this Schedule) be treated under section 87 as accruing to a person ("the beneficiary") in the year of return by virtue of a capital payment made to him in an intervening year.
> (2) Where this paragraph applies, a capital payment equal to so much of that capital payment as exceeds the amount otherwise charged shall be deemed for the purposes of this Schedule to be made to the beneficiary in the year of return.
> (3) The "amount otherwise charged" means the total of any chargeable gains attributed to the beneficiary under section 87(2) or 89(2) by virtue of the capital payment.
> (4) For the purposes of paragraph 13(5)(b) a deemed capital payment under this paragraph shall be treated as made when the actual capital payment mentioned in sub-paragraph (1) above was made.
> (5) Expressions used in this paragraph and section 10A have the same meanings in this paragraph as in that section.

## 46.23 Interest supplement

Para 13 Sch 4C TCGA provides:

> (1) This paragraph applies if—
> (a) chargeable gains are treated under paragraph 8 as accruing to a beneficiary by virtue of the matching (under section 87A) of all or part of a capital payment with the section 2(2) amount for a tax year ("the relevant tax year"), and
> (b) the beneficiary is charged to tax by virtue of the matching.
> (1A) Where part of a capital payment is matched, references in sub-paragraphs (2) and (3) to the capital payment are to the part matched.
> (2) The tax payable by the beneficiary in respect of the payment shall be increased by the amount found under sub-paragraph (3) below, except that it shall not be increased beyond the amount of the payment; and an assessment may charge tax accordingly.
> (3) The amount is one equal to the interest that would be yielded if an amount equal to the tax which would be payable by the beneficiary in respect of the payment (apart from this paragraph) carried interest for the chargeable period at the specified rate.

The "specified rate" means the rate for the time being specified in section 91(3).
(4) The chargeable period is the period which—
(a) begins with the later of the 2 days specified in sub-paragraph (5) below, and
(b) ends with 30th November in the year of assessment following that in which the capital payment is made.
(5) The 2 days are—
(a) 1st December in the tax year immediately after the relevant tax year, and
(b) 1st December falling 6 years before 1st December in the year of assessment following that in which the capital payment is made.

## 46.24 Settlement ceasing to exist after Sch4B-transfer of value

Para 13A Sch 4C TCGA provides:

Where a settlement ceases to exist after the trustees have made a transfer of value to which Schedule 4B applies, this Schedule has effect as if a year of assessment had ended immediately before the settlement ceased to exist.

## 46.25 Definitions

### 46.25.1 *Assets and market value*

Para 13(1) Sch 4B TCGA provides:

In this Schedule any reference to an asset includes money expressed in sterling.
References to the value or market value of such an asset are to its amount.

### 46.25.2 *Transfer*

Para 13 Sch 4B TCGA provides:

(2) Subject to sub-paragraph (3), references in this Schedule to the transfer of an asset include anything that is or is treated as a disposal of the asset for the purposes of this Act, or would be if sub-paragraph (1) above applied generally for the purposes of this Act.

(3) References in this Schedule to a transfer of an asset do not include a transfer of an asset that is created by the part disposal of another asset.

### 46.25.3 *Schedule 4C definitions*

Para 14 Sch 4C TCGA provides:

(1) In this Schedule—
(a) "transfer of value" has the same meaning as in Schedule 4B; and
(b) references to the time at which a transfer of value was made are to the time which is the material time for the purposes of that Schedule.
(2) In this Schedule, in relation to a transfer of value—
(a) references to the transferor settlement are to the settlement the trustees of which made the transfer of value; and
(b) references to a transferee settlement are to any settlement of which the settled property includes property representing, directly or indirectly, the proceeds of the transfer of value.
(3) References in this Schedule to beneficiaries of a settlement include—
(a) persons who have ceased to be beneficiaries by the time the chargeable gains accrue, and
(b) persons who were beneficiaries of the settlement before it ceased to exist,
but who were beneficiaries of the settlement at a time in a previous year of assessment when a capital payment was made to them.

## 46.26 Commentary

HMRC would regard schedule 4B as successful, as it has successfully stopped the schemes at which it is addressed.

Measured by any other criteria it is a failure. It is extremely wide (applying to many arrangements where there is no avoidance). It is so wonderfully complicated that one could not expect even reasonably conscientious trustees to comply with it, except the largest trusts with large budgets for UK professional advice. A full analysis - which would be several times the length of this long chapter - will never be written. It is in practice almost entirely ignored, by HMRC and by taxpayers. It remains like unexploded ammunition from a distant war: exceptionally careful taxpayers avoid it; others disregard it, generally with impunity as HMRC will neither know nor greatly care. While it was never satisfactory, the problems have been made worse by the extension of the scope of the s.87 charge in 2008.

In all these respects, of course, schedule 4B is not very different from other anti-avoidance legislation of its time.

If a serious attempt is ever made to rationalise the UK taxation of offshore trusts, something much better could be devised.

CHAPTER FORTY SEVEN

# GAINS OF NON-RESIDENT COMPANIES

## 47.1 Section 13 TCGA – Introduction

Non-resident companies generally pay no UK tax on chargeable gains. This presents an obvious means of CGT avoidance. HMRC's first answer to this is s.13 TCGA. The same problems arise for income of non-resident companies and for income and gains of non-resident trusts, but the statutory solutions are entirely different.

Section 13(1) TCGA provides:

> This section applies as respects chargeable gains accruing to a company—
> (a) which is not resident in the UK, and
> (b) which would be a close company if it were resident in the UK.

For the definition of close company see 73.17 (Definition of "close company"). In this chapter when I refer to a company I assume it is close (or that it would be close if UK resident).

### 47.1.1 *Cross references*

For s.13 gains accruing to offshore unit trusts, see 35.4 (Gains accruing to unit trust). For s. gains accruing in the year of arrival and departure see 6.16.1 (Section 13 TCGA). For double taxation relief see 50.14 (DT relief: s.13 TCGA).

For s.13 gains accruing to charities, see Kessler & Brown, *Taxation of Charities and Non-Profit Organisations*, (8th ed, 2011) para 4.6 (Section 13).

## 47.2 Attribution of gains to participator

Section 13(2) TCGA provides:

> Subject to this section, every person
> [a] who at the time when the chargeable gain accrues to the company is resident or ordinarily resident in the UK, and
> [b] is a participator in the company,
> shall be treated for the purposes of this Act as if a part of the chargeable gain had accrued to him.

The sidenote to s.13 calls this "attribution" of gains. Section 13(4)(9)(10) refers to gains "apportioned" to participators. The terms "attribute" and "apportion" are interchangeable. I refer to the gain treated as accruing to a participator under s.13 as "**the s.13 gain**" or "**the s.13 deemed gain**".

## 47.3 Non-resident trustees

Non-resident trustees would not be within s.13(2) TCGA because that only applies to UK residents. However, s.13(10) TCGA provides:

> The persons treated by this section as if a part of a chargeable gain accruing to a company had accrued to them shall include the trustees of a settlement who are participators
> [a] in the company, or
> [b] in any company amongst the participators in which the gain is apportioned under subsection (9) above,
> if when the gain accrues to the company the trustees are neither resident nor ordinarily resident in the UK.

Section 13(10) was added to the legislation in 1981, and the clumsy drafting raises some difficulties, discussed below.

## 47.4 Computation of gains accruing to non-resident company

It is necessary to ascertain the amount of the chargeable gains accruing to the non-resident company.

Section 13 only applies to chargeable gains, so reliefs (including substantial shareholding relief) which prevent a gain from being a chargeable gain apply for the purposes of s.13.

Section 13(11A) TCGA provides:

> For the purposes of this section the amount of the gain or loss accruing at any time to a company that is not resident in the UK shall be computed (where it is not the case) as if that company were within the charge to corporation tax on capital gains.

Indexation relief is applicable because a company within the charge to CT qualifies for that relief.

Section 295(1) CTA 2009 provides:

> The general rule for corporation tax purposes is that all profits arising to a company from its loan relationships are chargeable to tax as income in accordance with this Part.

Gains on debts and other loan relationships (including life policies and foreign exchange gains) are not within s.13. Applying the deeming provision of s.13(11A) they are chargeable to tax as income, so no chargeable gain accrues on the disposal.[1] The same applies to derivative contracts which are chargeable to corporation tax as income under part 7 CTA 2009. For a participator who is an individual or a trust, this seems too good to be true, which raises the question whether a court should construe the deeming provision purposively so as to avoid that result.[2] However, s.13 also applies to a participator which is a company. It would be anomalous if a corporate participator did *not* obtain indexation relief, and somewhat surprising if loan relationship gains were treated as chargeable gains. The battle of the anomalies does not give a clear result, and the deeming provision should be given full effect.

HMRC agree. They say:

> As a consequence of the application of the loan relationship rules, a gain which accrues to a non-UK resident company on disposal of a debt represented by a balance in a non-sterling bank account will not be a chargeable gain. If the company has no chargeable gain, section 13 is not engaged, and therefore UK resident participators cannot be liable to tax in respect of such disposals. This difference in treatment between non-sterling bank accounts held directly and those held indirectly via a

1 Section 37 TCGA 1992.

2 As was done in *De Rothschild v Lawrenson* 67 TC 300.

> non-UK resident company is long standing and there are no plans for its amendment.[3]

Gains on debts or policies often qualify for other CGT reliefs, so the question whether such gains could fall within s.13 may not arise.

## 47.5 Identifying the participators

It is necessary to identify the participators in the non-resident company. Section 13(12) TCGA provides:

> In this section "participator", in relation to a company, has the meaning given by section 454 of CTA 2010.

This takes us to the elaborate standard definition; see 73.15 (Definition of participator). It was not drafted with s.13 in mind. One company can have too many participators for s.13 to cope with easily. I refer to this as the problem of "**overlapping participators**".

The problem may arise in the case of trusts,[4] loan creditors[5] and chains of companies.[6] The problem is solved in different ways in each case.

## 47.6 Overlapping participators: trustees and beneficiaries

Suppose a company is owned by a trust. The trustees are participators. The beneficiaries, except perhaps discretionary beneficiaries, are participators under s.454(1) CTA 2010 since they have an interest in the trust property. See 73.15.3 (Trustees and beneficiaries).

The difficulties this would cause for s.13 TCGA were recognised, and beneficiaries are taken out of s.13 by s.13(14) TCGA:

> For the purposes of this section, where—
> (a) the interest of any person in a company is wholly or partly represented by an interest which he has under any settlement ("his

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3 Statement published online 9 Dec 2009 *www.hmrc.gov.uk/cnr/remittance-basis.htm*.

4 See 47.6 (Overlapping participators: trustees and beneficiaries).

5 See 47.8 (Overlapping participators: loan creditors).

6 See 47.10 (Chains of companies).

beneficial interest”), and

(b) his beneficial interest is the factor, or one of the factors, by reference to which that person would be treated (apart from this subsection) as having an interest as a participator in that company,

the interest as a participator in that company which would be that person’s shall be deemed, to the extent that it is represented by his beneficial interest, to be an interest of the trustees of the settlement (and not of that person), and references in this section, in relation to a company, to a participator shall be construed accordingly.

The CG Manual correctly provides:

> **57222 Basic conditions for Section 13 TCGA 1992: Beneficiaries: Section 13(4) TCGA 1992** [April 2009]
> Where the trustees of a settlement, whether resident in the UK or not, are participators in a non-resident company then in certain circumstances a beneficiary of the settlement will also be within the definition of participator. The effect of Section 13(14) is that once you reach shares or other interests held by trustees, except in the case of a bare trust, see CG34300, you stop there. In deciding how the chargeable gain of the company should be apportioned, you treat the trustees as if they were the beneficial owners of their shares or other interests and apportion the gain to them as appropriate, ignoring the interests of the beneficiaries. If the trustees are resident then their share of the gain is assessed on them, [or on the settlor under TCGA 1992, S 77 in relevant cases].[7] If the trustees are non-resident then the gain is subject to TCGA 1992, S 86 and TCGA 1992, S 87, see CG57395. Any interest as a participator in the non-resident company which the beneficiary holds in their own right, for example by a personal holding of shares in the non-resident company, will remain within Section 13.

## 47.7 *Foundations*

At first sight, a foundation may be a close company within s.13. At first sight, s.13(14) does not apply to a foundation as “settlement” in s.13(14) has the IT/CGT meaning: a foundation is not a settlement in that sense..

If that is right, two questions arise:

(1) are beneficiaries of a foundation participators?[8]

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7 Words in square brackets are out of date since 2008.

8 See 73.15.3 (Trustees and beneficiaries).

(2) assuming they are participators, what is the extent of their interest under s.13(3)?

These questions raise imponderable and unexplored sub-issues: what are the rights of the beneficiaries (a matter of the construction of the foundation constitution under the law of the foundation); and do those rights amount to "interests" for these purposes (a matter of UK law)?

It is suggested that the presumption against double taxation applies: since a foundation is a settlement for the purposes of s.87, it should not fall within the scope of s.13. The better view is that a foundation is a settlement within the protection of s.13(14); but an alternative route to the same destination is that a foundation is not a company within the meaning of s.13.

In practice HMRC accept that foundations should be taxed as trusts so these questions do not arise.[9]

## 47.8 Amount of gain attributed to each participator

Once one has identified the participators, one asks how much of the company's gain is attributed to each of them. Section 13(3) TCGA provides:

> That part shall be equal to the proportion of the gain that corresponds to the extent of the participator's interest as a participator in the company.

This takes us to s.13(13) TCGA:

> In this section—
> (a) references to a person's interest as a participator in a company are references to the interest in the company which is represented by all the factors by reference to which he falls to be treated as such a participator;...

That is, "interest" in s.13(3) is not construed in a narrow or technical manner. The section continues:

> (b) references to the extent of such an interest are references to the proportion of the interests as participators of all the participators in

9 See 72.6.4 (HMRC view).

> the company (including any who are not resident or ordinarily resident in the UK) which on a just and reasonable apportionment is represented by that interest.

What is just and reasonable? The CG Manual starts with general comments:

> **57260 Section 13 TCGA 1992: Participators' fractional interests** [October 2009]
> ...
> *The just and reasonable requirement*
> It is quite possible for the different criteria by which persons are participators to produce different percentages for one person's interest in a company. So under one test, for example entitlement to income, A may have 60% and B have 40% and under another test, for example entitlement to capital, A have 36%, B have 54% and C have 10%. This can happen even with relatively simple company structures, for example where there are preference shares, or loans. The total amount of gains apportioned cannot exceed the chargeable gain of the non-resident company. In this situation the gain has to be apportioned as is just and reasonable. This includes taking into account the interests of non-residents.
> In considering a just and reasonable apportionment you should take into account all relevant factors, and not simply make an arithmetical adjustment. It would not usually be correct merely to average out the interests using the different factors. The aim of the provisions is to ensure that the gain is attributed to the participators who have the real economic interest in the non-resident company and who will derive the benefit of the gain however indirectly. The just and reasonable apportionment prevents an inappropriate part of the gain being attributed to persons without real economic interests, for example commercial loan creditors, see below.

## 47.9 Overlapping participators: loan creditors

The problem of overlapping participators including loan creditors is solved, or fudged, by a just and reasonable apportionment. The CG Manual provides:

> **57260. Section 13 TCGA 1992: Participators' fractional interests** [October 2009]
> *Loan creditors*
> Any loan creditor of the non-resident company is within the definition of

participator as applied for the purposes of Section 13. The aim of the provisions is to ensure that the gain is attributed to the participators who have the real economic interest in the non-resident company. There will be cases where a loan creditor will be a person or institution (such as a bank or similar financial institution) which has loaned money to the non-resident company as a matter of business on commercial terms. The interest of such a loan creditor acting at arms length will be limited to an expectation of repayment of the amount loaned together with payments of interest at a commercial rate. There will be no expectation that the loan creditor can or will benefit from the profits or gains of the non-resident company. In such a case it would not be just and reasonable to apportion any of the gain to a loan creditor of this type. The attribution should be made to those participators who have a real economic interest in the capital gains.
Where there are participators who are loan creditors it will be necessary to review all of the circumstances to satisfy yourself that the interests of the loan creditors can be excluded for the reasons in the preceding paragraph.
In some cases the persons with the real economic interest in the non-resident company will be loan creditors whether or not they are participators under one or more of the other tests set out in CG57221. In such cases, where there is participation in more than one way, it may be appropriate, depending on the facts of the case, to aggregate their interests of those persons in reaching an apportionment that is just and reasonable.
In other cases the persons with the real economic interest in the non-resident company may be providing the funds which the loan creditor has loaned to the company, and may be persons who are entitled to secure that income or assets (whether present or future) of the company will be applied directly or indirectly for their benefit, see the test in CG57221, and may be participators in their own right by virtue of that test.

## 47.10 CG Manual examples: shareholders v. loan creditors

### 47.10.1 *Non-resident shareholder*

The CG Manual starts with a very simple example:

**57280. Computation of TCGA 1992, S 13 charge** [April 2009]
Facts

- a non-resident company has issued share capital of 100 Ordinary shares
- A, B, C and D each own 25 shares
- A, B, C are all R/OR and domiciled in the UK. D is NR/NOR
- the non-resident company realises a gain of 200,000

CGT computations

You compute the TCGA 1992, S 13 charge as follows.

***STEP 1***

Calculate the gain that would have arisen if the non-resident company had been resident in the UK. This is 200,000.[10]

***STEP 2***

Determine the interests of all participators, including any who are not resident in the UK, by applying the tests of participation appropriate to the circumstances. In this case each of the four participators has a 25 per cent interest.

***STEP 3***

Calculate the proportion of the gain apportionable to the interests of each participator. Calculate the interests of all participators, including any who are not resident in the UK. In this case the proportion for each participator is 25% of 200,000 = 50,000

***STEP 4***

Consider whether the gains calculated in Step 3 represent a just and reasonable apportionment. In this case the apportionment is just and reasonable. Gains of 50,000 are attributed to each of A, B and C and treated as gains accruing to them on the date on which the gain actually accrued to the company.

D is not liable to UK taxation. But it would not be just and reasonable to reapportion D's gain of 50,000 to A, B and C as D has a real economic interest in the non-resident company.

### 47.10.2 *Examples with loan creditors*

The CG Manual then gives two examples involving loan creditors. The first involves a loan on commercial terms:

**57281. Computation of TCGA 1992, S 13 charge** [October 2009]

Facts

- A and B each own 50 shares
- A and B are both R/OR and domiciled in the UK
- C is a loan creditor for 400,000. The loan is an arm's length commercial transaction and interest is payable at a fully commercial rate on the loan
- the non-resident company realises a gain of 500,000
- the total capital of the non-resident company after the gain is 1,000,000

The solution is to disregard the loan creditor, though the Manual takes many lines to reach this conclusion:

---

10 Chargeable gains can accrue whether or not a company is UK resident. See 43.1 (Territorial scope of CGT), but the method of computation of the gain is different for a UK resident company. However this does not make any difference to the examples.

CGT computations
You compute the TCGA 1992, S 13 charge as follows.
STEP 1
Calculate the gain that would have arisen if the non-resident company had been resident in the UK. This is 500,000.[11]
STEP 2
Determine the interests of all participators, including any who are not resident in the UK, by applying the tests of participation appropriate to the circumstances.
A is a 50% participator by reference to the shareholding of 50 shares
B is a 50% participator by reference to the shareholding of 50 shares
C is a participator as a loan creditor, being entitled to an amount of 400,000 out of the total capital of 1,000,000
STEP 3
Calculate the proportion of the gain apportionable to the interests of each participator. In this case the proportion for each participator is
A (as shareholder) 500,000×50% = 250,000
B (as shareholder) 500,000×50% = 250,000
C (as loan creditor) 500,000×40% = 200,000
STEP 4
Consider whether the gains calculated in Step 3 represent a just and reasonable apportionment. In this case the apportionment is not just and reasonable as the total of the gains under the initial apportionment exceeds the actual gain. C is a participator only by virtue of being a commercial loan creditor, see CG57265. C's entitlement as loan creditor should be ignored, subject to a review of the circumstances to establish that C is merely a commercial loan creditor and has no entitlement to a share of profits or gains, and that there are no other arrangements. In this example it is assumed that there are no other arrangements and therefore the whole of the gain should be apportioned by reference to the interests in shares. The final apportionment becomes
A (as shareholder) 500,000×50% = 250,000
B (as shareholder) 500,000×50% = 250,000

The second example is the same but the loan is interest-free and from a shareholder:

**57282. Computation of TCGA 1992, S 13 charge** [April 2009]
Facts
- a non-resident company has issued share capital of 100 Ordinary shares
- A and B each own 50 shares
- A and B are both R/OR and domiciled in the UK
- A is a loan creditor for 200,000. No interest is payable on the loan
- the non-resident company realises a gain of 500,000.
- the total capital of the non-resident company after the gain is 1,000,000

11 See above footnote.

The solution is *still* to disregard the loan creditor, though the Manual is not quite so confident in its answer:

> CGT computations
> You compute the TCGA 1992, S 13 charge as follows.
> STEP 1
> Calculate the gain that would have arisen if the non-resident company had been resident in the UK. This is 500,000.[12]
> STEP 2
> Determine the interests of all participators, including any who are not resident in the UK, by applying the tests of participation appropriate to the circumstances.
> A is a 50% participator by reference to the shareholding of 50 shares
> B is a 50% participator by reference to the shareholding of 50 shares
> A is also a participator as a loan creditor, being entitled to an amount of 200,000 out of the total capital of 1,000,000. If all of the assets of the company were to be distributed immediately after the accrual of the gain the entitlements of A and B would be
> A: 200,000 (as loan creditor) plus 50% of the balance of 800,000 (as shareholder), a total of 600,000 or 60% of the assets.
> B: 400,000, 50% of the balance of 800,000 (as shareholder), or 40 % of the assets.
> STEP 3
> Calculate the proportion of the gain apportionable to the interests of each participator. In this case there are two possible apportionments.
> A: 500,000×50% = 250,000
> B: 500,000×50% = 250,000
> or
> A: 500,000×60% = 300,000
> B: 500,000×40% = 200,000
> STEP 4
> Consider whether the gains calculated in Step 3 represent a just and reasonable apportionment. As there are at least two possible apportionments we must consider all of the facts relating to the arrangements under which A's loan was made and the arrangements regarding profits and gains of the company.
>
> - Does the loan agreement give A any preferential rights to profits or gains, or simply to a repayment of the capital?
> - Is B entitled to an equal share of profits or gains?
>
> In such cases there is no easy answer and a full consideration of all of the relevant circumstances is necessary. On the bare facts of this example A has no preferential rights and consequently an apportionment by reference to the shareholdings, effectively excluding A's participation as loan creditor, may be just and reasonable. If so, the gain would be attributed

12 See above footnote.

A: 500,000×50% = 250,000
B: 500,000×50% = 250,000

## 47.10.3 *Two classes of shares*

The CG Manual's next example concerns a company with two classes of shares:

> **57283. Computation of TCGA 1992, S 13 charge** [April 2009]
> Facts
> - a non-resident company has issued share capital of 100 A shares and 100 B shares.
> - both classes of shares carry equal voting rights but the B shares carry no entitlement to dividends or distributions in a winding-up.
> - the A shares are owned by X who is R/OR and domiciled in the UK
> - the B shares are owned by Y who is NR/NOR
> - the non-resident company realises a gain of 200,000.
>
> CGT computations
> You compute the TCGA 1992, S 13 charge as follows.
> STEP 1
> Calculate the gain that would have arisen if the non-resident company had been resident in the UK. This is 200,000.[13]
> STEP 2
> Determine the interests of all participators, including any who are not resident in the UK, by applying the tests of participation appropriate to the circumstances.
> voting rights distributions
> X 50% 100%
> Y 50% 0%
> X is a 50% participator by reference to voting rights attached to the shareholding in A shares.
> Y is a 50% participator by reference to voting rights attached to the shareholding in B shares.
> X is a 100% participator by reference to rights to dividends and distributions attached to the shareholding in A shares.
> STEP 3
> Calculate the proportion of the gain apportionable to the interests of each participator.
> X (rights to income and capital) 200,000×100% = 200,000
> Y (voting rights) 200,000×50% = 100,000
> STEP 4
> Consider whether the gains calculated in Step 3 represent a just and reasonable apportionment. In this case the apportionment is not just and reasonable as the total of the gains under the initial apportionment exceeds the actual gain. A full

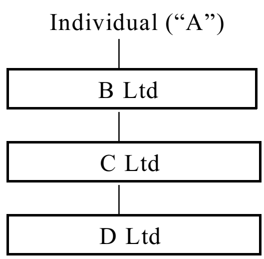
13 See above footnote.

review of all of the circumstances would be necessary. It appears that the true economic interest in the non-resident company is held solely by X. Y's entitlement should be ignored, and the whole of the gain apportioned to X.

## 47.11 Chains of companies

### 47.11.1 *Overlapping participators: chains of wholly owned companies*

Suppose a chain of wholly owned companies:



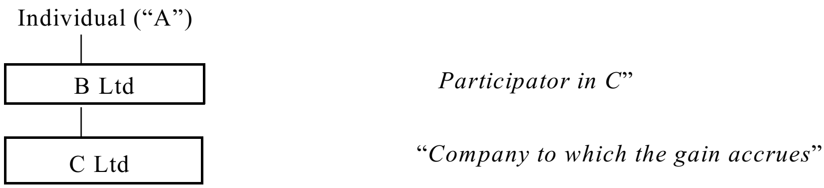

C Ltd is a participator in D Ltd under s.454(1) CTA 2010. But A and B Ltd are also participators, under s.454(2)(c) CTA 2010.[14] This is so wherever the companies are resident. Chains of wholly owned companies raise the problem of overlapping participators.

Section 13(9) TCGA provides:

> [a] If a person who is a participator in the company at the time when the chargeable gain accrues to the company is itself a company which
> [i] is not resident in the UK but which
> [ii] would be a close company if it were resident in the UK,
> [b] [i] an amount equal to the amount apportioned under subsection (3) above out of the chargeable gain to the participating company's interest as a participator in the company to which the gain accrues
> [ii] shall be further apportioned among the participators in the participating company according to the extent of their respective interests as participators, and
> [c] subsection (2) above shall apply to them accordingly in relation to the amounts further apportioned,
> [d] and so on through any number of companies.

14 See 73.15.1 (Chain of wholly owned companies).

Suppose a simple chain of two wholly owned non-resident companies:




If a gain accrues to C, what is apportioned to A? Under s.13(9)[b][i] it is "an amount equal to the amount apportioned under s.13(3)" to B as a participator in C. This is not well drafted, as nothing is apportioned under s.13(3) to B. No apportionment can be made since B is not UK resident![15] But the courts must correct that infelicity and construe the words to mean, the amount that would have been apportioned to B, had it been UK resident.

The CG Manual provides:

> **57290. Indirect interests : Introduction** [April 2009]
> Without special rules UK resident shareholders or participators could avoid the TCGA 1992, S 13 charge by placing another non-resident company between themselves and the company making the gain. TCGA 1992, S 13(9) prevents this by allowing the Revenue to look through a chain of non-resident companies. The gain is apportioned to the first tier of UK residents or non-resident trusts in the chain of interests. For TCGA 1992, S 13(9) to apply each company in the chain must itself satisfy the basic conditions outlined in CG57220.
> Therefore each company must be
> - a company that is not resident in the UK and
> - a company that would be a close company if it was resident in the UK.

The CG Manual begins with a straightforward example:

EXAMPLE 1[16]

15 One might also argue that apportionment is under s.13(2) and not s.13(3).
16 I have added the diagrams to increase clarity.

| | |
|---|---|
| Mr A | *UK resident and domiciled shareholder* |
| B Ltd | *non-resident close company* |
| C Ltd | *non-resident close company* |
| D Ltd | *non-resident close company* |

Gains accruing to D Ltd are not attributed to C under s.13(2) because C is not UK resident. See s.13(2)[a]. But the CG Manual correctly notes:

> Any gains of D Ltd can be apportioned to Mr A because TCGA 1992, S 13(9) allows you to look through the chain of non-resident closely controlled companies.

The next example concerns a chain including a resident company:

EXAMPLE 2

| | |
|---|---|
| Mr A | *UK resident and domiciled shareholder* |
| B Ltd | *UK resident company* |
| C Ltd | *non-resident close company* |
| D Ltd | *non-resident close company* |

The Manual analyses this as follows:

> Any gains of D Ltd can be apportioned to B Ltd but not Mr A. This is because B Ltd is the first UK resident shareholder in the chain.

This was correct before 1995, when s.13(2) and (9) TCGA only apportioned gains to a *shareholder* in a non-resident company. A is not a shareholder of D Ltd. But why can't A be assessed now under s.13(2) or (9)? A *is* a participator in D Ltd. Perhaps this restricted rule is implied by s.13(9) TCGA. Or if not, perhaps it would be just and reasonable to apportion under 13(2) to company B and to no-one else. One way or the other, the problem of overlapping participators in chains of companies is solved by stopping at the first UK resident company.

EXAMPLE 3

| | |
|---|---|
| Mr A | *UK resident and domiciled shareholder* |
| B Ltd | *closely controlled*[17] *non-resident company* |
| C Ltd | *UK resident close company* |
| D Ltd | *non-resident close company* |

Any gains of D Ltd can be apportioned to C Ltd but not Mr A even though Mr A owns shares in B Ltd a closely controlled non-resident company. (Gains which accrue to B Ltd in its own right on disposal of its own assets can be apportioned to Mr A.)

The next Manual example is a straightforward variation on the above:

**57291. Indirect interests: UK resident shareholder in the chain of participators** [April 2009]
When considering the operation of TCGA 1992, S 13(9) each chain of shareholdings must be considered separately.
Example

| | |
|---|---|
| Mr A | *UK resident and domiciled shareholder* |
| B Ltd | *UK resident company* |
| C Ltd | *non-resident close company* |
| D Ltd | *non-resident close company* |

| | |
|---|---|
| Mrs B | *UK resident and domiciled shareholder* |
| E Ltd | *non-resident close company* |

The gains of [E Ltd][18] can be apportioned to Mrs B because she is the

17 The express "closely controlled" is used here (somewhat unhelpfully) as a synonym of "close".

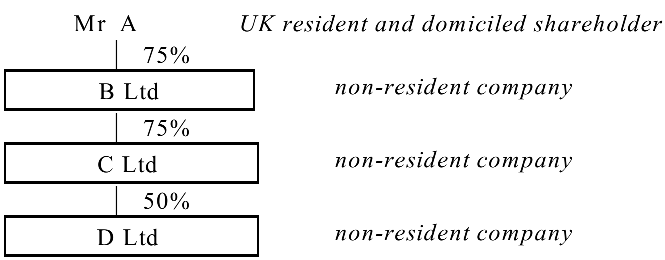
18 The original reads "D Ltd" which must be a slip for "E Ltd", if the diagram is correct.

first UK resident shareholder in that chain of shareholdings. The gains of D Ltd cannot be apportioned to Mr A because B Ltd is the first UK resident shareholder in that chain of shareholdings.

## 47.12 Chains of companies not wholly owned

We have so far considered simple chains of wholly owned companies. The CG manual continues with an example of a less than 100% chain:

> **57291. Indirect interests: UK resident shareholder in the chain of participators** [April 2009]
> ... You calculate the extent of a person's indirect interest on a particular test of participation by multiplying the proportional interest in the assets of each company in the chain.
>
> EXAMPLE




> If D Ltd makes gains of 100,000 the TCGA 1992, S 13 charge on Mr A is £100,000×50%×75%×75% = £28,125.

Mr A is a participator in B Ltd. Mr A is not a participator in D Ltd but that does not matter because C Ltd is a participator in D Ltd, B Ltd is a participator in C Ltd, and gains of D Ltd are attributed to Mr A under s.13(9) TCGA. It is assumed for the purposes of the example that D Ltd is close, which is not necessarily the case; it depends on the other shareholdings, which are not specified in the example.

## 47.13 Section 13 remittance basis

Section 14A TCGA provides a relief which I call "**the s.13 remittance basis**". Section 14A(1) provides:

> This section applies if—

> (a) by virtue of section 13, part of a chargeable gain that accrues to a company on the disposal of an asset is treated as accruing to an individual in a tax year, and
> (b) the individual is not domiciled in the UK in that year.

In short, the relief applies to a remittance basis taxpayer. Section 14A(2) provides the relief:

> The part of the chargeable gain treated as accruing to the individual ("the deemed chargeable gain") is a foreign chargeable gain within the meaning of section 12 if (and only if) the asset is situated outside the UK.

I refer to those deemed chargeable gains as "**s.13 deemed gains**" to distinguish them from other deemed chargeable gains.

Section 14A(3) TCGA provides for the remittance basis:

> For the purposes of Chapter A1 of Part 14 of ITA 2007 (Remittance Basis)—
> (a) treat any consideration obtained by the company on the disposal of the asset as deriving from the deemed chargeable gain, and
> (b) unless the consideration so obtained is of an amount equal to the market value of the asset, treat the asset as deriving from the deemed chargeable gain.

In the absence of express provision, the s.13 deemed gain could not be remitted as it does not exist. Section 14A(3)(a) deals with that problem.

Section 14A(3)(b) is necessary since the equivalent rule in s.809T ITA only applies to gains accruing on a disposal by an individual.

Suppose:

(1) A non resident company ("OC") disposes of a foreign situate asset and realises a gain.
(2) The gain (or part) is deemed to accrue to F (an individual taxable under the remittance basis).

F is subject to tax on the gain if OC brings/receives/uses the sum in the UK, if a company is a relevant person in relation to F. A company within s.13 will be a relevant person.

If OC distributes the sum by way of dividend and F brings/receives/uses the sum in the UK then F is subject to two charges:

(1) CGT on the s.13 gain (for what F receives is derived from the gain)

and

(2) IT on the distribution.

Company distribution relief may apply. The same applies if OC is held by an IP trust.

Likewise if OC is wound up and the liquidator distributes the sum by way of capital distribution, and F brings/receives/uses the sum in the UK then F is subject to two charges:

(1) CGT on the s.13 gain (for what F receives is derived from the gain) and

(2) CGT on the disposal of the shares in OC.

Company distribution relief may apply.

## 47.14 10% *de minimis* exemption

Section 13(4) TCGA provides:

> Subsection (2) above shall not apply in the case of any participator in the company to which the gain accrues where the aggregate amount falling under that subsection to be apportioned
> [a] to him and
> [b] to persons connected with him
> does not exceed one tenth of the gain.

I refer to this as **"the 10% *de minimis* exemption".**

Suppose a non-resident trust holds less than 10% of a non-resident company. Can the trust qualify for the *de minimis* exemption? The difficulty is that s.13(4) does not in terms disapply the whole of s.13: it disapplies s.13(2). The provision governing a non-resident trust is s.13(10) which provides:

> The persons treated *by this section* as if a part of a chargeable gain accruing to a company had accrued to them shall include the trustees of a settlement who are participators
> [a] in the company, or
> [b] in any company amongst the participators in which the gain is apportioned under subsection (9) above,
> if when the gain accrues to the company the trustees are neither resident nor ordinarily resident in the UK.

The words "by this section" must refer in particular to section 13(2), for that is the provision which treats persons as a part of the chargeable gain accruing to the non-resident company had accrued to them. Accordingly, the disapplication of s.13(2) in a *de minimis* case must also disapply the attribution in subsection (10).

### 47.14.1 *Aggregation of connected person's interest*

In order to be satisfied that a participator ("A") in a non-resident company ("OC") qualifies for the 10% *de minimis* exemption, it is necessary to identify all persons connected with A (ie co-participators in OC) to whom gains fall to be apportioned under s.13(2).

In deciding whether A qualifies for the *de minimis* exemption, one does not add up the interests in OC of A and *all* persons connected with A and ask if that amounts to more than 10% of OC. One only counts connected persons *to whom gains fall to be apportioned under s.13(2)*. One ignores connected co-participators if gains do not fall to be apportioned to them under that subsection.

For example, assume OC is a straightforward non-resident company and:

(1) A owns 8% of the shares in OC. (Unless the connected person rule applies, A would qualify for the 10% *de minimis* exemption.)
(2) C (the only participator in OC who is connected with A) owns 3% of the shares in OC. (So if the interest of C is aggregated with the interest of A, A does not qualify for the *de minimis* exemption.)[19]

It is necessary to consider separately the cases where C is an individual, a company and a trust, and the cases where C is resident and non-resident, so there are at least six possibilities.

A does not qualify for the 10% *de minimis* exemption if C is

(1) a UK resident individual taxed on the arising basis[20]
(2) a UK resident company, or
(3) a UK resident trust.

In all these cases the gains of OC do fall to be apportioned to C under s.13(2).

A does qualify for the *de minimis* exemption if C is a *non-resident individual*. In this case, gains cannot be apportioned to C under s.13(2).

---

19 Similarly, C would not qualify for the *de minimis* exemption, but we focus on the position of A.

20 Further consideration would be needed if C were a remittance basis taxpayer who did not remit the s.13 deemed gain.

This is the case even if C is within the temporary non-residence rules.

A does qualify for the *de minimis* exemption if C is a non-resident *company*. In this case, gains of OC might be apportioned to participators in C, but that does not prevent A from qualifying for the *de minimis* exemption unless those participators are themselves connected with A.

Lastly, does A qualify for the 10% *de minimis* exemption if C is a non-resident *trust*? The question is whether gains of OC fall to be apportioned to the trust, under s.13(2). Section 13(10) says (or assumes) that the trustees are treated *by this section* as if gains of OC had accrued to them. The gains are attributed to the trustees under the combined effect of subsection (2) and subsection (10). Whether or not that could be described as an attribution *under s.13(2)* is a matter that could be answered either way, depending on context. In this context, it is suggested that A does qualify for the *de minimis* exemption. This result is consistent with the position for non-resident companies and non-resident individuals. If this result was contrary to common sense (particularly in a tax avoidance context) a court might construe section 13(4) more loosely. But there may be many connected co-participators and A may not be able to know whether they are trustees or not, particularly in the case of non-residents. So it is sensible to disregard the interests of non-resident trustees for the purposes of the aggregation test.

Even adopting this approach, it will often not be possible for a participator to know whether the 10% *de minimis* exemption applies or not, but one must do the best one can.

Interests held by pension funds cannot be aggregated for the 10% *de minimis* exemption. See 47.16 (Pension schemes).

## 47.15 Non-resident trading company

Section 13(5) TCGA provides some relief for a non-resident trading company:

> This section shall not apply in relation to ...
> (b) a chargeable gain accruing on the disposal of an asset used, and used only—
>   (i) for the purposes of a trade carried on by the company wholly outside the UK, or
>   (ii) for the purposes of the part carried on outside the UK of a trade carried on by the company partly within and partly outside the

> UK,
>
> (c) a chargeable gain accruing on the disposal of currency or of a debt within section 252(1), where the currency or debt is or represents money in use for the purposes of a trade carried on by the company wholly outside the UK...

I cannot see the point of s.13(5)(c) which duplicates s.13(5)(b)(i), but it does not matter.

Gains on debts are in any case outside the scope of s.13 because of the loan relationship rules.

## 47.16 Non-resident company within CT

Section 13(5) TCGA provides:

> This section shall not apply in relation to ...
> (d) to a chargeable gain in respect of which the company is chargeable to tax by virtue of section 10B.[21]

Thus the CT charge has priority over a s.13 charge.

## 47.17 Pension schemes

Pension schemes qualify for CGT relief under s.271(1)(c) and (1A) TCGA:

> (1) The following gains shall not be chargeable gains—
> ...
> (c) any gain accruing to a person from his acquisition and disposal of assets held by him as part of a fund—
> (i) mentioned in section 614(2) of the Taxes Act,
> (ii) to which section 615(3) of the Taxes Act applies, or
> (iii) mentioned in section 648, 649, 650, 651 or 653 of ITEPA 2003;
> ...
> (1A) A gain accruing to a person on a disposal of investments held for the purposes of a registered pension scheme is not a chargeable gain.

This does not confer relief from s.13 deemed gains but s.13(10B) TCGA

21 See 74.1 (Why does permanent establishment matter?).

provides relief:

> A chargeable gain that would be treated as accruing to a person under subsection (2) above shall not be so treated if—
> (a) it would be so treated only if assets that are assets of a pension scheme[22] were taken into account in ascertaining that person's interest as a participator in the company, and
> (b) at the time the gain accrues a gain arising on a disposal of those assets would be exempt from tax by virtue of section 271(1)(c) or (1A).

A beneficiary of a pension scheme might be a participator in a non-resident company held by the scheme, but they are protected by the exclusion for beneficiaries.[23]

Section 13(10B) also prevents aggregation of a pension scheme's interest with the interest of a person connected with the trustees of the pension scheme, for the purposes of the 10% *de minimis* exemption. That will not normally arise, as trustees of a pension scheme are not usually connected to other persons, but it could happen, eg if the trustees were partners in an investment partnership.

## 47.18 Partnership holding non-resident company

Suppose a partnership holds a non-resident company to which a gain accrues. Section 59(1) TCGA provides:

> Where 2 or more persons carry on a trade or business in partnership—
> (a) tax in respect of chargeable gains accruing to them on the disposal of any partnership assets shall, in Scotland as well as elsewhere in the UK, be assessed and charged on them separately, and
> (b) any partnership dealings shall be treated as dealings by the partners and not by the firm as such.

This does not apply to a s.13 gain, which is not a gain on the disposal of

---

22 This expression is defined in s.13(10B):
"In para (a) above 'assets of a pension scheme' means assets held for the purposes of a fund or scheme to which any of the provisions mentioned in para (b) above applies."

23 See 47.6 (Overlapping participators: trustees and beneficiaries).

a partnership asset. But the partners are participators in the company, and it is just and reasonable (because it fits the scheme of the TCGA) to attribute the s.13 gain to the partners under s.13(2) TCGA. That is, HMRC do not need s.59 TCGA to tax the partners.

## 47.19 Company distribution relief

Section 13 could often give rise to double taxation and there are three reliefs to prevent this. Statute does not provide names for the reliefs, so I coin the following terminology:
"**Company distribution relief**": s.13(5A) relief on distribution by non-resident company.
"**Company disposal relief**": s.13(7) relief on disposal of interest in non-resident company.
"**Reimbursement relief**": s.13(11) relief on reimbursement by non-resident company.

Section 13(5A) TCGA provides:

> Where—
> (a) an amount of tax is paid by a person in pursuance of subsection (2) above, and
> (b) an amount in respect of the chargeable gain is distributed (either by way of dividend or distribution of capital or on the dissolution of the company) before the end of the period specified in subsection (5B) below,
>
> the amount of tax (so far as neither reimbursed by the company nor applied as a deduction under subsection (7) below) shall be applied for reducing or extinguishing any liability of that person to income tax, CGT or corporation tax in respect of the distribution.

In short, the s.13 tax is set against tax on the distribution.

The CG manual provides:

> **57351. Gains accruing on/after 28/11/95: Outline of tax credit relief**
> [October 2009]
> [The manual summarises s.13(5A) and continues] It is important to note that relief under Section 13(5A) TCGA 1992 is only due where a charge arises under Section 13 in respect of a gain and a further charge arises in respect of a distribution of an amount in respect of the same gain, and that both charges arise on the same person. Where a gain is attributed to

> participator A and the distribution is made to participator B no relief can be given to B as B has not paid tax under Section 13...
>
> **57360. Quantifying tax set-off available following capital dividends or distributions** [April 2009]
>
> ... Once capital gains tax has been paid under section 13(2), then the whole of that tax is available for set-off against any tax liability on a subsequent distribution where the conditions for relief are met. Should only half of the gain be distributed this does not mean that only half of the section 13 capital gains tax can be set off. The section 13 tax represents a pool of tax credit to be used up against tax liability arising from appropriate distributions in respect of the same gain. Thus if only half of the gain is distributed but the tax liability on the distribution is at a higher rate than the tax on the section 13 gain, the tax credit relief will be more than half of the Section 13 tax.
>
> **57362. Need to have paid tax under Section 13(2)** [April 2009]
>
> It is a condition of section 13(5A) relief that the tax arising on the gain attributed under section 13 must have been paid. In some cases the liability on the section 13 gain and on the distribution will arise in the same year of assessment or accounting period, and in other cases the tax on the section 13 gain will not have been paid.
>
> In practice relief may be given by set off providing that the only reason preventing relief being given is that tax on the section 13 gain is unpaid.

For the purpose of s.13(5A) it is necessary to ascertain the liability of the participator to income tax in respect of the distribution from the company.

Section 13(7A) TCGA provides:

> In ascertaining for the purposes of subsection (5A) or (7) above the amount of CGT[24] or income tax chargeable on any person for any year

24 The reference to CGT is not appropriate after the FA 2008 repealed s.13(7A)(b) (c) (d) because s.13(7A) now deals with income tax only. Similarly, the reference to s.13(7) is not appropriate as from 2008, s.13(7A) is only relevant for the purposes of company distribution relief in s.13(5A) and does not apply to company disposal relief in s.13(7). The references made sense before the former paragraphs (b) to (d) were part of s.13(7A). Before 2008, s.13(7A) continued:

> "(b) any gain accruing in that year on the disposal by that person of any asset representing his interest as a participator in the company shall be regarded as forming the highest part of the gains on which he is chargeable to tax for that year;
> (c) where any such distribution as is mentioned in subsection (5A)(b) above falls to be treated as a disposal on which a gain accrues on which that person is so chargeable, that gain shall be regarded as forming the next highest part of the gains

on or in respect of any chargeable gain or distribution—

(a) any such distribution as is mentioned in subsection (5A)(b) above and falls to be treated as income of that person for that year shall be regarded as forming the highest part of the income on which he is chargeable to tax for the year;

## 47.19.1 *HMRC examples*

The CG Manual tries to provide two straightforward worked examples. The first sets s.13 tax against a dividend. The second sets it against a capital distribution:

**57365. Examples of relief under Section 13(5A) TCGA 1992 on a distribution to participators** [April 2009]
This example illustrates the operation of Section 13(5A) TCGA 1992 if the company realises a gain and distributes an amount in respect of the gain to participators.

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on which he is so chargeable, after any gains falling within para (b) above; and
(d) any gain treated as accruing to that person in that year by virtue of subsection (2) above shall be regarded as the next highest part of the gains on which he is so chargeable, after any gains falling within para (c) above."

The CG Manual provides:

**57375. Tax adjustment and reliefs: Tax relief ordering rules: Section 13(7A) TCGA 1992** [April 2009]
Before tax year 2008-09, where the events which could give rise to relief under section 13(5A) and (7) occurred within a single tax year, there could, in certain circumstances, be computational problems. To prevent this subsection (7A) set out the order of priority to be given to each tax charge. In ascertaining for the purposes of subsections (5A) and (7) the amount of CGT or IT which is chargeable on a person for a year, the order was
a. any distribution which is chargeable as income is treated as the top slice of income for that year
b. any gain accruing on the disposal of any asset representing the participator's interest in the non- resident company is treated as the top slice of gains for that year
c. any gain accruing on a capital distribution is treated as the second slice of gains for that year
d. the gain attributed to the participator under Section 13 is treated as the third slice of gains for that year.
In 2008-09 and later years Capital Gains Tax is charged at a fixed rate regardless of an individual's income and so these priority rules are not necessary. [Author's note: the provision might have been retained to deal with the CGT annual exemption, but that is trivial.]

***Facts***

- A UK resident shareholder owns half the shares in a non-resident close company. The company structure is straightforward and the UK resident is a 50% participator. The shareholder does not claim the remittance basis.
- In January 2009 the non-resident company sells an asset realising a gain of £100,000.
- The UK resident has no other gains in 2008-09 but is chargeable to Capital Gains Tax at 18%.
- In June 2009 the company makes a distribution of £100,000 to its shareholders. The UK resident is chargeable at 40% on the amount received.[25]

***Capital Gains Tax treatment***

January 2009 - The ordinary rules of Section 13 TCGA 1992 apply. Half the gain of £100,000 is attributable to the shareholder and is chargeable to Capital Gains Tax in 2008-09. The tax due is

| | |
|---|---|
| Section 13 gain | £50,000 |
| less annual exempt amount | -£ 9,600 |
| Gain | £40,400 |
| **CGT @ 18%** | **£ 7,272** |

June 2009 – The tax paid under section 13(2) is available for set off. The Income Tax due on the distribution for 2009-10 is

| | |
|---|---|
| Distribution | £50,000 |
| IT @ 40% | £20,000 |
| less Section 13 tax | -£ 7,272 |
| Tax due | £12,728 |

**57366. Examples of relief: Section 13(5A) TCGA 1992: Company dissolved: Payment to participators** [April 2009]

This example illustrates the operation of Section 13(5A) TCGA 1992 if the company realises a gain, is then dissolved and there is a payment to the participators.

***Facts***

A UK resident shareholder owns half the shares in a non-resident close

25 The rate of tax would not normally be 40%. The error arose because the author amended the dates of the text of the example in order to appear up to date (the earlier text is preserved in the 7th edition of this work) but (somewhat negligently) did not make the consequential amendment which should follow from the change of date.

company. The company structure is straightforward and the UK resident is a 50% participator.

- The shares cost £10,000 in July 2009.
- In March 2010 the non-resident company sells an asset realising a gain of £100,000.
- The UK resident has no other gains in 2009-2010 but is chargeable to Capital Gains Tax at 40%.[26]
- In July 2011 the non-resident company is dissolved. There is an excess of assets over liabilities. The liquidator makes a capital distribution to shareholders. The total sum distributed to shareholders is £200,000.
- The UK resident has no other gains in 2011-12 but is chargeable to Capital Gains Tax at 18%.

**Capital Gains Tax treatment**

March 2010 - The ordinary rules of Section 13 TCGA 1992 apply. Half the gain of £100,000 is attributable to the shareholder and is chargeable to Capital Gains Tax in 2009-10. The tax due is

| | |
|---|---|
| Section 13 gain | £50,000 |
| Less annual exempt amount (say) | -£10,000[27] |
| | £40,000 |
| CGT @ 18% | £ 7,200 |

June 2011 - 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. But a capital gain has now accrued to the shareholder because a capital distribution has been received from the liquidator. Section 122 TCGA 1992 applies. The Capital Gains Tax liability for 2011-12 is

| | |
|---|---|
| Proceeds | £100,000 |
| Less cost | - £ 10,000 |
| Gain | £ 90,000 |
| Less annual exempt amount (say) | -£ 10,500 |
| | £ 89,500[28] |

26 See above footnote for the reason for this.

27 The correct figure is 10,100 but the author presumably composed the example before the amount of the annual exemption was known.

28 The author of the manual appears to have made a careless arithmetical mistake here. The reader is invited to speculate what penalties HMRC would think appropriate if a tax return contained as many errors as the two worked examples in the HMRC manual.

| | |
|---|---|
| CGT @ 18% | £ 16,110 |
| Less Section 13 tax | -£ 7,200 |
| Tax due | £ 8,910 |

47.19.2 *Time limit for distribution*

Section 13(5B) TCGA sets out the time limit for company distribution relief:

> The period referred to in subsection (5A)(b) above is the period of three years from—
> (a) the end of the period of account of the company in which the chargeable gain accrued, or
> (b) the end of the period of twelve months beginning with the date on which the chargeable gain accrued,
> whichever is earlier.

The drafting is convoluted, but in plain English the time limit is the earlier of:
(1) three years from the end of the accounting period; or
(2) four years from the date of the gain.

47.19.3 *Remittance basis taxpayer participator*

Company distribution relief applies to foreign s.13 gains which are taxed on a remittance basis, but the relief only sets tax on the s.13 gain against tax on the distribution, so the relief does not apply unless the s.13 gain is remitted (so tax is paid on it), and the distribution is remitted (so tax actually paid on the distribution qualifies for relief). Thus suppose:
(1) Year 1: A company realises a gain deemed to accrue to a remittance basis taxpayer under s.13 but not taxed as it is not remitted.
(2) Year 3: The company declares a dividend in respect of the gain. The dividend is RFI but not taxable as it is not remitted.
(3) Year 10: the gain and the dividend are remitted.
The relief applies. The time limit is met as the distribution was within 3 years of the relevant time, the time that the gain accrued to the company. The date of the remittance is not relevant.

## 47.20 Company disposal relief

Section 13(7) TCGA provides:

> The amount of CGT paid by a person in pursuance of subsection (2) above (so far as neither reimbursed by the company nor applied under subsection (5A) above for reducing any liability to tax) shall be allowable as a deduction in the computation under this Act of a gain accruing on the disposal by him of any asset representing his interest as a participator in the company.

This sets tax against the gain, so it is not generous. The CG Manual provides:

> **57370. Tax adjustment and reliefs: disposal of interest by UK resident participator: Section 13(7) TCGA 1992** [April 2009]
> [The manual summarises s.13(7) and continues] No deduction is due if the tax was paid by the non-resident company, see CG57390. Indexation allowance is not given on the tax paid. Although the tax is allowed as a deduction in computing the gain it is not expenditure within Section 38(1)(a) TCGA 1992 or Section 38(1)(b) TCGA 1992. Therefore it is not relevant allowable expenditure for indexation allowance purposes, see CG17240.
> NOTE. If a taxpayer is within the charge to Capital Gains Tax, neither indexation allowance nor taper relief apply to disposals of assets on or after 6 April 2008. Previously indexation allowance had been frozen at April 1998. For indexation allowance see CG17207+ and for taper relief see CG17895+.

The point about indexation would only be relevant to a corporate taxpayer.

> **57371 Disposal of interest/shares by UK resident** [April 2009]
> This example illustrates the deduction under Section 13(7) TCGA 1992 if the taxpayer sells shares in a non-resident company whose gains have been apportioned under Section 13 TCGA 1992.
> **Facts**
> - June 2008 a taxpayer buys 500 out of the 750 issued shares in X Ltd, a non-resident close company, at a cost of £100,000.
> - March 2009 X Ltd realises a gain of £6,000. 500/750×£6,000 = £4,000 is apportioned to the taxpayer. The amount is included in the 2008-09 Capital Gains Tax assessment. The taxpayer is liable at 18% and tax of £720 is due.
> - August 2010 the taxpayer sells the shares for £130,000.

**Chargeable Gain**

| | | £ |
|---|---|---|
| Disposal proceeds | | 130,000 |
| less Cost | 100,000 | |
| less Section 13(7) deduction | 720 | -100,720 |
| **Chargeable gain** | | **29,280** |
| less Annual exempt amount (say) | | -10,200 |
| Amount chargeable | | 19,080 |

NOTE. If a taxpayer is within the charge to Capital Gains Tax, neither indexation allowance nor taper relief apply to disposals of assets on or after 6 April 2008. Previously indexation allowance had been frozen at April 1998. For indexation allowance see CG17207+ and for taper relief see CG17895+.

This is wholly theoretical as in this situation the taxpayer would and should claim company distribution relief under s.13(5A). The only possible use of company disposal relief would be
(1) to increase an allowable loss, or
(2) in cases where the disposal gave rise to a loss or relief for other losses would obviate the gain.

## 47.21 Reimbursement by non-resident company

Tax on the s.13 gain is due from the UK resident participator and not from the company. The participator has no statutory right of indemnity against the company. But it is possible that the company might pay the tax on the s.13 gain voluntarily, or perhaps a participator might protect himself by entering into a contract requiring the company to pay the tax.

Section 13(11) TCGA provides:

> If any tax payable by any person by virtue of subsection (2) above is paid
> [a] by the company to which the chargeable gain accrues,
> [b] or in a case under subsection (9) above is paid by any such other company,
> the amount so paid shall not for the purposes of income tax, CGT or corporation tax be regarded as a payment to the person by whom the tax was originally payable.

The CG Manual provides a précis:

> **57390. Payment of UK tax by NR company**
> The non-resident company may pay the UK tax due from a UK resident

> when gains have been apportioned to him under TCGA 1992, S 13. If so, TCGA 1992, S 13 (11) provides that the payment of the tax on behalf of the UK resident does not give rise to any further liability in the hands of the UK resident. You do not treat the payment as income of the resident or as a capital distribution in respect of the shares in the non-resident company. TCGA 1992, S 13 (11) will also apply if the liability arises because a UK resident has an indirect shareholding in the non-resident company. The liability can be paid by any of the non-resident close companies in the chain.

Reimbursement is better than an income distribution in respect of the gain as the reimbursement is tax free, whereas an income distribution is subject to income tax (at income tax rates) with the benefit of CGT relief (at CGT rates). Of course, the non-resident company will need to consider whether it would be proper to make the reimbursement as a matter of company law (eg are there other shareholders who may be prejudiced?).

## 47.22 Loss accruing to non-resident company

### 47.22.1 *Arising basis participator*

Section 13(1)(2) TCGA only attributes gains (not losses) to a participator, so in the absence of further provision a participator would have no relief for losses accruing to the non-resident company. Section 13(8) TCGA provides some relief for losses:

> [a] So far as it would go to reduce or extinguish chargeable gains accruing by virtue of this section to a person in a year of assessment this section shall apply in relation to a loss accruing to the company on the disposal of an asset in that year of assessment as it would apply if a gain instead of a loss had accrued to the company on the disposal,
> [b] but shall only so apply in relation to that person;[29]
> [c] and subject to the preceding provisions of this subsection this section shall not apply in relation to a loss accruing to the company.

The CG Manual correctly provides:

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29 I do not understand the words in [b] and would be grateful if any reader could explain why they are there. Perhaps they are just otiose.

**CG57295 - NR companies: losses: - general** [April 2009]
S13 TCGA 1992 is concerned with the apportionment of gains not losses. If the disposal by the non-resident company gives rise to a loss then that loss cannot be apportioned to UK residents for them to set it off against their other gains. However, the loss can be set-off

- against gains made by the same company in the same year of assessment
- against gains made by other non-resident companies which have been apportioned to the taxpayer in the same year of assessment.

*Losses of the same company (S13(8) TCGA 1992)*
If the non-resident company makes gains and losses in the same year of assessment the losses can be set off against the gains. Any surplus losses cannot be carried forward or back to set-off against gains arising in a different year of assessment.
*Losses of different companies*
If the UK resident is a participator in more than one non-resident company the proportion of the gains and losses of those companies apportioned to the UK resident can be set off against each other in the same year of assessment. Any surplus loss cannot be carried forward or back to set against the gains arising in different years of assessment.

Careful timing of disposals is needed to ensure that the loss relief is used: s.13 losses should not exceed s.13 gains in any year.

47.22.2 *Remittance basis participator*

Section 14A(4) TCGA 1992 provides:

If—
(a) the deemed chargeable gain is a foreign chargeable gain (within the meaning of section 12),
(b) section 809B, 809D or 809E of ITA 2007 (remittance basis) applies to the individual for the year mentioned in subsection (1), and
(c) any of the deemed chargeable gain is remitted to the UK in a tax year after that year,
the chargeable gain treated under section 12(2) as accruing may not be reduced or extinguished under section 13(8).

Careful planning is needed to ensure that loss relief is available.

### 47.22.3 *Non resident trust participator*

The position is similar as for a UK participator. The aim should be that company losses should not exceed s.13 gains in any year, so that the losses can be set against the gains under s.13(8) TCGA.

## 47.23 Negligible value claims

Section 24 TCGA provides:

> (1A) A negligible value claim may be made by the owner of an asset ("P") if condition A or B is met.

The usual case is condition A:

> (1B) Condition A is that the asset has become of negligible value while owned by P.[30]

The claim should be made by the non-resident company, though in practice HMRC have accepted claims by UK resident participators.[31] It is possible that the non-resident company might authorise a person to make claims on its behalf, especially if that person is the direct or indirect owner and subject to tax under s.13 on 100% of the company's gains.
Section 24(2)(a) TCGA provides the relief:

> Where a negligible value claim is made:
> (a) this Act shall apply as if the claimant had sold, and immediately reacquired, the asset at the time of the claim or (subject to paragraphs (b) and (c) below) at any earlier time specified in the claim, for a consideration of an amount equal to the value specified in the claim.

Section 24(2)(b) TCGA specifies the limit of the carry back:

> (b) An earlier time may be specified in the claim if:
> (i) the claimant owned the asset at the earlier time; and
> (ii) the asset had become of negligible value at the earlier time; and

30 Condition B (not discussed) arises when the disposal by which P acquired the asset was a no gain/no loss disposal.

31 Private correspondence.

either

(iii) for capital gains tax purposes the earlier time is not more than two years before the beginning of the year of assessment in which the claim is made; or

(iv) for corporation tax purposes the earlier time is on or after the first day of the earliest accounting period ending not more than two years before the time of the claim.

The time limit here is that in (iv), on or after the first day of the earliest accounting period of the non-resident company ending not more than two years before the time of the claim, since s.13(11A) TCGA provides:

> For the purposes of this section the amount of the gain or loss accruing at any time to a company that is not resident in the UK shall be computed (where it is not the case) as if that company were within the charge to corporation tax on capital gains.

## 47.24 Non-resident group relief

A full discussion of group relief requires a book to itself. The discussion here must be somewhat curtailed.

### 47.24.1 *Meaning of "non-resident group"*

Section 14(4) TCGA provides:

> For the purposes of this section—
> (a) a "non-resident group" of companies—
> (i) in the case of a group, none of the members of which are resident in the UK, means that group, and
> (ii) in the case of a group, 2 or more members of which are not resident in the UK, means the members which are not resident in the UK;
> (b) "group" shall be construed in accordance with section 170.

In outline, the definition of group is in s.170(3) TCGA:

> Subject to subsections (4) to (6) below—
> (a) a company (referred to below and in sections 171 to 181 as the "principal company of the group") and all its 75 per cent subsidiaries form a group and, if any of those subsidiaries have 75

per cent subsidiaries, the group includes them and their 75 per cent subsidiaries, and so on, but

(b) a group does not include any company (other than the principal company of the group) that is not an effective 51 per cent subsidiary of the principal company of the group.

The CG Manual provides:

**57401. NR group**

For the purposes of TCGA 1992, S 13 TCGA 1992, S 14(4)(b) amends the definition of group in TCGA 1992, S 170 by omitting the references to companies resident in the UK and particular types of company. It then defines a non-resident group as being either

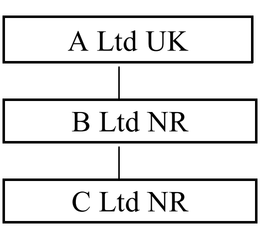
- two or more members of the same group, using the amended definition, both of which are non-resident. A UK resident company cannot be a member of the non-resident group. A non-resident company cannot be a member of the UK group. But a UK resident company can group two non-resident companies, see Example 1

or

- the whole of the group if none of the members are resident in the UK.

FA 2000, Sch 29, Para 1 amended TCGA 1992, S 170 to remove the requirement that members of a group had to be resident in the UK. For the purposes of TCGA 1992, S 14, the definition of a non-resident group remains unchanged by this amendment.

EXAMPLE 1[32]

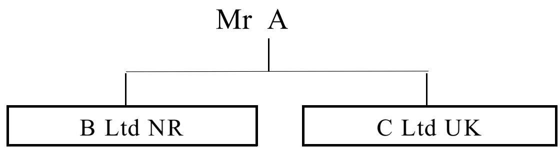



B Ltd and C Ltd form a non-resident group.

A Ltd is not a member of the non-resident group but it does have the effect of overseas “grouping” B Ltd and C Ltd.

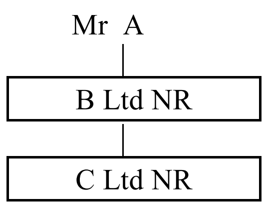
32 I have added the diagrams to increase clarity.

EXAMPLE 2




B Ltd and C Ltd do not form a non-resident group because they are not members of any group.

EXAMPLE 3




B Ltd and C Ltd form a non-resident group because all of the companies in the group are not resident.

47.24.2 *Group relief*

Section 14 TCGA provides:

**Non-resident groups of companies**

(1) This section has effect for the purposes of section 13.

(2) The following provisions—

(a) section 41(8),

(b) section 171 (except subsections (1)(b) and (1A)),

(c) section 173 (with the omission of the words “to which this section applies” in subsections (1)(a) and (2)(a) and “such” in subsections (1)(c) and (2)(c) and with the omission of subsection (3)),

(d) section 174(4) (with the substitution of “at a time when both were members of the group” for “in a transfer to which section 171(1) applied”), and

(e) section 175(1) (with the omission of the words “to which this section applies”),

shall apply in relation to non-resident companies which are members of a non-resident group of companies as they apply in relation to companies which are members of a group of companies.

This incorporates group relief for UK groups by reference.

Section 171(1) TCGA confers the relief. Amended as s.14 TCGA directs, this provides:

> Where—
> (a) a company ("company A") disposes of an asset to another company ("company B") at a time when both companies are members of the same group,
> company A and company B are treated for the purposes of corporation tax on chargeable gains as if the asset were acquired by company B for a consideration of such amount as would secure that neither a gain nor a loss would accrue to company A on the disposal.

Section 171 goes on to set out 11 exceptions where the relief does not apply; these are not discussed here.

The CG Manual provides:

> **57404. Section 14 – UK resident** [April 2007]
> As shown in Example 3 in CG57401 Section 14 TCGA 1992 applies even if the UK resident shareholder[33] is not a company. Some taxpayers and tax advisers are uncertain about this because Section 171 TCGA 1992 includes the words 'so far as relates to Corporation Tax on chargeable gains'.[34] They suggest this means Section 14 can only apply if the Section 13 TCGA 1992 charge would be to Corporation Tax on chargeable gains. We do not take this restrictive view. This practice was published in Tax Bulletin, Issue 7, page 74.[35]

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33 This should read: "participator".

34 The Manual is a decade out of date, because since 2000 the wording is "for the purposes of corporation tax on chargeable gains" but the revised wording does not alter the position.

35 Now classified as RI 43 which provides:

"**Non-resident companies: attribution of gains to UK shareholders: 'non-resident groups': TCGA 1992 ss13, 14, 171–174, 175(1), 178–180**
In some circumstances gains realised by non-resident companies may be attributed to shareholders who are resident or ordinarily resident in the UK. The main provisions are in TCGA 1992 s 13. The scope of the legislation is not quite as wide ranging as it may seem because some of the group provisions which apply to UK groups for the taxation of gains—for example those relating to intra-group transfers—are imported for s 13 purposes from elsewhere in TCGA 1992 (see s 14). An intra-group transfer by members of a 'non-resident group' would thus be treated as taking place at no gain and no loss so there would be no gain on the disposal to

This is a somewhat cavalier view. Normally it will favour the taxpayer and so will not be challenged. But there are cases where it will be in the taxpayer's interest to argue that group relief does not apply.

### 47.24.3 *Clawback charge*

Section 14(3) TCGA provides:

> Section 179 (except subsections (1)(b) and (1A)) shall apply for the purposes of section 13 as if for any reference therein to a group of companies there were substituted a reference to a non-resident group of companies, and as if references to companies were references to companies not resident in the UK.

This incorporates the clawback rules for groups by reference. Amended as s.14(3) directs, s.179 TCGA in outline provides:

> (1) This section applies where—
> (a) a company not resident in the UK ("company A") acquires an asset from another company not resident in the UK ("company B") at a time when company B is a member of a non-resident group,
> ...
> (c) company A ceases to be a member of that non-resident group within the period of six years after the time of the acquisition.
> References in this section to a company not resident in the UK ceasing to be a member of a non-resident group of companies not resident in the UK do not apply to cases where a company not resident in the UK ceases to be a member of a non-resident group in consequence of another member of the non-resident group ceasing to exist.
> ...
> (2) Where 2 or more associated companies not resident in the UK cease to be members of the non-resident group at the same time, subsection (1) above shall

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attribute to UK shareholders.

In relation to the application of the no gain/no loss rule in these circumstances [HMRC] have been asked whether the words 'so far as relates to corporation tax on chargeable gains' in TCGA 1992 s 171 limit its application to situations where the gain on the intra-group transaction would otherwise be within the charge to corporation tax.

In [HMRC's] view the no gain/no loss rule is not limited in this way. The benefit of the rule is given whether the shareholder is assessable to CGT or to corporation tax. A similar view is also taken when considering the operation of any of the other sections referred to in TCGA 1992 s 14."

not have effect as respects an acquisition by one from another of those associated companies not resident in the UK.

(2A) Where—

(a) a company not resident in the UK ("company A") that has ceased to be a member of a non-resident group of companies not resident in the UK ("the first non-resident group") acquired an asset from another company not resident in the UK ("company B") which was a member of that non-resident group at the time of the acquisition,

(b) subsection (2) above applies in the case of company A's ceasing to be a member of the first non-resident group so that subsection (1) above does not have effect as respects the acquisition of that asset,

(c) company A subsequently ceases to be a member of another non-resident group of companies not resident in the UK ("the second non-resident group"), and

(d) there is a connection between the two non-resident groups,

subsection (1) above shall have effect in relation to company A's ceasing to be a member of the second non-resident group as if it had been the second non-resident group of which both companies not resident in the UK had been members at the time of the acquisition.

(2B) For the purposes of subsection (2A) above there is a connection between the first non-resident group and the second non-resident group if, at the time when company A ceases to be a member of the second non-resident group, the company not resident in the UK which is the principal company of that non-resident group is under the control of—

(a) the company not resident in the UK which is the principal company of the first non-resident group or, if that non-resident group no longer exists, which was the principal company of that non-resident group when company A ceased to be a member of it;

(b) any person or persons who control the company not resident in the UK mentioned in para (a) above or who have had it under their control at any time in the period since company A ceased to be a member of the first non-resident group; or

(c) any person or persons who have, at any time in that period, had under their control either—

    (i) a company not resident in the UK which would have been a person falling within para (b) above if it had continued to exist, or

    (ii) a company not resident in the UK which would have been a person falling within this paragraph (whether by reference to a company not resident in the UK which would have been a person falling within that paragraph or to a company not resident in the UK or series of companies not resident in the UK falling within this subparagraph).

(2C) This section shall not have effect as respects any asset if, before the time when company A ceases to be a member of the non-resident group or, as the case may be, the second non-resident group, an event has already occurred by virtue of which the company not resident in the UK falls by virtue of section 101A(3) to be treated as having sold and immediately reacquired the asset at the time specified in subsection (3) below.

(2D) This section shall not have effect as respects any asset if, before the time when company A ceases to be a member of the non-resident group or, as the case may be, the second non-resident group, an event has already occurred by virtue of which the company not resident in the UK falls by virtue of section 101C(3) to be treated as having sold and immediately reacquired the asset at the time specified in subsection (3) below.

(3) If, when company A ceases to be a member of the non-resident group, company A, or an associated company not resident in the UK also leaving the non-resident group, owns, otherwise than as trading stock—

(a) the asset, or

(b) property to which a chargeable gain has been carried forward from the asset on a replacement of business assets,

then, subject to subsection (4) below, company not resident in the UK A shall be treated for all the purposes of this Act as if immediately after its acquisition of the asset it had sold, and immediately reacquired, the asset at market value at that time.

(4) Any chargeable gain or allowable loss accruing to company A on the sale referred to in subsection (3) above shall be treated as accruing to company A at whichever is the later of the following, that is to say—

(a) the time immediately after the beginning of the accounting period of that company not resident in the UK in which or, as the case may be, at the end of which the company not resident in the UK ceases to be a member of the non-resident group; and

(b) the time when under subsection (3) above it is treated as having reacquired the asset;

and sections 138 to 142 of CTA 2010 have effect accordingly as if the actual circumstances were as they are treated as having been.

(5) Where, apart from subsection (6) below, a company not resident in the UK ceasing to be a member of a non-resident group by reason only of the fact that the principal company of the non-resident group becomes a member of another non-resident group would be treated by virtue of subsection (3) above as selling an asset at any time, subsections (6) to (8) below shall apply.

(6) The company in question shall not be treated as selling the asset at that time; but if—

(a) within 6 years of that time the company in question ceases at any time ("the relevant time") to satisfy the following conditions, and

(b) at the relevant time, the company in question, or a company not resident in the UK in the same non-resident group as that company, owns otherwise than as trading stock the asset or property to which a chargeable gain has been carried forward from the asset on a replacement of business assets,

the company in question shall be treated for all the purposes of this Act as if, immediately after its acquisition of the asset, it had sold and immediately reacquired the asset at the value that, at the time of acquisition, was its market value.

(7) Those conditions are—

(a) that the company not resident in the UK is a 75 per cent subsidiary of one or more members of the other non-resident group referred to in subsection (5) above, and

(b) that the company not resident in the UK is an effective 51 per cent subsidiary of one or more of those members.

(8) Any chargeable gain or allowable loss accruing to the company not resident in the UK on that sale shall be treated as accruing at the relevant time.

(9) Where—

(a) by virtue of this section a company not resident in the UK is treated as having sold an asset at any time, and

(b) if at that time the company not resident in the UK had in fact sold the asset at market value at that time, then, by virtue of section 30, any allowable loss or chargeable gain accruing on the disposal would have been calculated as if the consideration for the disposal were increased by an amount,

subsections (3) and (6) above shall have effect as if the market value at that time had been that amount greater.

(9A) Sections 450 and 451 of CTA 2010 (meaning of control) shall have effect for the purposes of subsection (2B) above as it has effect for the purposes of Part 10 of CTA 2010; but a person carrying on a business of banking shall not for the purposes of that subsection be regarded as having control of any company not resident in the UK by reason only of having, or of the consequences of having exercised, any rights of that person in respect of loan capital or debt issued or incurred by the company not resident in the UK for money lent by that person to the company not resident in the UK in the ordinary course of that business.

(10) For the purposes of this section—

(a) 2 or more companies not resident in the UK are associated companies not resident in the UK if, by themselves, they would form a non-resident group of companies not resident in the UK,

(b) a chargeable gain is carried forward from an asset to other property on a replacement of business assets if, by one or more claims under sections 152 to 158, the chargeable gain accruing on a disposal of the asset is reduced, and as a result an amount falls to be deducted from the expenditure allowable in computing a gain accruing on the disposal of the other property,

(c) an asset acquired by company A shall be treated as the same as an asset owned at a later time by that company not resident in the UK or an associated company not resident in the UK if the value of the second asset is derived in whole or in part from the first asset, and in particular where the second asset is a freehold, and the first asset was a leasehold and the lessee has acquired the reversion.

(13) Where under this section company A is to be treated as having disposed of, and reacquired, an asset, all such recomputations of legibility in respect of other disposals, and all such adjustments of tax, whether by way of assessment or by way of discharge or repayment of tax, as may be required in consequence of the provisions of this section shall be carried out.

## 47.25 Private residence relief

Suppose T owns a non-resident company, which holds a house that is T's main residence. If the company disposes of the house, and a gain accrues to T, does private residence relief apply? Section 222(1) TCGA provides:

> This section applies to a gain accruing to an individual so far as attributable to the disposal of, or of an interest in—
> (a) a dwelling-house or part of a dwelling-house which is, or has at any time in *his* period of ownership been, his only or main residence, or
> (b) land *which he has* for his own occupation and enjoyment with that residence as its garden or grounds up to the permitted area.
> (emphasis added)

The gain does accrue to an individual, and it is attributable to the disposal of the dwellinghouse. However, no relief applies because:
(1) the condition in (b) is not met: there is no land which T *has*;
(2) the condition in (a) is not met: the company's period of ownership is not *his* period of ownership.
T might argue that the section should be read non-literally, but it is not absurd to deny private residence relief when a house is held through a company. The policy is consistent with s.13(11A) TCGA which computes gains as if the company were within the charge to CT, and no-one suggests a UK resident company qualifies for private residence relief.

Likewise if the company is held by a trust, no relief applies to the trustees and the gain on the disposal is a s.2(2) amount or a s.86 amount.

## 47.26 Administration and appeals

The CG Manual provides:

> **57270. Liaison: other offices** [April 2009]
> As you are required to make an apportionment that is just and reasonable by reference to the interests of all of the participators, you will need to liaise with other officers dealing with participators in the non-resident company. In appropriate cases you should agree that a single nominated officer co-ordinate the progress of the enquiries, or conduct the enquiry in respect of some or all of the participators, for example, where all of the participators are represented by the same agent. In any case where a non-resident trust is involved, CAR (Residence), see CG57395, should be notified and will normally act as the office co-ordinating HMRC's enquiries.
> ... It will usually be appropriate to ensure that all appeals relating to the

extent of the interests of participators with regard to a particular gain are heard at the same hearing, see AH1795.

CHAPTER FORTY EIGHT

# CAPITAL LOSSES

## 48.1 Deduction of losses

Section 2(2) TCGA provides for the deduction of losses:

> Capital gains tax shall be charged on the total amount of chargeable gains accruing to the person chargeable in the year of assessment, after deducting—
> (a) any allowable losses accruing to that person in that year of assessment, and
> (b) so far as they have not been allowed as a deduction from chargeable gains accruing in any previous year of assessment, any allowable losses accruing to that person in any previous year of assessment (not earlier than the year 1965–66).

Section 2 refers to a "person", so it applies to individuals, trustees, companies and PRs.

Section 2(2)(a) deducts current year losses and s.2(2)(b) deducts brought forward losses. Section 2(3) TCGA disallows carry-back of losses (unnecessarily) and provides two commonsense restrictions on loss relief:

> [a] Except as provided by section 62,[1] an allowable loss accruing in a year of assessment shall not be allowable as a deduction from chargeable gains accruing in any earlier year of assessment, and
> [b] relief shall not be given under this Act more than once in respect of any loss or part of a loss, and
> [c] shall not be given under this Act if and so far as relief has been or may be given in respect of it under the Income Tax Acts.

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1 See 45.4 (Carry-back of losses on death).

The restriction on carry-back of losses means that careful timing of disposals may make the difference between losing and using the losses.

In this chapter:

"**Personal losses**" means losses accruing to individuals.

"**Trust losses**" means losses accruing to trustees.

For offshore fund losses, see 32.21 (Losses). For losses in the year of arrival and departure from the UK, see 6.18.1 (Losses). For losses of temporary non-residents see 8.5 (Gains and losses accruing in intervening years). For s.13 losses see 47.21 (Loss accruing to non-resident company). For interaction of loss relief and foreign tax credits, see 50.5.6 (HMRC practice: quantum of relief).

## 48.2 Allowable loss

Section 2 TCGA refers to "allowable" losses. This is a label which brings in a large number of rules; for whenever the drafter wishes to disallow a loss they direct that it is not allowable. The starting point is s.16 TCGA which provides:

> (1) Subject to sections 261B, 261D and 263ZA and except as otherwise expressly provided the amount of a loss accruing on a disposal of an asset shall be computed in the same way as the amount of a gain accruing on a disposal is computed.
> (2) Except as otherwise expressly provided, all the provisions of this Act which distinguish gains which are chargeable gains from those which are not, or which make part of a gain a chargeable gain, and part not, shall apply also to distinguish losses which are allowable losses from those which are not, and to make part of a loss an allowable loss, and part not; and references in this Act to an allowable loss shall be construed accordingly.

Section 16(2A) TCGA requires a claim to be made when the loss accrues (which may be some years before the loss is used):

> A loss accruing to a person in a year of assessment shall not be an allowable loss for the purposes of this Act unless, in relation to that year, he gives a notice to an officer of the Board quantifying the amount of that loss; and sections 42 and 43 of the Management Act shall apply in relation to such a notice as if it were a claim for relief.

In this chapter I assume losses are allowable unless otherwise stated.

## 48.3 Loss accruing to non-resident

Section 16(3) TCGA provides:

> [a] 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
> [b] 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.[2]

In short, a loss accruing to a person who is neither resident nor ordinarily resident in the UK is not an allowable loss. This gives a symmetry with the principle that a gain accruing to such a person is not in principle subject to CGT. Section 16(3) refers to a "person", so it applies to individuals, trustees, companies and PRs. However, there is some relief for non-resident trusts within s.86, 87 TCGA; see below; there is also some relief for losses of non-resident companies within s.13 TCGA.[3]

The realisation of losses outside the scope of CGT is wasteful. Unless the temporary non-residence rules apply:

(1) An individual leaving the UK may consider realising losses before they become non-resident.
(2) An individual planning to come to the UK may postpone the disposal of assets with inherent losses until they acquire UK resident status.

## 48.4 Carry-back of losses on death

Section 62(2) TCGA provides for carry-back of losses on death:

> Allowable losses sustained by an individual in the year of assessment in which he dies may, so far as they cannot be deducted from chargeable gains accruing in that year, be deducted from chargeable gains accruing to the deceased in the 3 years of assessment preceding the year of

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2 The situation in s.16(3)[b] is very rare: see 43.8 (Non-resident trader with UK branch).

3 See 47.21 (Loss accruing to non-resident company).

> assessment in which the death occurs, taking chargeable gains accruing in a later year before those accruing in an earlier year.

Section 62(2A) TCGA provides:

> Amounts deductible from chargeable gains for any year in accordance with subsection (2) above shall not be so deductible from any such gains so far as they are gains that are treated as accruing by virtue of section 87 or 89(2) (read, where appropriate, with section 10A).

Thus the disallowance of personal losses against s.87 deemed gains continues on death. That is consistent with the general rule.

## 48.5 Loss accruing to non-resident trustees

### 48.5.1 *Section 87 and trust losses*

Section 87(4) TCGA provides:

> The section 2(2) amount for a tax year for which this section applies to the settlement is—
> (a) the amount upon which the trustees would be chargeable to tax under section 2(2) for that year if they were resident and ordinarily resident in the UK in that year ...

Under this definition, losses accruing to trustees in a tax year could be set against gains accruing to the trustees in the same year, in computing the s.2(2) amount. But losses of an earlier year in which the trustees were not resident could not be carried forward and set against gains of a later year, because s.16(3) TCGA disallows such losses.[4] However s.97(6) TCGA allows losses to be carried forward:

> Section 16(3) shall not prevent losses accruing to trustees in a year of assessment for which section 87 of this Act or section 17 of the 1979 Act applied to the settlement from being allowed as a deduction from chargeable gains accruing in any later year (so far as they have not previously been set against gains for the purposes of a computation under either of those sections or otherwise).

4 See 48.3 (Loss accruing to non-resident).

Carried forward losses will usually be used to reduce s.2(2) amounts of a subsequent year. But if the trust became UK resident they could be set against gains to reduce the trustees' own liability. A trust is therefore sometimes better than absolute ownership by a remittance basis taxpayer, whose personal losses may be disallowed.

### 48.5.2 *Section 86 and trust losses*

Under s.86 TCGA the settlor is taxed on what I call "**the s.86 amount**", which is the amount on which trustees would be charged to tax if UK resident.[5] Under this provision losses accruing to trustees in a tax year could be set against gains accruing to the trustees in the same year, in computing the s.86 amount. But losses of an earlier year in which the trustees were not resident could not be carried forward and set against gains of a latter year because s.16(3) TCGA disallows such losses. However para 1(2) sch 5 TCGA provides:

> In construing section 86(1)(e) as regards a particular year of assessment [that is, in order to ascertain the s.86 amount] —
> (a) any deductions provided for by section 2(2) shall be made in respect of disposals of any of the settled property originating from the settlor, and
> (b) section 16(3) shall be assumed not to prevent losses accruing to trustees in one year of assessment from being allowed as a deduction from chargeable gains accruing in a later year of assessment (so far as not previously set against gains).

### 48.5.3 *Loss accruing before s.86 conditions satisfied*

Para 1(6) sch 5 TCGA provides:

> The following rules shall apply in construing section 86(1)(e) as regards a particular year of assessment ("the year concerned") in a case where the trustees fall within section 86(2)(a)—
> (a) if the conditions mentioned in section 86(1) are not fulfilled as regards the settlement in any year of assessment falling before the year concerned, no deductions shall be made in respect of losses accruing before the year concerned;

5 See 44.7 (Section 86 amount condition).

(b) if the conditions mentioned in section 86(1) are fulfilled as regards the settlement in any year or years of assessment falling before the year concerned, no deductions shall be made in respect of losses accruing before that year (or the first of those years) so falling,

but nothing in the preceding provisions of this sub-paragraph shall prevent deductions being made in respect of losses accruing in a year of assessment in which the conditions mentioned in section 86(1)(a) to (d) and (f) are fulfilled as regards the settlement.

### 48.5.4 *Loss on disposal before 19 March 1991*

For completeness, para 1(7) Sch 5 TCGA provides:

> In construing section 86(1)(e) as regards a particular year of assessment and in relation to a settlement created before 19th March 1991, no account shall be taken of disposals made before 19th March 1991 (whether for the purpose of arriving at gains or for the purpose of arriving at losses).

## 48.6 Disallowance of personal losses against s.87 gains

Section 2(4) TCGA provides:

> If chargeable gains are treated by virtue of section 87 or 89(2)[6] as accruing to a person in a tax year ("the relevant deemed gains")—
> (a) subsection (2) has effect as if the relevant deemed gains had not accrued, and
> (b) the amount on which the person is charged to capital gains tax for that year is the sum of—
> (i) the amount given by subsection (2) as it has effect by virtue of para (a), and
> (ii) the amount of the relevant deemed gains.

This is clumsily expressed.[7] The drafting technique is to isolate the

6 Section 2(5) TCGA provides: "In subsection (4) the reference to section 87 or 89(2) is to that section read, where appropriate, with section 10A."

7 Section 62(2A) TCGA illustrates how the point could be clearly expressed; see 48.4 (Carry-back of losses on death).
Obscurity in statutory drafting *does* matter. In *Futter v Futter* [2011] STC 890 trustees made an appointment in the mistaken belief that personal losses could be set

"relevant deemed gains" (ie the s.87 deemed gains) from the loss relief in s.2(2) TCGA. The effect is that personal losses may not be set against s.87 deemed gains accruing to the individual.

### 48.6.1 *Commentary*

The disallowance of personal losses against s.87 deemed gains was introduced in 1998 because of the difficulties of interaction with taper relief. The CG Manual provides:

> **34272 Personal losses [June 2005]**
> ... For 1998–99 onwards the beneficiary's personal allowable losses are not available to reduce these attributed gains. It is not possible to identify any particular gain with a capital payment and so the changes introduced for Section 77 and Section 86 gains, see CG34865+, for 2003–04 onwards could not be extended to Section 87 gains.

The repeal of taper in 2008 should have allowed personal losses to be set once again against s.87 deemed gains. Presumably this point was overlooked or perhaps the deliberate decision was made to discourage the use of trusts. It is submitted that the rule disallowing personal losses against s.87 deemed gains should be repealed.

## 48.7 Personal losses and s.86 gains

Personal losses can be set against s.86 gains under s.2(2) TCGA.

For completeness, s.2(7) TCGA deals with the situation where a settlor has made two or more settlements:

> Where in any year of assessment—
> (a) there are amounts treated as accruing to a person by virtue of section 86,
> (b) two or more of those amounts, or elements of them—
> (i) relate to different settlements,
> (c) losses are deductible from the amounts or elements mentioned in para (b) above but are not enough to exhaust them all,

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against s.87 deemed gains. If s.2 had been clearly drafted, it is unlikely that the mistake would have been made.

> the deduction applicable to each of the amounts shall be the appropriate proportion of the aggregate of those losses.
> The "appropriate proportion" is that given by dividing the amount in question by the total of the amounts.

This is only necessary to ascertain what amount can be recovered under the settlor's indemnity against each settlement.

## 48.8 Loss accruing to remittance basis taxpayer

### 48.8.1 *"Foreign loss" and "UK loss"*

The legislation distinguishes between foreign losses and other losses. Section 16ZA(6) TCGA gives "**foreign loss**" a commonsense meaning:

> In this section "foreign loss" means a loss accruing from the disposal of an asset situated outside the UK.

In this discussion, "**UK loss**" means a loss which is not a foreign loss, ie a loss on a disposal of a UK situate asset.

### 48.8.2 *History*

The complex rules can be better understood if one understands the constraints faced by the drafter. It is difficult to think of a satisfactory rule for losses of a remittance basis taxpayer. Relief for all losses is too generous when only some gains are taxable. Relief for foreign losses remitted to the UK is not satisfactory, as it would usually be easy to remit the losses to the UK, so that amounts to a relief for (almost) all losses, at least for a well advised taxpayer. Moreover in the case of the extinction of an asset there may be nothing to remit.

The pre-2008/09 solution was to disallow relief on foreign losses on foreign domiciliaries (to whom the remittance basis applied compulsorily – there was no claim needed). The CGT remittance basis was a package with advantages and this disadvantage. This was a rough and ready solution, but simple and workable. However the introduction of the claim for the CGT remittance basis in 2008 changed the situation. If foreign losses of foreign domiciliaries were disallowed only in years that the individual claimed the remittance basis, then individuals may claim the remittance basis in the year that they realise gains and not in the year that they realise losses. On the other hand, the failure to claim would often be expensive in other ways, and as a simple and pragmatic solution it has much to commend it.

The FD draft clauses 2007 proposed to disallow all foreign losses of foreign domiciliaries, but that was EU non-compliant (not to mention unfair). HMRC presumably agreed, and a new solution had to be devised in the rushed weeks between publication of the FD draft clauses and the Finance Bill, allowing insufficient time for HMRC to consider the issues, and none at all for consultation.

### 48.8.3 *Summary*

EN FB 2008 provides this summary:

> 355. The overall effect of these new rules is that:
> [1] on the first occasion when a non-UK domiciled individual claims remittance basis for a tax year, the individual may make an election in relation to their foreign losses;
> [2] if the individual does not make an election, foreign losses of that tax year and all future tax years will not be allowable losses; and
> [3] if the individual makes an election, special rules apply to the deduction of allowable losses where there are foreign chargeable gains.
> 356. The effect of the special rules is that:
> [1] where foreign chargeable gains are remitted to the UK in a tax year later than that in which the asset was disposed of,
> [a] no losses of that later year, or of any year later than that in which they arose, are deductible from those gains, and
> [b] they may not be covered by the AEA [annual exempt amount] of the year in which they are remitted; and
> [2] if remittance basis is claimed for the tax year in which foreign chargeable gains arise, the allowable losses available for deduction from gains of that year are deducted
> [a] first from foreign chargeable gains that both arise and are remitted in that year,
> [b] then against foreign chargeable gains arising but not remitted in that year, and
> [c] only then from any other (non-foreign) chargeable gains arising in that year.

### 48.8.4 *Relevant tax year*

The legislation uses the expression "**relevant tax year**". Section 16ZA(1) TCGA provides:

> In this section "the relevant tax year", in relation to an individual, means the first tax year for which—
> (a) section 809B of ITA 2007 (claim for remittance basis) applies to the individual, and
> (b) the individual is not domiciled in the UK.

In short, the relevant tax year is the first year that the individual claims the remittance basis (it does not matter whether or not the individual is a long-term resident, ie whether or not the £30k remittance basis charge is due). One can put off the relevant year by not making a remittance basis claim but that is not generally going to be worthwhile. In most cases the relevant tax year will be 2008/09 or the earliest year of UK residence if later.

An individual within s.809D or 809E (sub £2k taxpayer or non-taxpayer) is not within s.809B so all losses are allowable in the usual way.

### 48.8.5 *Loss election*

Section 16ZA TCGA provides:

> (2) An individual may make an election under this section for the relevant tax year (in which case sections 16ZB and 16ZC have effect in relation to the individual for the relevant tax year and all subsequent tax years). ...
> (4) Sections 42 and 43 of the Management Act (procedure and time limit for making claims), except section 42(1A) of that Act, apply in relation to an election under this section as they apply in relation to a claim for relief.
> (5) An election under this section is irrevocable.

Thus a taxpayer claiming the remittance basis has a once in a lifetime opportunity to make an election under s.16ZA (which I call a "**loss election**") and this election (if made) applies for the rest of their life. It is impossible to know what will be the best choice and the taxpayer will have to guess. This is almost unprecedented in tax legislation.

RDR Manual provides:

> **41170 - Foreign Losses**
> The election should be made for the first year for which the remittance basis is claimed, irrespective of whether the individual has any foreign chargeable gains or overseas losses in that year. The election will usually be made within the white space in the Capital Gains supplementary pages of the same SA Return as the first remittance basis claim is made. The election is irrevocable.
> The usual time limits for claims/elections at TMA70/s42 and 43 apply.

## 48.9 Disallowance of foreign losses if no election is made

Section 16ZA(3) TCGA provides:

> If an individual does not make such an election, foreign losses accruing to the individual in
> a the relevant tax year, or
> b any subsequent tax year except one in which the individual is domiciled in the UK
> are not allowable losses.

In short, if no election is made, foreign losses accruing to a foreign domiciliary are not allowable. UK losses are allowable in the usual way.

Section 16ZA(3) only applies to foreign losses accruing in the relevant tax year. What about foreign losses accruing to a UK resident foreign domiciled individual before 2008/09? The answer is that such losses would normally be disallowed under s.16(4) TCGA as it had effect before 2008/09:

> In accordance with section 12(1), losses accruing on the disposal of assets situated outside the UK to an individual resident or ordinarily resident but not domiciled in the UK shall not be allowable losses.[8]

8 This wording is confusing. It means that losses accruing to a foreign domiciliary on a disposal by the foreign domiciliary of foreign situated property are not allowable. It does not mean that losses are not allowable on a disposal (by any person) to a foreign domiciliary.

### 48.9.1 *Planning*

It may sometimes be possible for a foreign domiciliary in this position to avoid this problem by taking action before disposing of an asset on which a loss will accrue. Consider:
(1) making assets UK situate prior to disposal;[9]
(2) an inter-spouse transfer.[10]
A foreign domiciliary who claims the remittance basis may be worse off than if they had not made the claim, if (1) they fail to make the loss election (2) they realise disallowed foreign losses; and (3) they remit sufficient gains to the UK.

## 48.10 Position if loss election is made

In the following discussion:

**"Promptly remitted gains"** means foreign gains taxed on the remittance basis which are remitted in the year that the gains accrue.
**"Postponed remitted gains"** means foreign gains taxed on the remittance basis which are remitted in a year after the gains accrue. Statute calls these "relevant gains." (It is generally better to adopt statutory terminology, for better or for worse, but my terminology is so much clearer than "relevant gains" that it makes the discussion easier to follow.)
**"Unremitted gains"** means foreign gains taxed on the remittance basis which are not remitted (and so not subject to CGT).

Section 16ZB TCGA provides:

> **16ZB Individual who has made election under section 16ZA: foreign chargeable gains remitted in tax year after tax year in which accrue**[11]
> (1) This section applies to an individual for a tax year ("the applicable tax year") if—
> (a) the individual has made an election under section 16ZA,

9 Contrast 43.5 (CGT planning: making property non-UK situate).
10 See 48.12 (Inter-spouse transfer).
11 *Sic*: the heading is incoherent.

(b) foreign chargeable gains[12] accrued to the individual in or after the relevant tax year (within the meaning of section 16ZA) but before the applicable tax year, and
(c) by reason of the remission[13] of any of the foreign chargeable gains to the UK, chargeable gains are treated under section 12 as accruing to the individual in the applicable tax year ("the relevant gains").

The key terms here are
– *relevant tax year* (the first year the remittance basis is claimed).[14]
– *relevant gains*. Relevant gains are in my terminology **postponed remitted gains**.
– *applicable tax year* (the year – after the relevant tax year – in which the postponed remitted gains are remitted).

In short, s.16ZB applies if there are postponed remitted gains. At this point the drafting becomes exceptionally clumsy.[15]

Section 16ZB(2) TCGA continues:

> Section 2(2) or (4) has effect for the applicable tax year as if the relevant gains had not accrued.

Section 16ZB(2) isolates the postponed remitted gains from the loss relief in s.2(2) TCGA. Section 16ZB(3) TCGA goes on:

> The amount on which the individual is charged to capital gains tax for the applicable tax year is (instead of the amount given by section 2(2) or (4)(b), as reduced under section 3) the sum of—
> (a) the adjusted taxable amount, and
> (b) the amount of the relevant gains.

12 This expression has its usual commonsense meaning. Section 16ZB(5) TCGA provides: "In subsection (1) 'foreign chargeable gains' has the meaning given by section 12(4)." (If the drafter had made this a TCGA-wide definition, s16ZB(5) would not have been necessary.)

13 Section 16ZB(6) TCGA provides (somewhat unnecessarily): "For the purposes of subsection (1)(c) foreign chargeable gains are remitted to the UK if they are regarded as so remitted for the purposes of section 12."

14 See 48.8.4 (Relevant tax year).

15 The drafter had adopted the clumsy drafting technique of s.2(4) TCGA which it is helpful to read first, in order to understand s.16ZB; see 48.6 (Disallowance of personal losses against s.87 gains).

### 48.10.1 *The adjusted taxable amount*

Section 16ZB(4) TCGA provides:

> "The adjusted taxable amount" is—
> (a) if section 3(1) (annual exempt amount) does not apply to the individual for the applicable tax year, the amount given by section 2(2) or (4)(b) as it has effect by virtue of subsection (2), and
> (b) otherwise, so much of that amount as exceeds the exempt amount for the applicable tax year (within the meaning of section 3).

In short, the adjusted taxable amount is the amount of gains less losses (and less the CGT annual exemption if available) apart from the postponed remitted gains.

So in short, if one makes the loss election:

(1) all losses (UK and foreign losses) are allowable against:
  (a) UK gains
  (b) foreign gains if
    (i) taxed on an arising basis (because no remittance basis claim is made in the year that the gains accrue); or
    (ii) promptly remitted gains (remitted in the year that the gains accrue).
(2) under s.16ZB postponed remitted gains do not qualify for:
  (a) *any* loss relief (either UK losses or foreign losses) or
  (b) the CGT annual exemption.

Section 16ZC TCGA relaxes the rule in (2)(a) by allowing some losses against postponed remitted gains:

> **16ZC Individual who has made election under section 16ZA and to whom remittance basis applies**
> (1) This section applies to an individual for a tax year if—
> (a) the individual has made an election under section 16ZA for the tax year or any earlier tax year,
> (b) section 809B, 809D or 809E of ITA 2007 (remittance basis) applies to the individual for the tax year, and
> (c) the individual is not domiciled in the UK in the tax year.

In short, the section applies to a remittance basis taxpayer who makes a loss election.

Section 16ZC continues:

> (2) The following steps apply for the purpose of calculating the amount on which the individual is to be charged to capital gains tax for the tax year.
> *Step 1* Deduct any relevant allowable losses from the chargeable gains referred to in subsection (3) in the order in which they appear there (starting with para (a) of that subsection).

"Relevant allowable losses" simply means allowable losses. (The drafter is overfond of the word "relevant".) Section 16ZC(7) TCGA provides:

> In this section "relevant allowable losses" means the allowable losses that section 2(2) provides may be deducted from chargeable gains accruing to the individual in the tax year, ...

48.10.2 *The loss deduction order*

This takes us to s.16ZC(3) TCGA which sets out the deduction order:

> The chargeable gains are—
> (a) foreign chargeable gains[16] accruing to the individual in the tax year, to the extent that they are remitted[17] to the UK in that year,
> (b) foreign chargeable gains accruing to the individual in that year, to the extent that they are not so remitted in that year, and
> (c) chargeable gains accruing to the individual in that year (other than foreign chargeable gains).[18]

So in my terminology, losses are set against gains in this order:
(a) promptly remitted gains;
(b) unremitted foreign gains;
(c) UK gains.

16 Section 16ZC(7) TCGA provides the standard definition: "In this section ... 'foreign chargeable gains' has the meaning given by section 12(4)".

17 Section 16ZC(6) TCGA provides (somewhat unnecessarily): "For the purposes of subsection (3) foreign chargeable gains are remitted to the UK if they are regarded as so remitted for the purposes of section 12."

18 For completeness, s.16ZC(5) TCGA provides: "Chargeable gains treated as accruing under s.12 are not within subsection (3)(c)" – though I do not see why it was necessary to say that – it seems clear in any event.

Losses set against (2) are not wasted but they are not used until the unremitted gains are remitted.

48.10.3 *Use of deductions*

Our journey takes us to Step 2:

> *Step 2* Treat the amount referred to in section 2(2) or (4)(a) or 16ZB(3)(a) as being equal to—
> (a) the amount it would be if there were no relevant allowable losses, minus
> (b) the total amount deducted under Step 1 from chargeable gains within subsection (3)(a) or (c).

For completeness, s.16ZC(4) TCGA provides:

> Chargeable gains treated as accruing under section 87 or 89(2) (read, where appropriate, with section 10A) are not within any paragraph of subsection (3).

This maintains the disallowance of personal losses against s.87 gains.[19] Section 16ZD TCGA provides:

> (1) This section applies if section 16ZC applies to an individual for a tax year.
> (2) Any allowable loss deducted under step 1 of section 16ZC(2) is to be regarded (for the purposes of section 2(2)(b)) as allowed as a deduction from chargeable gains accruing to the individual in the tax year.
> (3) If a deduction is made under step 1 of section 16ZC(2) from a foreign chargeable gain within section 16ZC(3)(b), the amount of the foreign chargeable gain is reduced by the amount deducted.

48.10.4 *Insufficient losses*

Step 1 continues:

19 See 48.6 (Disallowance of personal losses against s.87 gains).

> If allowable losses are deductible from the chargeable gains referred to in subsection (3)(b) but are not enough to exhaust them all—
> (a) those chargeable gains are to be ordered according to the day on which they accrued,
> (b) the losses are to be deducted from those gains in reverse chronological order (starting with the last chargeable gain to accrue), and
> (c) if allowable losses are deductible from chargeable gains that accrued on a particular day but are not enough to exhaust all of the chargeable gains that accrued on that day, the amount deducted from each of those chargeable gains is the appropriate proportion of the losses.
> In para (c) "the appropriate proportion", in relation to a chargeable gain, is the amount of that gain divided by the total amount of the chargeable gains that accrued on the day in question.

### 48.10.5 *Record-keeping*

The record-keeping from 2008 is extremely onerous. Before 2008 a taxpayer had only to keep a total of brought forward losses and remitted gains. But now (if a taxpayer makes a loss election) they need to keep track of which year losses accrue, and which day and year postponed remitted gains accrue, in order to apply these loss rules.

## 48.11 When is a loss election worthwhile?

Careful timing of realisation of losses and of remittances is necessary in order to maximise loss relief if a loss election is made. A few general points can be made.

A person who will realise UK losses and not foreign losses should not make a loss election.

A person who will realise UK losses and foreign losses, but can use inter spouse transfers to avoid disallowable foreign losses should not make an election.

A person who will realise foreign losses and not UK losses should make an election.

In other cases is it a matter of guesswork.

## 48.12 Inter-spouse transfer

Suppose a foreign domiciled individual ("H") owns a foreign situate asset which will give rise to a loss. It will often happen that:

(1) The loss on the disposal by H will not be allowable.

(2) If

(a) H gives the asset to H's spouse ("W") and

(b) W disposes of the asset

then W will realise an allowable loss (for instance W may not have made a remittance basis claim).

In principle, W can realise an allowable loss. However s.16A TCGA provides:

> (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.[20]

"Tax advantage" has the standard definition. Section 16A(2) TCGA provides:

> "tax advantage" means—
> (a) relief or increased relief from tax,
> (b) repayment or increased repayment of tax,
> (c) the avoidance or reduction of a charge to tax or an assessment to tax, or

20 What is the point of s.16A(3)(b) TCGA? How can a tax advantage be secured for any person *other* than the person to whom the loss accrues? The answer is if the loss accrues to a non-resident company or trustee, for the tax advantage might be enjoyed by a settlor (under s.86) or a beneficiary (under s.87) or a participator (under s.13). But this is not relevant to inter-spouse transfers.

> (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 an inter-spouse transfer is to obtain the loss, the loss is disallowed. Of course it depends on the precise facts whether that is actually a main purpose, but in many (I think, most) cases it would be so. HMRC rightly say in relation to identifying the main purpose:

> 16. Hence it will be relevant to draw a comparison in order to consider whether, in the absence of the tax considerations:
> • the transaction giving rise to the advantage would have taken place at all;
> • if so, whether the tax advantage would have been of the same amount; and
> • whether the transaction would have been made under the same terms and conditions.

It will very often be the case that the inter-spouse transfer is made only for tax reasons and would not be made in the absence of tax. However, HMRC say:

> 17. ... Nor will the new legislation *ordinarily* prevent a genuine loss on a real disposal of an asset from being set off against a person's own gains, including the case where, before the real disposal that gives rise to the genuine loss, the person acquires the relevant asset from a spouse or civil partner at no gain/no loss under section 58 [TCGA].[21]

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21 "Avoidance of tax through the creation and use of capital losses: HMRC Guidance." This guidance passed through various drafts to versions of 21 March 2007 and the current guidance of 19 July 2007, accessible *www.hmrc.gov.uk/cgt/cgt-recent-developments.pdf* and reprinted (with variations) in the CG Manual Appendix 9. See too example 5:

"40. Mr H has shares in S plc which are standing at a loss. Mrs H has shares in a separate company, T plc, standing at a gain. Mr H transfers his shares to Mrs H under the no-gain, no-loss rule in section 58 TCGA, and she then sells both holdings of shares. The loss on the shares in S plc covers the gain arising from the shares in T plc, and so no CGT is payable by Mrs H.

41. Taking the spouses together, Mr and Mrs H each have shares which they want

> (Emphasis added)

According to this, s.16A does not apply to genuine losses, and the loss in the case under discussion is genuine.

The first question this raises is: what is meant by genuine loss and why is the spouse's loss genuine? At first the unlawyerlike term "genuine" seems almost impossible to pin down, but I suggest that the concept intended here is the tax avoidance/mitigation distinction.[22] A loss is genuine (in the intended sense) if it is in accordance with the intention of Parliament, a special tax regime, and has economic consequences. The inter-spouse transfer in principle meets those criteria. This view is confirmed by para 13 of the Guidance Note:

> The straightforward use of a statutory relief does not of itself bring arrangements within the TAAR.

The straightforward use of a statutory relief could obviously be and frequently is done with the purpose of obtaining a tax advantage, but it is

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> 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."

But the factual inference in the last sentence is implausible, for the reasons explained above.

22 See 29.17.3 ("Genuine").

not tax avoidance.[23]

The guidance at para 17 uses the word "ordinarily". When will it not apply? An example is if there is an arrangement under which the donee spouse immediately returns the proceeds of the disposal to the donor spouse. In that case the inter-spouse gift has no "economic consequences".

The next difficulty is to reconcile that guidance with the words of the statute. One might simply give up at this point:

> We think that the words "**tax avoidance**" should be substituted for "**tax advantage**"... the guidance contradicts the legislation. Some transactions (such as transfers between spouses) are stated in the guidance not to be caught by the TAAR,[24] when it is strongly arguable that they are caught.[25]

If that is right, then the decision whether or not to apply the legislation in relation to inter-spouse transfers (and indeed many other cases) is made by HMRC with no redress by the taxpayer (outside judicial review discussed below). However, it is suggested, having regard to *Pepper v Hart*, that the reference to "tax advantage" should be read to mean tax avoidance in the strict sense. The fact that the definition here is based on words which in other contexts have been understood differently[26] does not determine the issue.

The reader may wonder whether this discussion matters, given that

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23 Para 5 of the Guidance Note issued on 27 March 2007 stated this expressly:
"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." But presumably HMRC noticed the inconsistency and the guidance note of 19 July 2007 was unhelpfully amended to read: "The legislation is intended to have effect where a person enters deliberately and knowingly into arrangements to gain a tax advantage."

24 A note on terminology. The label which HMRC give to anti-avoidance provisions of the s.16A type is *targeted* anti-avoidance rule ("**TAAR**"). This terminology was coined by HMRC and first used in a press release of 5 December 2005. The term has become so degraded that the Institute for Fiscal Studies can say without obvious irony that "TAARs need to be well targeted ... costs can outweigh the expected amount of lost revenues when a poorly targeted TAAR is compared with a well-targeted TAAR". The same report refers later to a "wide-ranging TAAR". Countering Tax Avoidance in the UK, TLRC discussion paper no.7, March 2009, para 8.18 accessible *www.ifs.org.uk/comms/dp7.pdf*.

25 Response of CIOT to consultation (8 February 2007).

26 See 29.14 (Consequence and Purpose).

HMRC have stated that they will not normally challenge the transfer of losses by inter-spouse transfers. On a constitutional level it matters to those who believe that tax should be based on law and not concession and discretion. On a practical level it matters if HMRC later decide to change their practice (which as the IR20 debacle shows is not a theoretical possibility) or if they choose to apply it inconsistently.

The IFS commentary deserves to be set out in full:

> 7.4 However, the width of this relatively simple provision [s.16A TCGA] meant that HMRC needed to publish 17 pages of detailed Explanatory Notes to explain how the legislation would be applied. So, considering the example of the person who sells shares standing at a loss in order to set the loss against a gain on another disposal, the Explanatory Notes explain that this transaction will not be prevented, albeit that the legislation could be used to prevent this.
> 7.5 There are several problems with this approach. First, the Explanatory Notes are not themselves subject to the scrutiny and care in drafting given to legislation. By their nature, Explanatory Notes are not drafted in the precise way required for legislation.
> 7.6 Second, HMRC does not have the power to legislate: taxation can only be imposed by the legislature[27] and while HMRC may decide upon its own interpretation of the legislation, that interpretation is not binding on taxpayers save to the extent confirmed by the courts. 'HMRC's role is to administer the UK's tax and customs systems.'
> 7.7 Third, the ability of taxpayers to rely on the guidance depends upon the type of transaction involved: if it is a single transaction entered into in reliance on specific guidance, the taxpayer can rely on the guidance (although enforcement may be cumbersome, for the reasons explained below). In contrast, if the taxpayer is seeking to rely on guidance in relation to a continuing state of affairs, the taxpayer is exposed to changes in that guidance. ...

### 48.12.1 *Is the HMRC guidance binding?*

The reader may regard these constitutional fundamentals as irrelevant to practice, but the IFS then turn to discuss the important issue of whether

27 [footnote original] Article 4 Bill of Rights 1689: ["That levying money for or to the use of the Crown by pretence of prerogative, without grant of Parliament, for longer time, or in other manner than the same is or shall be granted, is illegal."]

the guidance is enforceable:

> 7.8 To enforce guidance, the taxpayer must seek judicial review. Judicial review is a process that is costly and time consuming and which is not easily achieved. In order for a taxpayer to seek judicial review, an application for leave to apply for judicial review must be made within three months of the decision that is being challenged. The application is made to the High Court by a form setting out the grounds of the application and an affidavit setting out the factual background. Clearly, three months is an extremely short deadline even for the well-advised taxpayer. If the judge considers that the papers show an arguable case, leave to apply for judicial review is granted, but after this initial tight timescale matters may then move very slowly.
> 7.9 Consequently, a major drawback of judicial review at present is that it is effectively unavailable to most potential applicants: they do not know about it, cannot understand it, cannot afford it, or find the prospect of going to the High Court too daunting. This situation would be improved if the new Tribunals, which will handle tax appeals from 2009, have jurisdiction to review the exercise of discretionary acts by HMRC and review the application of HMRC guidance.[28]
> 7.10 In addition to the procedural and costs issues, the ability of taxpayers to use judicial review in the context of non-legislative rule-making is not always clear. It is beyond the scope of this paper to set out in detail the present state of the law with regard to the use of judicial review in relation to the exercise of powers by HMRC. However, certain points are addressed below, as the limits of challenge may be increasingly important as new ways of tackling avoidance are explored by the government.
> 7.11 In the context of this paper, the key issues limiting the ability to challenge by way of judicial review concern the application of judicial review to situations where HMRC has issued guidance to taxpayers generally regarding the application of legislation.
> 7.12 First, there are situations where HMRC guidance appears to differ from the conclusion that would be reached just by reading the legislation. An example of this arises in connection with the wide-ranging capital gains tax TAAR found in Section 16A TCGA 1992, where the legislation could be read to apply much more widely than HMRC maintains is the case in its Explanatory Notes. Where the HMRC treatment is recognised by HMRC as being a concession from

28 The hope that the new Tribunals will improve the position has not been realised.

the strict reading of the law, then there is the system of extra-statutory concessions. Even these raise issues of enforcement. The judiciary has frequently indicated that it is uncomfortable with the concessions system: for example, “One should be taxed by law and not be untaxed by concession”.[29]

7.13 That said, extra-statutory concessions have been upheld by the courts (although they are not enforceable in cases of avoidance). At the same time, the courts have decided that the power to grant them should only be exercised as part of HMRC’s duty of care and management. This was made clear in the case of *R (on the application of Wilkinson) v. IRC* where the Court of Appeal held that the Inland Revenue had no power to grant a concession to overrule an unequivocal piece of legislation unless this could be said to “facilitate the overall task of collecting taxes”. As a result of this case, the government announced that the power to make concessions from the strict application of tax law is not as wide as had previously been thought and consequently the concessions are being reviewed to determine those that are not within HMRC’s powers of “collection and management”. Section 160 of the Finance Act 2008 gives the Treasury power to make any existing concession statutory by order. In so doing, it defines an existing concession to include a statement of any sort – whether it is described as an extra-statutory concession, a statement of practice, an interpretation, a decision, a press release or in any other way – that provides a concession that a taxpayer would not, or may not, be entitled to under the law. This power of the Treasury only applies to existing concessions. Going forward, HMRC’s administrative powers have been limited by the Wilkinson case.

7.14 More difficulty is posed by statements made by HMRC that explain the legislation and are not considered by HMRC to deviate from the legislation. What if a taxpayer considers that HMRC’s guidance is wrong in law? The taxpayer could rely on making their argument through the courts, but that raises enormous cost issues and risk issues for the taxpayer. Alternatively, the taxpayer could seek judicial review on the basis that the HMRC treatment as shown by the guidance was “ultra vires”. However, in order to seek judicial review, the taxpayer also needs to show that they have sufficient interest in the matter to qualify them to make the application. These are high hurdles (albeit not impossible, as cases such as *R v Department of Social Security ex p.*

29 [Footnote original] Walton J in *Vestey v IRC (No. 2)* [1979] 3 WLR 915.

*Overdrive Credit Card Ltd*[30] show) and it must be asked whether many taxpayers would feel confident of passing these hurdles or be prepared to spend the money in order to do so. If the answer to that is that very few would, then effectively HMRC is legislating by default.
7.15 The other potential source of problems in HMRC guidance is the guidance changing. Usually, the reason given for a change in guidance is that HMRC has been advised that its guidance is wrong in law. Again, judicial review is potentially available, but the case of *R v C&E Commissioners ex parte F & I Services* held that while a taxpayer could rely on the legitimate expectation generated by guidance, that expectation is limited to circumstances where reliance has been placed on the changed statement. In that case, a VAT clearance for a voucher scheme was withdrawn following a change in view of the Customs and Excise as to the operation of the law. The taxpayer had incurred expense on the introduction of the scheme. It was stated by Lord Justice Sedley that "the law recognises no legitimate expectation that a public authority will act unlawfully. It is only where the expectation is of a particular exercise of managerial discretion that the court will begin to examine its legitimacy."[31]
7.16 Consequently, this paper maintains that the more tax rules are dealt with by way of non-legislative methods, the more exposed taxpayers become to these limited forms of redress. Government should only permit the increased use of non-legislative rule-making if the problems highlighted here are adequately tackled. ... [32]

Scope for judicial review is in my view even weaker than the IFS here suggest, for Guidance Note para 26 is intended to give HMRC freedom to disregard their own guidance note (or at least to give freedom to decide when it should or should not apply, which comes to the same thing):

> Examples of how the legislation will apply in particular circumstances are set out below. These examples are intended to show how different factors will be taken into consideration in deciding whether or not the TAAR applies in a given set of circumstances. They are not designed as templates for deciding whether a loss is or is not caught by the TAAR in any particular case.

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30 [1991] STC 129.
31 [2001] BTC 5266 at p.5283.
32 Countering Tax Avoidance in the UK, TLRC discussion paper no.7, March 2009, accessible *www.ifs.org.uk/comms/dp7.pdf*.

Thus unless my view on the construction of s.16A TCGA is adopted, the guidance is for all practical purposes unjusticiable. The position is not so much that HMRC are above the law, but that there is no law, only discretion. The uncertainty caused by provisions such as s.16A (which apply to corporation tax as well as CGT) is a major factor which encouraged companies such as WPP, Shire, Regus, Henderson, Charter, Beazley, Brit Insurance and UBM to leave the UK for Ireland or Switzerland.[33] Nevertheless, HMRC regard the provision as "successful"[34] (which if the only measure of success is preventing avoidance it no doubt is). So the current position will continue until HMRC change their view that preventing tax avoidance is a priority that trumps other policy considerations such as certainty and the rule of law.

33 A majority of Main Survey respondents expressed exasperation with the complexity and unpredictability of current anti-avoidance rules, all but one asserting that this was a phenomenon hindering the competitiveness of the UK economy. Freedman et al, Alternative Approaches to Tax Risk and Tax Avoidance: analysis of a face-to-face corporate survey (September 2008) accessible *ideas.repec.org/p/btx/wpaper/0814.html*.

34 OECD "Engaging with High Net Worth Individuals on Tax Compliance" September 2009 para 135; see: *www.oecd.org/document/5/0,3746,en_2649_33749_42902277_1_1_1_1,00.html*

CHAPTER FORTY NINE

# FOREIGN CURRENCY ISSUES

## 49.1 Foreign currency issues – introduction

It is generally accepted that UK tax is assessed in sterling. For instance, the RDR Manual provides:

> **31190 Exchange Rates**
> All entries on the SA Return should be in pounds sterling.

Foreign currency must be translated into sterling. For this purpose it is obviously necessary to decide the date(s) on which the exchange rate is determined ("**the currency conversion date**").

HMRC have put their views in a technical note dated 12 October 2009 ("**the HMRC currency technical note**").

Once one has identified the currency conversion date, one needs to ascertain the exchange rate on that date. Exchange rates at 31 March and 31 December can be found on the HMRC website.[1] Daily rates can be found on commercial websites. These may use slightly different criteria, and disagree slightly among themselves, but I expect in practice any published rate would be acceptable.[2]

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1 *www.hmrc.gov.uk/exrate*. This will not assist in the matters discussed in this chapter except for transactions which happen to occur on 31 March or 31 December.

2 The BI Manual provides:
"**39507. Exchange rate for tax purposes** [July 2009]
... Traders may use London closing rates (BIM39505) when translating foreign currency amounts into sterling in their accounts. Equally they may use other exchange rates, such as an exchange rate quoted by their bank, or the monthly average rates published by HMRC for VAT purposes. You only need to query the rate of exchange used if, exceptionally, it diverges markedly from rates obtained from reputable sources of this nature."
Similarly, the SAI Manual provides:

For life policies in foreign currency, see 30.3.5 (Computation of gains). For deeply discounted securities in foreign currency, see 34.3 (Securities denominated in foreign currency). For the (somewhat academic) IHT relief see 53.17 (Non-residents foreign currency bank accounts).

The position of UK resident companies is not considered.

## 49.2 CGT: Currency conversion date

There are two possible ways to compute the gain where an asset is purchased and sold in a foreign currency.

*Method 1*:

(a) Compute the gain using the foreign currency prices. For instance, suppose an asset is purchased for \$100 and sold for \$200; the gain is the \$ sale price less the \$ acquisition price = \$100;

(b) then convert that foreign currency gain to sterling at the date of disposal.

*Method 2*: Compute:

(a) The sale price converted to sterling at the rate on the date of disposal; less

(b) The acquisition cost converted to sterling at the rate on the date of acquisition.

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"**4310. Special calculations: Foreign currency securities**

...Although the London closing rate should in strictness be used in all the above cases, figures of rates of exchange supplied by taxpayers or their agents should normally be accepted, provided that they come from a reputable source (for example, an exchange rate quoted by the taxpayer's bank for the day in question) and the basis is used consistently."

Similarly, International Manual provides:

"**162160. Rate of exchange to use** [January 2011]

... Any reasonable established basis of conversion which has previously been applied in any particular case may continue to be used in that case if the taxpayer agrees to its consistent application. If there is a dispute which cannot be resolved within the terms of the established practice, the general basis described above should be adopted."

Where the official rate of exchange is different, it is considered that one should use commercial (black market) rates; this view is adopted in the USA: *Cinelli v. Commissioner of Internal Revenue* (1974) 502 F2d 695 United States Court of Appeals, Sixth Circuit.

For CGT it is well settled that the second solution is correct. In *Bentley v Pike* 53 TC 590 the taxpayer inherited German property when it was worth DM132k, and later sold it for DM152k. She argued that the gain was the difference between the two Deutschmark values, ie DM30k, and the currency conversion date was the date of disposal. The Court held that the gain was the sterling equivalent of the DM proceeds (currency conversion date at the date of disposal) less the value of the property at the time of acquisition. This decision was upheld in *Capcount Trading v Evans* 65 TC 545 where the issue was argued more fully before the Court of Appeal. In short, the taxpayer acquired shares for $85m and sold them for $50m. The taxpayer argued that they made a loss of $35m. That was rejected. The gain was calculated as the value of the proceeds (converted into sterling at the date of disposal) less the acquisition cost (converted into sterling at the date(s) of acquisition).

The CG Manual provides:

> **25391 - Remittance basis: gains to be computed in Sterling** [April 2010]
> Sterling is the currency in which capital gains computations are carried out (see *Bentley v Pike,* (53 TC 590) and *Capcount Trading v Evans* (65 TC 545)). You should therefore carry out a computation of the gain arising on the disposal of the foreign assets in sterling. Where transactions take place in foreign currency you should convert each separate entry for the computation into sterling using the spot rate applying at the date that part of the transaction occurred.

This approach is used whether the gain is taxed on an arising or the remittance basis. The RDR Manual provides:

> **31190 Exchange Rates**
> *Foreign Chargeable Gains*
> Foreign chargeable gains are calculated using sterling translations at the date of acquisition and the date of disposal. So the consideration received will be translated into sterling using the exchange rate at the time of disposal and allowable deductions will be translated using the exchange rate(s) at the time the expenditure was incurred (for example, when the asset was acquired). Thus the gain will be denoted in pounds sterling and will be the same whether taxed on the arising or the remittance basis.
> If the gain is held as foreign currency, the taxable sterling amount of the gain will not change, but separate gains or losses may accrue if the

foreign currency gains or loses value with respect to sterling before the gain is remitted.

## 49.3 Trading income and property income

The position for trading income is governed by SP 2/02 (not discussed here).

Property income is computed on the accountancy principles, just like trading income, so the same practice ought to apply.

## 49.4 Income taxed on arising basis: currency conversion date

The RDR Manual 31190 provides:

> **31190 Exchange Rates**
> *Foreign Income*
> Foreign income taxed on the arising basis is converted to pounds sterling at the exchange rate applicable on the day that it arose overseas.

This is not controversial. HMRC accept the use of the average rate for a tax year where income arises regularly through the year.[3]

## 49.5 Sterling income converted to foreign currency

The HMRC currency technical note provides:

> 6. Income that is regarded as 'foreign income' may be received offshore in sterling. It may later be converted into a foreign currency, for example if paid into a non-sterling account. In such cases the amount of a remittance basis user's foreign taxable income will be the amount actually due and originally received in sterling. It is of no relevance whether the eventual 'taxable remittance' that is, or that is derived from, that income is made in a foreign currency or is converted back into sterling before being remitted.

This is not controversial.

3 Private correspondence.

## 49.6 Income taxed on remittance basis: currency conversion date

Where income is taxed on the remittance basis, there are two possible views:

(1) The currency conversion date is the date of remittance. I refer to this as "**the HMRC view**".

(2) The currency conversion date is the date that the income arises. I refer to this as "**the practitioners view**" since it is adopted by the ICAEW and the great majority of practitioners.

### 49.6.1 *HMRC view*

The RDR Manual 31190 provides:

> **31190 Exchange Rates**
> *Foreign Income*
> ... Foreign income taxed on the remittance basis ... is subject to UK tax only when it is remitted to the UK. This remitted income should be translated into sterling at the exchange rate prevailing on the date of remittance.

The Manual gives a straightforward example.[4]

Similarly, the EI Manual provides:

> **40033: General earnings taxable when remitted to the UK** [December 2008]
> For earnings that are taxable when remitted to the UK the conversion should be made at the date they were remitted.

### 49.6.2 *Basis for HMRC view*

The HMRC currency technical note sets out HMRC's arguments in

4 "*Example (remittance) - Christophe*
C is a remittance basis user and has €8,000 income paid into his French bank account in June 2011 when the exchange rate is €0.705 to the pound, the equivalent of £5,642. He remits all €8,000 of this foreign income on 1 May 2013 when the exchange rate was €0.681.
He uses this 1 May exchange rate to convert this amount, giving a remitted amount of foreign income of £5,453; this is the amount he is taxed on."

support of the view that the currency conversion date is the date of remittance and not the date of receipt.

> 5. [1] Remittance basis users may receive income offshore in a foreign currency.
> [2] Such foreign income and earnings which are chargeable to tax on the remittance basis only become chargeable to UK tax when they are remitted to the UK. The remittance to the UK is the event that triggers the UK tax charge.
> [3] It is only at this point that it is necessary to ascertain the taxable amount (in sterling) remitted to the UK that is taxable as foreign income.
> [4] It follows that it is the date on which that amount is treated as remitted to the UK that the translation to sterling should occur.

Para 5[2] is not correct in relation to RFI. RFI is chargeable whether or not remitted, though the amount of the charge is limited to what is remitted.[5] The same applies for RFE. It is arguable that chargeable gains are only chargeable on remittance but HMRC do not say that gains are converted at the date of remittance

Para 5[3] is correct but [4] does not follow from it. For CGT it is likewise only necessary to ascertain the taxable amount when there is a remittance but no-one suggests that gains are converted at the date of remittance.

The HMRC technical note contains a lengthy discussion of case law, but there are no cases which address the issue, and analogies from CGT and IT cases in other contexts are not decisive. HMRC say:

> 15. There is little case law that addresses this point directly. Some early case law from the 1920s and 1930s deals with the taxation of companies and whether foreign exchange gains or losses should be regarded as capital or investment items, or form part of the company's trade. It is possible to draw only tentative principles from this, especially as in many cases the issue of arising or remittance basis was not in point.
> 16. The 1933 case of *Magraw v Lewis* (18 TC 222) concerned a pension of 229 South African pounds, paid to a UK resident, which had been awarded by the Government of the Union of South Africa and was paid by them through the High Commissioner of the Union Government in London. At the time such foreign income was chargeable when received in the UK. The case concerned

5 See 9.12 (Nature of charge on remitted RFI).

certain deductions made by the SA Government from the pension, but during the case the issue of how much should be taxed in British pound sterling was raised. In Magraw, the *pension was actually paid to the appellant in the UK in sterling,* so the exchange issue was a little different.[6] In the course of his judgement at the High Court Finlay J said, at page 225,

> What happened was this. The Appellant was paid a particular sum in UK pounds and by reason of the state of the exchange, the amount which he was paid in UK pounds was larger-a greater number of pounds-than the pension awarded to him in South Africa reckoned in South African pounds.
>
> He says that he ought not to pay Income Tax upon the amount which he has received in this country. I am bound to say that in regard to that the law appears to be as plain as in the other case...It is clear that the Income Tax authorities can have regard only to what is paid. What is paid is a pension of a particular amount in UK pounds, £268 I think it is -but the exact amount does not matter- that is paid to the Appellant.
>
> That is what he has to pay tax upon, and he has to pay on that in the appropriate number of pounds in British currency. As I say, about that point there does not appear to be any legal difficulty-indeed, I do not think there is any legal difficulty about either point...I cannot myself see that any one, even a layman, could conceive that there was any grievance when he gets a particular income in UK pounds, in paying tax in UK pounds at the appropriate rate upon that income.

17. In *Thomson v Moyse* 39 TC, whilst addressing a point about whether a remittance required a transmission from abroad, at the House of Lords Lord Reid said at p329 (bold emphasis added)

> Before considering these authorities, I think it well to see what the effect would be if this view were right. I take a case which no one has ever even suggested would not be within the scope of these provisions - the case of a bank acting as a collecting agent. If a customer hands to an English bank for collection a cheque drawn on a foreign bank, the English bank will send the cheque abroad for collection and, when notified that the money has been collected, it will give to the customer in this country the equivalent in sterling **at the current rate of exchange.**

18. References to other case law have been made to HMRC with regard to this issue.

*Bentley v Pike* [1981] STC 360 and *Capcount Trading v Evans* [1993] STC 11 - these concern Capital Gains Tax on chargeable gains accruing on the disposal of an asset, and therefore have no bearing on the issue of overseas income. They state that where there is an acquisition and disposal in a foreign currency the taxable capital gain is calculated by deducting the sterling value of the acquisition at the time of acquisition from the sterling value of the sale proceeds at the time of sale.

*Pattison v Marine Midland* 57 TC 219 related to tax on trading profits and the

6 [Author's note] Since the pension was paid in sterling, the exchange issue did not arise at all.

House of Lords upheld the decision of the Court of Appeal rejecting HMRC's contention that, with respect to a loan made by a company, the difference in sterling terms between the value of the dollars at the time of the loan and the time of the repayment represented a taxable trading profit of the company.
In *Capcount* the Court of Appeal specifically distinguished *Marine Midland* on the basis that it was concerned with trading profits whereas *Capcount* was concerned with capital gains. Nolan LJ states:

> "Against that background I do not find it surprising that, in the case of trading companies operating abroad the commercial accounting procedures which, it seems, commonly result in the profit being first computed in the particular overseas currency and then translated into sterling for tax purposes should be adopted and accepted by the Revenue...the income tax legislation, unlike the capital gains tax legislation, is not generally concerned with the measurement of a gain or loss on a single disposal but with a balance at the year end and computed on accounting principles."

19. The calculation of gains arising on non-sterling acquisitions and/or disposals in sterling is different from the calculation of the amount of taxable income in sterling; it is clear from *Bentley v Pike* that the sterling translation must be made using the exchange rate in force at the dates of the transaction (i.e. date of acquisition for acquisition cost, and disposal for disposal proceeds) and the calculation completed in sterling. This is understandable for CG calculation purposes, as CG is fundamentally a transaction-based tax.
20. Apart from the £2,000 threshold (see below), this note only concerns remittances of foreign income. *Bentley* and *Capcount* concern capital gains, not income, and are therefore not relevant. *Marine Midland* supports the approach taken by HMRC in the guidance. *Marine Midland* concerned trading profits rather than income but an individual's income is more on a par with the profits of a business than with capital gains because neither an individual's income nor the profits of a business require individual disposals. Consequently, there is no conflict between the principles established in *Marine Midland* and HMRC's position on the treatment of an individual's income.

For completeness, the HMRC currency technical note also states:

7. In all cases HMRC will tax the individual's foreign income as income; the question is simply what sterling value to give that income, and more importantly, when is it necessary to calculate that value. HMRC will never tax an amount greater than the income received; for example, if $50,000 US dollars are received then only $50,000 US dollars will ever be subject to tax - that is, the sterling equivalent of that $50,000 for income tax purposes at the time at which the UK tax liability occurs.
8. For a remittance basis user whose foreign income is received offshore in, say, dollars, there is no requirement to value the dollars twice (that is on date of receipt offshore and on the date an amount becomes taxable by virtue of being remitted to the UK). In other words, for income tax purposes, in order to tax the income received in dollars the conversion into sterling should only be made

> once, namely on the occasion that the income comes into charge...
> 12. This approach is in the remittance basis user's favour. This is because, whether the exchange rate on the date the income arises or the date it is remitted is used to translate the foreign income into sterling, there has to be consistency between the two - it has to be one or the other. An individual has an element of control over the date of remittance and can choose to remit income when the exchange rate is in his favour or not to remit income when the exchange rate is not in his favour. An individual does not generally have similar control over the date on which foreign income arises.

These are not arguments, or at least not arguments to be taken seriously.

### 49.6.3 *Currency conversion date: the correct view*

Since there is no statutory guidance and no clear guidance from the case law, the right answer is that which best suits the scheme of the provisions. It is considered that the correct view (which I have called "the practitioners view") is that the currency conversion date is the time the income arises not the date of remittance.

The HMRC view gives rise to many anomalies. Firstly, contrast the arising basis where the currency conversion date is the date income arises. Secondly, contrast the CGT remittance basis where the currency conversion date is (in short) when the gain arises. The anomaly is more striking when one bears in mind that some offshore income gains are computed on CGT principles but subject to income tax on remittance. Thirdly, contrast the IT remittance basis where income is received in sterling and immediately converted into a foreign currency.[7] Fourthly, contrast tax credits in a foreign currency where the currency conversion date is the date the income arises, or near that date.[8]

The next set of problems arises on the HMRC view if a remittance basis taxpayer receives foreign currency income and converts it into another asset, rather than paying it directly into a bank account. Suppose T receives income in euros and converts the euros into sterling and remits the sterling.

(1) Does T adopt the euro rate at the time of conversion into sterling?

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7 The HMRC view assumes that one always knows what currency income is received, but in the case of deemed income that is not the case, and in the case of trading income it may depends on the arbitrary choice or accounting practice.

8 See 49.10 (Tax credit relief: currency conversion date).

Then tax depends on administrative acts such as how the receipt is dealt with.

(2) Does T then adopt the euro rate at the time of remittance? That would be absurd and also gives rise to this further problem: Suppose T receives equal amounts of (a) foreign interest in euros and (b) foreign interest in sterling; T converts the euros to sterling and pays all the interest into one foreign sterling account, and later remits one half of the account to the UK. If one converts at the time of remittance T needs to decide whether T has remitted the sterling or the (formerly) euro interest. The answer is far from clear. On the practitioners view of course no problem arises.

Section 731 raises further problems on the HMRC view. If relevant income arises in a foreign currency, when does one convert that to sterling? If one converts at the time the income arises there is a further anomaly between s.731 and ordinary income. If one converts at the time there is a benefit, then a currency conversion may have to be done every time a benefit is conferred, which is unworkable.

### 49.6.4 *Problems arising when foreign currency depreciates against sterling*

HMRC say that their view (currency conversion date is the date of remittance) produces the right result where foreign currency depreciates against sterling, whereas the practitioners view causes an additional tax charge for taxpayers which they are concerned to avoid. The technical note provides:

> 13. ... Compare two taxpayers: Mr A is taxed on the arising basic. Mrs R on the remittance basis. Both receive RFE:
>
> *Exchange rates:*
>
> 1 May Year 1 $1 = £1.20.
> 1 May Year 2 $1 = £1.10.
> 1 May Year 3 $1 = £1.50
>
> Mr A and Mrs R receive $100,000 on 1 May in Year 1.
>
> Mr A will have to pay tax on £120,000 in Year 1. Whether he brings the $100,000 in to the UK on 1 May in Year 1 when it is worth £120,000, or on 1 May in Year 2 when it is worth £110,000, or on 1 May in Year 3, when it is worth £150,000, has no impact on Mr A's income tax liabilities.
>
> If Mrs R, on the other hand, translates her foreign income into sterling on 1 May Year 1 she will, on [the practitioners view], be said to have taxable RFE of £120,000.
>
> • In Year 2, she could remit every one of the $100,000 dollars received, which would translate only to £110,000 and yet still pay tax on £120,000 - which would

> appear that we are taxing an additional $9090,[9] or we are applying a tax rate of c.43.5%.
> 14. ...Theoretically, given large fluctuations in currency exchange rates, or with changes in higher tax rates, a situation could arise in which the tax due is actually more than the monies the individual actually receives in the UK ...

It is indeed unfair for a remittance basis taxpayer to be taxed on a sum larger than the sum which they remits to the UK. But this observation does not much support the HMRC view. First, this is in the HMRC view the position in relation to CGT. For CGT, HMRC appear to have no compunction in taxing a larger amount than remitted. In the HMRC view "a situation could arise in which the tax due is actually more than the monies the individual actually receives in the UK."

The RDR Manual provides an example where the essential facts[10] are as follows:

> **35030 Conditions A and B - remittances derived from foreign income or gains**
> *Example 4 (Marianne)*
> M used £25,000 of her foreign chargeable gains to purchase a car.
> M kept the car outside the UK.
> M later brings the car to the UK. The market resale value of the car is then £14,000.

The HMRC analysis is as follows:

> The amount remitted is still £25,000, that being the amount equal to the chargeable gains from which the property – the car – derived.

If - which is open to doubt - the HMRC CGT analysis is right, there is (on the practitioners view) a consistent unfairness and on the HMRC view an

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9 The correct figure appears to be $10,000.

10 The example in full (including its irrelevant detail) is as follows:
In example 1 above, Marianne, a remittance basis user, used £25,000 of her foreign chargeable gains to purchase a car. The car is regarded as derived from foreign income and gains.
Instead of bringing it straight to the UK, Marianne kept the car at her Italian villa for use on her visits to Italy. A few years later she then decides to bring the car to the UK for her and her daughter to use. At this time the approximate market resale value of the car is £14,000.

anomalous distinction between CGT and IT.

More fundamentally, HMRC have overlooked the mixed fund rules. The remittance is a transfer from a mixed fund, and s.809Q(3) ITA defines the extent to which such a remittance is to be regarded as income or capital. The rule is that such a remittance is to be regarded as income first, not income *and* capital gain. Further, under the mixed fund rule, the amount of the remittance does not exceed the value of the sum remitted.

The most serious set of problems with the HMRC view concern the interaction between IT and CGT, to which I now turn.

## 49.7 IT/CGT interaction - remittance from foreign currency bank account

Suppose:

(1) T (a remittance basis taxpayer) receives foreign currency income, say FC100, at a time when the exchange rate is FC1 = £1.

(2) T remits all the income when the exchange rate is (say) FC1 = £2.

On the practitioners view (currency conversion date is that of receipt) the interaction with CGT causes no difficulty. The remittance consists of £100 income and on the remittance (assuming there is a disposal) there is a remitted chargeable gain of £100.

On the HMRC view, considerable difficulties arise. It is necessary to consider separately

(1) the original HMRC view

(2) the revised HMRC view of the position before 16 December 2009

(3) the position after 16 December 2009

### 49.7.1 *Original HMRC view*

The RDR Manual (1st and 2nd editions) note took the view that there was a double charge to tax on the remittance:

(1) Income tax was charged on £200 (value of the currency when remitted); *and*

(2) CGT was taxed on the gain on the remittance. The gain was computed as the disposal proceeds (£200) less the acquisition cost (£100) = £100.

This had never been suggested before the publication of the RDR Manual, and (though the point would have been the same before the 2008 reforms) I doubt if anyone in the history of taxation ever put in a tax return on that basis.

### 49.7.2 *Revised HMRC view: position until 16 December 2009*

The HMRC currency technical note sought to defend its original view.[11] However HMRC announced a radical change of position on 16 December 2009:

> ... HMRC now accepts that section 37 TCGA applies in this situation to exclude from the calculation of the capital gain or loss arising on disposal (or part-disposal) of the FCBA [foreign currency bank account] the whole of, or the relevant part of, the withdrawal that is taxable as remitted income.[12]

HMRC continue:

> The exclusion of consideration from the capital gains computation under section 37 can[13] produce an anomalous result.
> By way of illustration, suppose the individual paid salary in foreign currency of FC20,000 into a FCBA abroad at a time when FC1.00 = £0.50.
> For CGT purposes, the cost of acquiring the FCBA is £10,000.
> In the next tax year he transfers the whole FC20,000 to the UK at a time when FC1.00 = £0.60, receiving a credit of £12,000 in his UK sterling bank account.

The HMRC analysis is as follows:

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11 "10. For capital gains tax purposes, the gains/losses on disposals of foreign currency and debits from foreign currency bank accounts occur simply because foreign currency and non-sterling debts with banks are chargeable assets (s21(1)(b) and s252 TCGA). For this reason, when funds are withdrawn from a non-sterling bank account, there is a disposal (or part-disposal) of an asset (that is, the debt owed by the bank). This does not preclude the withdrawn funds having the character of the income originally credited to the account. For example, if a non-domiciled remittance basis user was paid his salary (consisting totally of his relevant foreign earnings) of £25,000 into his Jersey account he might immediately purchase a painting with that £25,000 to decorate his Jersey holiday home. At that point it is clear that the untaxed income is both 'within' the painting and that the individual holds an asset as well. So it is with bank debts receivable: they are simply assets acquired using income and in which the character of the original income can clearly be discerned."

12 Accessible *www.hmrc.gov.uk/cnr/fcba-technical-note.pdf.*

13 [Author's note]. "Can" is inapt as the result on the HMRC revised view will always be anomalous.

> For income tax purposes the taxable amount is £12,000 (the value of FC20,000 at the time of remittance).
> For CGT purposes the computation is as follows:
>
> | | |
> |---|---|
> | Consideration for disposal of the FCBA | £12,000 |
> | Less exclusion under section 37 TCGA | £12,000 |
> | | nil |
> | Acquisition cost | £10,000 |
> | Loss | £10,000 |
>
> This loss for CGT purposes is excessive, because the individual has incurred no real loss in these circumstances. It arises because the TCGA rules adjust the consideration for the disposal of the FCBA, but there is no requirement to remove the relevant income element from the allowable cost of the FCBA. The loss is an arithmetical anomaly.[14]

The consequence of the revised HMRC view is as absurd as the original view, though under-taxation (through an artificial loss) has replaced double taxation, so taxpayers may be content.

### 49.7.3 *Does s.37 apply on remittance from FCBA?*

The revised HMRC view is based on the premise that s.37 TCGA applies

14 The passage identifies another anomaly:
"Where a remittance comprises only part of the funds in the FCBA, so there is only a part-disposal of the account, a second anomaly arises. The normal rule for apportioning the allowable cost of the asset between the part disposed of and the remainder (the familiar A/(A + B) formula in section 42 TCGA) is distorted by the exclusion of the taxable income from the consideration for the disposal (the A element of the formula). The consequence is that the cost attributable to the remainder under the A/(A + B) formula is greater than the amount that is proportionate to the size of the remainder.
By way of illustration of this second anomaly, where (say) 40% of the FCBA is remitted to the UK and that 40% is wholly taxable as a remittance of income, the consideration for the disposal is reduced by section 37 TCGA to nil, as in the example above. As the A element of the A/(A + B) formula is nil, the result is that the whole of the cost of the account is attributed to the remainder of the account, whereas under a properly proportionate formula only 60% of the total allowable cost should be attributed."
This is not a separate anomaly but simply a working through of the first anomaly, but nothing turns on that.

where income is remitted from a foreign currency bank account.

Section 37(1) TCGA provides:

> There shall be excluded from the consideration for a disposal of assets taken into account in the computation of the gain any money or money's worth
> [a] charged to income tax as income of, or
> [b] taken into account as a receipt in computing income or profits or gains or losses of,
> the person making the disposal for the purposes of the Income Tax Acts.

Section 37 TCGA does *not* apply. The proceeds of the disposal of the bank account are not "charged to tax as income" (any more than if the receipt had been taxed on the arising basis).[15] RFI is chargeable whether or not remitted, though the amount of the charge is limited to what is remitted.

### 49.7.4 *HMRC view from 16 December 2009: Sch 8A TCGA*

From 16 December 2009 it is necessary to consider sch 8A TCGA (introduced by the F(no.1)A 2010). The key concepts in the legislation are "the s.37 amount" and its counterpart, "the unreduced amount".

In order to see the definition of "the s.37 amount" we need to read the whole of para 1(1) sch 8A TCGA:

> This Schedule applies where—
> (a) an individual makes a disposal of a debt to which section 252(1) applies ("the relevant disposal"),

That is, a disposal of a foreign currency bank account. Para 1(1) continues:

> (b) the debt ("the section 252 debt") is not situated in the UK, and

That is, a disposal of a foreign bank account. Para 1(1) continues:

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15 See 9.12 (Nature of charge on remitted RFI).

(c) money or money's worth which is remitted foreign income[16] ("**the section 37 amount**") is excluded under section 37 from the consideration for the relevant disposal.

On (what I call) the practitioners view none of the consideration is excluded under s.37 and the s.37 amount is nil. On the HMRC view, the s.37 amount is the amount subject to income tax (applying the currency conversion date at the date of remittance).

Para 4 Sch 8A TCGA provides a commonsense definition of "the unreduced consideration":

> "the unreduced consideration" means the consideration for the relevant disposal ignoring the exclusion of the section 37 amount.

On the practitioners view the actual consideration always equals the unreduced consideration as the s.37 amount is nil.

We can now turn to the rules in para 2 and 3. (To anticipate, it will in due course appear that on the practitioners view these provisions will have no effect.)

> *Section 37 operates to exclude the whole consideration*
> 2 (1) This paragraph applies where the section 37 amount constitutes the whole of the unreduced consideration.
> (2) If the relevant disposal is a part disposal of the section 252 debt, section 42 applies as if the reference in subsection (2)(a) of that section to the consideration for the disposal were a reference to the unreduced consideration for the disposal.
> (3) Any loss accruing to the individual on the relevant disposal is not an allowable loss.
> *Section 37 operates to exclude part of the consideration*
> 3 (1) This paragraph applies where the section 37 amount constitutes part of the unreduced consideration.
> (2) For the purposes of this Act the relevant disposal is to be treated as if it were—
> (a) a disposal of so much of the section 252 debt as is represented by the

16 Para 1(2) provides a commonsense definition of "remitted foreign income":
"For this purpose 'remitted foreign income' means income of the individual which is chargeable to income tax on the alternative basis of charge set out in Chapter A1 of Part 14 of ITA 2007 (remittance basis)."

section 37 proportion of the sum mentioned in sub-paragraph (3) ("debt A"), and

(b) a separate disposal of so much of the section 252 debt as is represented by the remainder of that sum ("debt B").

(3) That sum is—

(a) if the relevant disposal is a disposal of the whole of the section 252 debt, the sum referred to in section 252(1), and

(b) if the relevant disposal is a part disposal of that debt, the proportion of the sum referred to in section 252(1) to which that part disposal relates.

(4) Sub-paragraphs (5) to (9) apply for the purposes of—

(a) the computation of the gain accruing on the disposals under sub-paragraph (2), and

(b) the application of Chapter 3 of Part 2 of this Act in relation to the part of the debt (if any) which remains undisposed of.

(5) The consideration for the disposal (before any exclusion under section 37) is—

(a) in the case of debt A, the section 37 amount, and

(b) in the case of debt B, the remainder of the unreduced consideration.

(6) If the relevant disposal is not a part disposal of the section 252 debt—

(a) the section 37 proportion of the debt costs and the disposal costs is to be attributed to debt A, and

(b) the remaining debt costs and disposal costs are to be attributed to debt B.

(7) Sub-paragraphs (8) and (9) apply if the relevant disposal is a part disposal of the section 252 debt.

(8) Section 42(2) applies as if it provided for the debt costs to be apportioned between debt A, debt B and the remainder of the section 252 debt in the proportions which those parts of the section 252 debt bear to one another.

(9) The section 37 proportion of the disposal costs is to be attributed to debt A and the remaining disposal costs are to be attributed to debt B.

(10) Any loss accruing to the individual on the disposal of debt A is not an allowable loss.

Para 4 provides some definitions:

In this Schedule—

"debt costs" means the sums which under section 38(1)(a) and (b) are attributable to the section 252 debt;

"disposal costs" means the costs within section 38(1)(c) in relation to the

relevant disposal;
"the section 252 debt", "the relevant disposal" and "the section 37 amount" are to be construed in accordance with paragraph 1;
"the section 37 proportion" means the proportion of the unreduced consideration which constitutes the section 37 amount;

HMRC explain these rules as follows:[17]

**Proposed changes to the TCGA rules**
For disposals on or after 16 December 2009, where the disposal is a withdrawal of funds from a FCBA that comprises in whole or in part an amount that is liable to tax as remitted income, the gain or loss arising will be calculated using the following steps:

- Identify the part of the withdrawal that is taxable as remitted income and, accordingly, excluded from the consideration for the disposal by virtue of section 37 TCGA ('the section 37 amount').
- Then proceed under A or B below, depending on whether the amount remitted is wholly or partially the section 37 amount.

***A – Remittance is wholly the section 37 amount***

a. Where the section 37 amount is the whole of the balance on the account, so there is a full disposal of the account, the loss arising on the disposal will not be an allowable loss for CGT purposes.
b. Where the section 37 amount is only part of the account, so there is a part-disposal of the account, disapply the normal part-disposal formula in section 42 TCGA.
    - Instead, apportion the allowable cost of the account between the part disposed of and the remainder in proportion to the amounts withdrawn and retained, and compute the loss on the part disposed of accordingly (so that section 37 reduces the consideration to Nil but the proportionate cost is deducted).
    - The loss arising on the disposal will not be an allowable loss for CGT purposes.

***B – Remittance is partially the section 37 amount***

a. Treat the disposal as, in effect, two disposals, one comprising the section 37 amount and the other comprising the rest of the remittance.
b. Where the two disposals are of the whole of the balance on the

17 Capital Gains Tax: Gains and Losses on Foreign Currency Bank Accounts held by Remittance Basis Users, accessible *www.hmrc.gov.uk/cnr/fcba-technical-note.pdf.* This is referred to in EN F(No.1)A 2010.

account, so there is altogether a full disposal of the account:

- Apportion the allowable cost of the account between the two disposals in proportion to the sums comprised in each disposal (disregarding the exclusion of the section 37 amount from the consideration for one of the disposals) and compute the gain or loss on each disposal accordingly.
- The loss arising on the disposal related to the section 37 amount will not be an allowable loss for CGT purposes (this is bound to be a loss because the effect of section 37 is to reduce the consideration to Nil but the proportionate cost is deducted).
- The gain or loss arising on the other disposal will be chargeable or allowable in the normal way.

c. Where the two disposals together comprise only part of the account, so that there is a part-disposal of the account:
   - Disapply the normal part-disposal formula in section 42 TCGA.
   - Instead, apportion the allowable cost of the account between the two disposals and the remainder in proportion to the sums comprised in each disposal (disregarding the exclusion of the section 37 amount from the consideration for one of the disposals) and the balance remaining in the account and compute the gain or loss on each disposal accordingly.
   - The loss arising on the disposal related to the section 37 amount will not be an allowable loss for CGT purposes (this is bound to be a loss because the effect of section 37 is to reduce the consideration to Nil but the proportionate cost is deducted).
   - The gain or loss arising on the other disposal will be chargeable or allowable in the normal way.

**Examples**

The following examples illustrate how the new rules will work.

*Example 1 – Remittance wholly income, whole account remitted (sterling depreciates)*

Account contains foreign currency (FC) 20,000, cost £10,000. FC 20,000 is remitted at a time when its value is £12,000. The entire remittance is chargeable to income tax.

There is no split between a section 37 amount and another amount because section 37 applies to the whole remittance.

| | |
|---|---|
| Gross consideration | £12,000 |
| Less section 37 adjustment | £12,000 |
| Net consideration | Nil |
| Allowable expenditure | £10,000 |
| Loss | (£10,000) |

Loss of £10,000 is not an allowable loss.

*Example 2 – Remittance partly income, whole account remitted (sterling depreciates)*

Account contains FC 20,000, cost £10,000. FC 20,000 is remitted at a time when its value is £12,000. FC 12,000 of the remittance, with a value of £7,200, is chargeable to income tax.

The section 37 amount is £7,200 (representing FC 12,000). The non-section 37 amount is £4,800 (representing FC 8,000).

Expenditure is allocated pro-rata:

| | |
|---|---|
| To the section 37 amount, 12/20 × £10,000 | = £6,000 |
| To non-section 37 amount, 8/20 × £10,000 | = £4,000 |

The section 37 amount computation:

| | |
|---|---|
| Gross consideration | £7,200 |
| Less section 37 adjustment | £7,200 |
| Net consideration | Nil |
| Expenditure | £6,000 |
| Loss | (£6,000) |

Loss of £6,000 is not an allowable loss.

Non-S37 amount computation:

| | |
|---|---|
| Consideration | £4,800 |
| Allowable expenditure | £4,000 |
| Chargeable gain | £800 |

The chargeable gain £800 is liable to CGT in the normal way.

*Example 3 – Remittance wholly income, whole account remitted (sterling appreciates)*

Account contains FC 30,000, cost £30,000. FC 30,000 is remitted when its value is £27,000. The entire remittance is chargeable to income tax.

There is no split between a section 37 amount and another amount because section 37 applies to the whole remittance.

| | |
|---|---|
| Gross consideration | £27,000 |
| Less section 37 adjustment | £27,000 |
| Net consideration | Nil |
| Expenditure | £30,000 |

| | |
|---|---|
| Loss | (£30,000) |

Loss of £30,000 is not an allowable loss.

*Example 4 – Remittance partly income, whole account remitted (sterling appreciates)*

Account contains FC 30,000, cost £30,000. FC 30,000 is remitted when its value is £27,000, of which FC 20,000, with a value of £18,000, is chargeable to income tax.

The section 37 amount is £18,000 (representing FC 20,000). Non-section 37 amount is £9,000 (representing FC 10,000).

Expenditure is allocated pro rata:

| | |
|---|---|
| To the section 37 amount 20/30 × £30,000 | = £20,000 |
| To non-section 37 amount 10/30 × £30,000 | = £10,000 |

The section 37 amount computation:

| | |
|---|---|
| Gross consideration | £18,000 |
| Less section 37 adjustment | £18,000 |
| Net consideration | Nil |
| Allocated expenditure | £20,000 |
| Loss | (£20,000) |

Loss of £20,000 is not an allowable loss.

Non-section 37 amount computation:

| | |
|---|---|
| Consideration | £ 9,000 |
| Allowable expenditure | £10,000 |
| Loss | (£ 1,000) |

Loss of £1,000 is allowable in the normal way.

*Example 5 – Remittance wholly income, part account remitted (sterling depreciates)*

Account contains FC 80,000, cost £60,000. FC 30,000 is remitted when its value is £30,000. The entire remittance is chargeable to income tax.

There is no split between a section 37 amount and another amount because section 37 applies to the whole remittance.

The part-disposal A/(A+B) formula does not apply. Instead, expenditure is allocated pro-rata:

| | |
|---|---|
| To the section 37 amount, 30/80 × £60,000 | = £22,500 |
| To the remainder, 50/80 × £60,000 | = £37,500 |

The section 37 amount computation:

| | |
|---|---|
| Gross consideration | £30,000 |
| Less section 37 adjustment | £30,000 |
| Net consideration | Nil |
| Expenditure | £22,500 |
| Loss | (£22,500) |

Loss of £22,500 is not an allowable loss.

The allowable expenditure remaining for the balance of the bank account is £37,500, apportioned as above.

*Example 6 – Remittance wholly income, part account remitted (sterling appreciates)*

Account contains FC 50,000, cost £40,000. FC 30,000 is remitted when its value is £18,000. The entire remittance is chargeable to income tax.

There is no split between a section 37 amount and another amount because section 37 applies to the whole remittance.

The part-disposal A/(A+B) formula does not apply. Instead, expenditure is allocated pro-rata:

| | |
|---|---|
| To the section 37 amount, 30/50 × £40,000 | = £24,000 |
| To the remainder, 20/50 × £40,000 | = £16,000 |

The section 37 amount computation:

| | |
|---|---|
| Gross consideration | £18,000 |
| Less section 37 adjustment | £18,000 |
| Net consideration | Nil |
| Expenditure | £24,000 |
| Loss | (£24,000) |

Loss of £24,000 is not an allowable loss.

The allowable expenditure remaining for the balance of the bank account is £16,000, apportioned as above.

*Example 7 – Remittance partly income, part account remitted (sterling*

*depreciates)*
Account contains FC 200,000, cost £160,000. FC 120,000 is remitted when its value is £120,000, of which FC 20,000, with a value £20,000, is chargeable to income tax.

The remittance is split between a section 37 amount of £20,000 (representing FC 20,000) and a non-section 37 amount of £100,000 (representing FC 100,000).

The part-disposal A/(A+B) formula does not apply. Instead, expenditure is allocated pro-rata:

| | |
|---|---|
| To the section 37 amount, 20/200 × £160,000 | = £16,000 |
| To the non-section 37 amount, 100/200 × £160,000 | = £80,000 |
| To the remainder, 80/200 × £160,000 | = £64,000 |

The section 37 amount computation:

| | |
|---|---|
| Gross consideration | £20,000 |
| Less section 37 adjustment | £20,000 |
| Net consideration | Nil |
| Expenditure | £16,000 |
| Loss | (£16,000) |

Loss of £16,000 is not an allowable loss.

Non-section 37 amount computation:

| | |
|---|---|
| Consideration | £100,000 |
| Allowable expenditure | £80,000 |
| Chargeable gain | £20,000 |

Total chargeable gain £20,000.

The allowable expenditure remaining for the balance of the bank account is £64,000, apportioned as above.

*Example 8 – Remittance partly income, part account remitted (sterling appreciates)*
Account contains FC 50,000, cost £35,000. FC 15,000 is remitted when its value is £9,000, of which FC 5,000, with a value of £3,000, is chargeable to income tax.

The remittance is split between a section 37 amount of £3,000 (representing FC 5,000) and a non-section 37 amount of £6,000 (representing FC 10,000).

The part-disposal A/(A+B) formula does not apply. Instead, expenditure is allocated pro-rata:

| | |
|---|---|
| To the section 37 amount 5/50 × £35,000 | = £ 3,500 |
| To the non-section 37 amount 10/50 × £35,000 | = £ 7,000 |
| To the remainder 35/50 × £35,000 | = £24,500 |

The section 37 amount computation:

| | |
|---|---|
| Gross consideration | £3,000 |
| Less section 37 adjustment | £3,000 |
| Net consideration | Nil |
| Expenditure | £3,500 |
| Loss | (£ 500) |

Loss of £500 is not an allowable loss.

Non-section 37 amount computation:

| | |
|---|---|
| Consideration | £6,000 |
| Allowable expenditure | £7,000 |
| Loss | (£1,000) |

Loss of £1,000 is allowable in the normal way.

The allowable expenditure remaining for the balance of the bank account is £24,500, apportioned as above.

### 49.7.5 *Commentary: how did we get into this mess?*

The reader who has followed the text to here will probably agree with the author that this is a simply appalling mess. How it could have been allowed to arise? Like most disasters, there are multiple causes. First HMRC's mistaken (though longstanding) view on the currency conversion date. Secondly HMRC's mistaken (and recent) change of view on s.37. Thirdly, HMRC's refusal to expose to the test of public scrutiny the technical advice that said to have been received from Counsel on the currency conversion date (and perhaps - who knows? - on the s.37 issue). Fourthly, HMRC's contemptuous dismissal of the concerns raised by the ICAEW and other professional bodies and refusal to contemplate even the possibility that they may be right and the HMRC view wrong. Fifthly, rushed announcement of proposals (taking effect from the date of their announcement) to counteract the pro-taxpayer anomalies arising from the HMRC revised s.37 view. Sixthly, the rushed enactment of the same without a pause which would have required the above to be defended in Parliament. Seventhly, the disregard for practicalities and failure to consider whether the law as enacted is one that can reasonably be complied with. Eighthly the failure to look at the position more broadly and ask what the law in this area ought to be. (Even if the HMRC view were right on the currency conversion date and the s.37 issue, the reform of sch 8A was the wrong way to proceed. I suggest that anyone who seeks to defend it should be given three (not exceptionally complex) sets of bank statements in three currencies, say 100 sheets overall, with (say) 30 entries on each sheet, and invited to carry out the computations which would be necessary.)

For what could be done to improve the law, see 49.18 (Commentary: Solution to foreign currency problems). The procedural changes to avoid such problems happening again in other areas require significant cultural shifts in the Treasury and HMRC in favour of transparency and consultation with professional bodies. It will be interesting to see whether the coalition government will succeed in bringing this about.

## 49.8 Sub-£2k taxpayer: currency conversion date

### 49.8.1 *HMRC practice: 2008/09*

The 1st edition of the RDR Manual (published 31 March 2009) provided:

> For the purposes of determining whether the amount of an individual's foreign income which is 'not remitted' in a tax year is below £2,000 they obviously cannot apply [what HMRC regard as] the usual principle for remittance basis users of using the exchange rate at time of remittance. So, and only for the purposes of deciding whether ITA07/s809D applies, the individual's foreign income amounts should be converted to pounds sterling at the rate of exchange prevailing *on the date that the unremitted income arose.* Foreign gains are always calculated in pounds sterling.

Thus the currency conversion date was the date the income or gains arose. The Manual continued with a practical concession on computing that rate. The concession (in short) allowed an average annual exchange rate:

> However, where income credits are frequent throughout the year, you can accept calculations where the individual has chosen to convert their income using the average, or ‘mean’ rate of exchange for the tax year in question. The amount of unremitted income arrived at using this method must not differ greatly from an amount which would be arrived at using ‘spot’ rates, for example in times of high exchange rate volatility. If adopted, this method must be used consistently in future tax years for income from this source.
> This applies only to unremitted income (not gains) which is received in frequent instalments throughout the tax year and where a ‘spot rate’ calculation would be an excessive undertaking, for example bank interest received daily or weekly.

The practice only applied for the purposes of the £2k test:

> Note - If any of this foreign income is later remitted to the UK, it will be liable to UK tax at that point. The rate of exchange that should be used when declaring the remittance is the actual rate of exchange on the date of remittance into the UK. This will mean that the same foreign income may be converted at different exchange rates, depending on the reason for the conversion.

The 2nd edition of the RDR Manual announced that HMRC changed their mind, but the old view is still allowed for 2008/09:

> **31190 Exchange Rates**
> ... HMRC revised its practice regarding the calculation of ‘unremitted foreign income’ in guidance August 2009. For tax year 2008-09 this manual and other published guidance advised that for the purposes of ITA07/s809D only, foreign income should be converted to pounds sterling at the rate of exchange prevailing on the date that the unremitted income arose. It also allowed that, where income credits were frequent throughout the year, the individual could convert their income using the average, or ‘mean’ rate of exchange for the tax year in question. This is no longer the practice, but individuals wishing to use the remittance basis under ITA07/s809D may continue to follow the previous guidance to determine whether they are ‘below the £2,000 threshold’ for tax year 2008-09 only, if they so wish.

Thus in 2008/09, a taxpayer has a choice over the currency conversion date:

(1) the time that the income arises (with an option to use the year's average exchange rate); or
(2) 5th April 2009.

### 49.8.2 *HMRC view from 2009/10*

The RDR Manual now provides:

> **31190 Exchange Rates**
> *Remittance basis users below the "£2,000 threshold"*
> ... For the purposes of determining whether the amount of an individual's foreign income which is "not remitted" in a tax year is below £2,000 they obviously cannot apply [what HMRC regard as] the usual principle for remittance basis users of using the exchange rate at time of remittance. Instead the balance of the unremitted foreign income is converted to pounds sterling *at the rate of exchange prevailing on the date last day of the tax year.*
> ITA07/s809D(2) provides that the amount of an individual's "unremitted" foreign income and gains for a tax year is-
> (a) the total amount of what would (if this section applied) be the individual's foreign income and gains for that year, minus
> (b) the total amount of those income and gains that are remitted to the UK in that year.
> So the above formula may be carried out in the foreign currency, looking at total income received and total income remitted, per currency, during the tax year. The balance which is left is the "unremitted foreign income". This is translated into sterling using the exchange on the last day of the tax year (5 April) to ascertain whether the 'unremitted foreign income' is below the £2,000 limit.

Thus the currency conversion date is that on 5th April of each year. I refer to this as "**the 5 April conversion view**". This practice only applied for the purposes of the £2k test and only for income, not for gains:

> This practice applies for the purposes of deciding whether ITA07/s809D applies ONLY. All of the individual's foreign income amounts for a tax year must be taken into account.
> *Example: Michaela*
> M received foreign income on 10 April of $5,000 when the exchange rate was (£1=$2).

> She remitted \$1,500 to the UK on 15 May when the exchange rate was £1=\$1.50 She will pay tax on the sterling amount of £1,000.
> At the end of the tax year, M's 'unremitted foreign income' will be calculated using the exchange rate at the end of the tax year, which is £1=\$1.80.
> This is calculated as follows:
>
> | | |
> |---|---|
> | Total foreign income and gains for that year | \$5,000 |
> | less | |
> | Amount of that foreign income remitted during year | (\$1,500) |
> | Unremitted foreign income | \$3,500 |
>
> If the exchange rate at the end of the year was £1=\$1.50 then the \$3,500 unremitted foreign income would be £2,333, which is above the threshold. ...

The HMRC currency technical note provides the reason for the 5 April conversion view:

> 29. On further consideration of the wording of s809D, HMRC took the view that for foreign income, this calculation can only be made on the last day of the tax year, as that is the only date an individual's total and unremitted foreign income for a tax year can be ascertained. Consequently the foreign currency should be translated into sterling on that date also, for both the total foreign income and the remitted foreign income for the purposes of s.809D only.
> 30. Although UK income tax is charged on sterling amounts, it does not follow that the calculations to get to an income threshold such as this in s809D necessarily have to be made in sterling. Consequently the formula of deducting the remitted income from the total income can be carried out in the foreign currency on the last day of the tax year and then the balance which is left namely the "unremitted foreign income" can be translated into sterling on that date to ascertain whether it is below the £2,000 limit.

Thus the basis for the 5 April conversion view is the (erroneous) HMRC view that the currency conversion date for remitted income is the date of remittance. If the practitioners view is accepted, that the currency conversion date is the date that the income arises, s.809D does not raise any problem, as obviously the same approach should apply there also.

## 49.9 Nominated income and gains: currency conversion date

The RDR Manual provides:

> **31190 Exchange Rates**
> *Nominated income and gains*
> Nominated income and gains are charged to UK tax on the arising basis... This means that any foreign income that is nominated for the purpose of the Remittance Basis Charge is converted to pounds sterling at the exchange rate that applied on the date the income arose.
> Foreign chargeable gains are always calculated in pounds sterling at the rate of exchange that applied on the date the gain is realised.

The Manual gives a straightforward example.[18]

## 49.10 Tax credit relief: currency conversion date

International Manual provides:

> **162160. Rate of exchange to use** [January 2011]
> For the purpose of computing tax credit relief, foreign tax, payable directly or by deduction, should be converted into sterling at the rate of exchange obtaining on the date when the foreign tax for which credit is to be allowed becomes payable.
> *In practice*
> a. Offices need not make enquiries in all cases in order to establish the precise date on which the foreign tax became payable under the foreign country's laws. Where the date is not known, the date of payment of the tax can normally be taken as the payable date. Where the foreign tax has been deducted at source from income, for example, from dividends, interest or royalties, the payable date will normally be the same date as the date on which the income is paid. If, however, the taxpayer objects, or a substantial amount of tax is involved, the actual payable date should be determined. In many cases the date can be obtained from the demand note, provided that there has been no appeal against the foreign charge. If any difficulty arises in determining the payable date, in a case where such date is material, or if the taxpayer objects to this basis, the case should be submitted to the Offshore Personal Tax Team (part of Charity, Assets & Residence) in the case of individuals and to Business

18 "*Example (Francoise)*
F is a non-domiciled individual who is subject to the Remittance Basis Charge. She decides to nominate €20,000 of foreign income. The exchange rate on the date the income arose was €0.744 to the pound. She uses this rate to calculate the equivalent nominated amount of foreign income in sterling, which is £14,880."

> International, Outward Investment Team in all other cases...

The Manual does not distinguish between an arising basis taxpayer and a remittance basis taxpayer. So on the HMRC view, the currency conversion date for remitted income is the date of remittance, but the currency conversion date for the tax credit on the same income is the date that the tax was paid, which may not even be close. That is yet another anomaly arising from the HMRC view that the currency conversion date is the date of remittance.

## 49.11 Foreign currency bank accounts: CGT

The legislation deals separately with foreign currency bank accounts and foreign currency not in a bank account (notes and coins). But bank accounts are the usual way to hold money, so that is the more important area.

A bank account is a debt, and a chargeable gain does not usually arise from a debt. Section 251 TCGA provides:

> Where a person incurs a debt to another, whether in sterling or in some other currency, no chargeable gain shall accrue to that (that is the original) creditor or his personal representative or legatee on a disposal of the debt...

However this relief is disapplied for foreign currency bank accounts.[19] Section 252(1) TCGA provides:

> Subject to subsection (2) below,[20] 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 rule applies to all bank accounts whether in the UK or not. However

19 Another exception concerns a debt on a security but that is not relevant to bank accounts.

20 This relates to the personal expenditure exemption, see 49.16 (Foreign currency for personal expenditure).

it only applies to FC bank accounts.[21]

For sterling bank accounts, the general rule is that no chargeable gain can arise. Of course, no chargeable gain or loss would normally arise from a sterling account in any case, so the relief is somewhat theoretical.

## 49.12 Meaning of "disposal" of bank account

Since CGT is charged on a disposal of a bank account (and certain other debts) we need to know the meaning of "disposal". Section 251(2) TCGA provides:

> Subject to the provisions of sections 132, 135 and 136[22] and subject to subsection (1) above, the satisfaction of a debt or part of it (including a debt on a security as defined in section 132) shall be treated as a disposal of the debt or of that part by the creditor made at the time when the debt or that part is satisfied.

The CG Manual sets out the basic principle:

> **78330. Foreign currency bank accounts** [April 2010]
> When foreign currency is deposited in a bank account there is, for CGT purposes, a disposal of the currency for its sterling value at that time. ... each withdrawal from the currency account is a (part) disposal of the debt for the sterling value of the currency obtained.

### 49.12.1 *Transfer between accounts: SP 10/84 concession*

SP 10/84 provides:

> **Foreign bank accounts**
> 1. At present [ie before 1984], under TCGA 1992 s 252(1), direct transfers from one foreign[23] bank account to another are treated as a

21 The CG Manual 78330 formerly provided: "Foreign currency certificates of deposit in bearer form are not within TCGA 1992, s.252." The passage was deleted in April 2010. One is left to speculate as to whether HMRC have changed their view. The issue would require an examination of the nature of certificates of deposit.

22 These exceptions are not relevant here.

23 The same applies to UK bank accounts if not denominated in sterling: perhaps the author assumes that all UK bank accounts are sterling accounts.

disposal and an acquisition of assets for CGT purposes.

This is correct 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. This will depend on the bank documentation but it is suggested that they should normally be regarded as a single asset. A bank (as a matter of banking law, assuming English law principles apply) owes only a single debt to a customer even if the customer has two accounts. If two accounts at the same bank were separate assets, a routine sweep facility between a deposit account and a current account would result in a regular series of disposals, which would be surprising.

SP 10/84 provides a concession:

> 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.

Although labelled a statement of practice, this is obviously a concession[24] and I refer to it as "**the SP 10/84 concession**".

### 49.12.2 *Transfer between accounts by foreign domiciliary: extended SP 10/84 concession*

The SP 10/84 concession does not apply "in relation to an account to which TCGA 1992 s 275(l) applies". This is a reference to what is now s.275(1)(l) which provides:

> a debt which—
> (i) is owed by a bank, and
> (ii) is not in sterling, and

24 HMRC agree: they describe it as a "non-statutory practice" in their comments on the extended concession, below.

> (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 that individual is resident in the UK and the branch or other place of business of the bank at which the account is maintained is itself situated in the UK.[25]

Thus the SP 10/84 concession does not apply to a foreign bank account of a UK resident foreign domiciliary, though it does apply to a UK bank account of a UK resident foreign domiciliary. (The SP could have been more lucidly expressed, but there it is.)

The SP 10/84 concession does apply to non-resident trusts (important for s.87 purposes) because the s.275(1)(l) exception only concerns individuals.

HMRC say:

> It has been suggested that this non-statutory practice [the SP 10/84 concession] should be extended to include overseas bank accounts held by individuals who are not domiciled in the UK. Our initial analysis has shown that such a change would be outside HMRC's administrative discretion, and would therefore require primary legislation...[26]

HMRC sensibly did not attempt to explain why the SP 10/84 concession was outside their discretion for foreign domiciliaries when it could be applied for everyone else. But on 27 January 2010 HMRC announced that the change shown to be impossible in December turned out to be possible after all:

> **Extension of the SP10/84 practice**
>
> An individual who is not domiciled in the UK may treat all bank accounts which:
>
> - are in his name
> - are in a particular foreign currency
> - are not situated in the UK for the purposes of the Taxation of Chargeable Gains Act 1992 and are therefore not within the scope of SP10/84
>
> as one account and disregard direct transfers among such accounts for capital gains purposes.

25 See 71.12 (Bank account).

26 Statement published online 9 Dec 2009 *www.hmrc.gov.uk/cnr/remittance-basis.htm*.

> Once adopted this practice must be applied to all future direct transfers among such bank accounts in that taxpayer's name containing that particular currency.
>
> **Comments on the extended practice, and examples**
>
> A non-UK domiciled individual with FCBAs in a particular currency both in the UK and overseas may treat all the UK accounts as one 'aggregated' account and all the overseas accounts as a second, distinct, 'aggregated' account.

I refer to this as "**the extended SP 10/84 concession**". HMRC continue:

> A direct transfer from an overseas account to a UK account, or vice versa, even if in the same currency, will not be disregarded for capital gains purposes and the individual will need to consider whether a computation of his or her capital gain or loss will be necessary in order to make a correct tax return.

There is still a difference between a UK domiciliary (governed by the original SP 10/84 concession) and a foreign domiciliary (governed by the extended SP 10/84 concession). A UK domiciliary may transfer from a foreign account to a UK account (or vice versa) without a disposal. A foreign domiciliary may not do so. This is so whether or not the individual is a remittance basis taxpayer. The reason for this anomaly is not clear and HMRC did not consider it necessary to offer an explanation. The discrimination against foreign domiciliaries (who are caught by this rule whether or not they claim the remittance basis) is contrary to EU law.

HMRC give three examples:

> **Example 1**
>
> Peter is UK domiciled and resident in the UK and has a Euro-denominated bank account in London and two Euro-denominated bank accounts in Paris and Munich. Under SP10/84 Paul has been, and will remain, able to treat all three accounts as a single account and disregard direct transfers between them for capital gains tax purposes. Paul is unaffected by the changes described in this note.
>
> **Example 2**
>
> Peter is domiciled in Germany but is resident in the UK. He has two Euro accounts in London and two in Berlin. Until now Peter has been able to treat the two UK-based accounts as a single account, but the German accounts had to be treated as separate assets in their own right. Under the [extended SP 10/84 concession], Peter will continue to treat

> his two UK-based accounts as one account but, from 6 April 2008, may treat his two non-UK accounts as a different single account so that direct transfers between the German Euro accounts will be disregarded. However, transfers from either German account to one of the London accounts, or to any other account not denominated in Euros, will be a disposal for capital gains tax purposes.
>
> **Example 3**
>
> Mary is domiciled in Poland but is resident in the UK and has the following bank accounts:
>
> • Euro accounts in London, Manchester, Paris and Krakow
>
> • US Dollar accounts in London, Seattle, Philadelphia, Zurich and St Helier (Channel Islands)
>
> Until now Mary has been able to treat the two UK-based Euro accounts as a single account. Under the [extended SP 10/84 concession], she is able to treat each of the following groups of accounts a single account and to disregard direct transfers between accounts within each group for capital gains tax purposes:
>
> • The London and Manchester Euro accounts
>
> • The Paris and Krakow Euro accounts
>
> • The US Dollar accounts in Seattle, Philadelphia, Zurich and St Helier (but not the account in London)
>
> Transfers between accounts in different groups (for instance between the London and Paris Euro accounts, or between the Paris Euro account and the Zurich Dollar account) will be disposals for capital gains tax purposes.[27]

HMRC do not specify a commencement date for the extended SP 10/84 concession. It appears from example 2 above that they envisage it taking effect from 2008/09, which is logical though the announcement came too late for those putting in tax returns in that year.

## 49.13 Share matching rules or part disposal rules?

### 49.13.1 *Outline of share matching rules*

Sections 104-106A TCGA provide a set of rules known as "**share matching rules**".[28] A constant series of amendments over the years has

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27 Accessible *www.hmrc.gov.uk/cnr/cgt-transfers-fc.htm*.

28 A note on terminology. The statutory term is "share pooling" but "share matching" is a more accurate label.

resulted in scrappy drafting. A full discussion of these rules needs a short book to itself. Fortunately an outline will suffice for the purposes of this chapter and EN FB 2008 provides one. Before 2008/09:

> These rules apply when "fungible assets" (identical assets which cannot therefore be readily separately identified, such as shares of the same class in a company) are disposed of. Where someone disposes of some of their shares (or similar fungible assets), which they have acquired at different times and at different prices, the rules are necessary to determine what expenditure is allowed...
> To apply the existing [pre-2008] rules, it is potentially necessary to identify fungible assets disposed of with assets acquired in the following order:
> • assets acquired on the date of disposal;
> • assets acquired in the 30 days following the date of disposal (this is an anti-avoidance provision, intended to prevent "bed and breakfasting", under which people disposed of assets and reacquired them within the next few days, to realise losses or to realise gains to utilise their annual exempt amount while still, in effect, holding the assets);
> • assets acquired between 6 April 1998 and the date of disposal, on a "last in, first out" (LIFO) basis;
> • assets acquired between 1 April 1982 and 5 April 1998 (these assets are treated as a single asset, known as a "section 104 holding");
> • assets acquired between 7 April 1965 and 31 March 1982 (also treated as a single asset, a "1982 holding"); and
> • assets held at 6 April 1965, on a LIFO basis.

From 2008/09:

> 68. The abolition of the kink test, indexation allowance, and taper relief provides the opportunity to simplify these rules considerably. The single "section 104 holding" can in future include all fungible assets acquired before the date of disposal, and the order of matching can be reduced to:
> • assets acquired on the date of disposal;
> • assets acquired in the 30 days following the date of disposal; and
> • assets in the enlarged section 104 holding.

### 49.13.2 *The statutory provisions in outline*

In outline, s.104(1) TCGA provides the basic rule:

> Any number of securities of the same class acquired by the same person in the same capacity shall for the purposes of this Act (subject to express provision to the contrary) be regarded as indistinguishable parts of a single asset growing or diminishing on the occasions on which additional securities of the same class are acquired or some of the securities of that class are disposed of. ...

Section 105(1) TCGA provides the same day rule:

> Paragraphs (a) and (b) below shall apply where securities of the same class are acquired or disposed of by the same person on the same day and in the same capacity—
> (a) all the securities so acquired shall be treated as acquired by a single transaction and all the securities so disposed of shall be treated as disposed of by a single transaction, and
> (b) all the securities so acquired shall, so far as their quantity does not exceed that of the securities so disposed of, be identified with those securities.

Section 106A(5) TCGA provides the 30 day rule:

> Subject to subsection (4) above, if within the period of thirty days after the disposal the person making it acquires securities of the same class, the securities disposed of shall be identified—
> (a) with securities acquired by him within that period, rather than with other securities; and
> (b) with securities acquired at an earlier time within that period, rather than with securities acquired at a later time within that period.

### 49.13.3 *Do the share matching rules apply to foreign currency bank accounts?*

A bank account is not a "security" but the word here is given an artificially wide meaning. Section 104(3) TCGA provides:

> For the purposes of this section and sections 105, 107, 110 and 114 ... "securities" does not include relevant securities as defined in section 108 but, subject to that, means—
> (i) shares or securities of a company; and
> (ii) any other assets where they are of a nature to be dealt in without identifying the particular assets disposed of or acquired;...

The same definition is incorporated into s.106 and 106A TCGA by reference: see s.106A(10) TCGA. I refer to "securities" within the definition of s.104(3) as "**s.104(3) securities**" to distinguish them from "securities" in the usual sense of the word.

CG Manual before April 2010 stated clearly (and in some places still states) that the share matching rules apply to foreign bank accounts, ie a bank account was regarded as a s.104(3) security. The Manual provides:

> **78332. Identification of disposals with acquisitions** [April 2010]
> The debt represented by a credit balance in a bank account is a single asset for chargeable gains purposes. [*See CG50500+ for further advice on the pooling rules generally*]...

The words in italics were deleted in April 2010. However in the discussion of the share matching rules, the CG Manual still provides:

> **50220. Meaning of 'security' and 'securities'** [April 2010]
> '*Security' for the purposes of share identification rules*
> ... The definition in TCGA 1992, Section 104(3) includes the word that it is seeking to define. The reason for this is that the share identification rules are intended to apply to all fungible assets such as shares, securities *and foreign currency*.[29]

HMRC now say:

> **Calculation of gains and losses: share matching and part disposal rules**
> The Residence, Domicile and Remittances Manual (RDRM) was published on the HMRC website in August 2010 and includes some guidance on foreign currency bank accounts. The simplified examples in the RDRM used the part disposal rules in section 42 TGCA 1992 to calculate gains and losses arising from withdrawals from such accounts. *Although both lead to the same result mathematically,* concerns have been expressed that this is contrary to HMRC guidance at paragraph

29 Similarly CG Manual para 78316 [April 2010]: "Foreign currency [in the context this means foreign currency bank accounts as well as foreign currency notes and coins] is subject to the same rules of identification and pooling as unquoted shares and securities."

> CG78332 of the Capital Gains Manual which suggests that these gains and losses should be calculated on the basis of the share matching rules in Chapter 4 Part 1 TCGA 1992 (section 104 onwards).

It is not the case that the share matching rules and part disposal rules lead to the same result mathematically (if they did why have two sets of rules?). It is true to say that the post-2008 rules will quite often lead to the same result.

> The basis of the view expressed in the RDRM is that a debt represented by a credit in an individual's bank account is a single asset, rather than a series of fungible assets. Therefore any withdrawal of part of the funds in a bank account will be a part disposal of a single asset to which the share matching rules cannot apply. However, the guidance at CG78332 is not wholly explicit on this point and has given rise to possible misinterpretation.

The guidance at CG78332 was in fact clear though the author did not like what it said. The statement discloses a certain lack of candour (a less charitable commentator would use a stronger expression) but there it is.

> HMRC are currently in the process of revising this guidance to remove any ambiguity on this point.
> In the meantime, HMRC will not insist that any tax computations of gains and losses arising from movements between foreign currency bank accounts which were carried out for years up to and including 2007-08 using the share matching rules need to be revisited. However, the part disposal rules should be followed from 2008-09 onwards, unless that is not a practical proposition, for instance, because IT systems were in place to calculate gains and losses using the share matching rules. In such cases the change to using part-disposal rules should be made from 2009-10.

Presumably no-one seriously expects 2008/09 computations (which would have been made by the time of the HMRC statement) to be revised. Incidentally, the author at this point has (rightly) forgotten the earlier comment that the share matching rules and part disposal rules lead to the same result mathematically.

> In any case, where it is necessary to use share matching rules for 2008-09, the rules must be the revised ones introduced in Finance Act

> 2008. Continuing to use the old LIFO (last in, first out) and other rules that ceased to apply for disposals after 5 April 2008 will not be acceptable.[30]

Is the current HMRC view (part disposal rules rather than share matching rules) correct? The question is whether the asset is a s.104(3) "security" ie whether the asset is "of a nature to be dealt in without identifying the particular assets disposed of or acquired". Foreign currency not in a bank account (notes and coins) are certainly s.104(3) securities though it would be relatively unusual for that to matter. But HMRC are strictly right to change their mind and argue that a bank account is not a s.104(3) security.[31]

In favour of the former HMRC view, it could be said that bank accounts raise the same problems as fungible assets, and it is appropriate that the share matching rules should be construed loosely so as to encompass them. Before 2008, the rules also provided a much more practical way of dealing with the problems raised by foreign currency bank accounts though that largely ceased to be the case after the 2008 reforms; see below.

The applicable rule is therefore the part disposal rule in s.42 TCGA which provides:

> (1) Where a person disposes of an interest or right in or over an asset, and generally wherever on the disposal of an asset any description of property derived from that asset remains undisposed of, the sums which under paragraphs (a) and (b) of section 38(1) are attributable to the asset shall, both for the purposes of the computation of the gain accruing on the disposal and for the purpose of applying this Part in relation to the property which remains undisposed of, be apportioned.
> (2) The apportionment shall be made by reference—
> (a) to the amount or value of the consideration for the disposal on the

30 Statement first published online 9 Dec 2009 *www.hmrc.gov.uk/cnr/remittance-basis.htm*.

31 If a bank account were a security, it would be "securities of the same class". This expression is partly defined in s.104(3)
"shares or securities of a company shall not be treated as being of the same class unless they are so treated by the practice of a recognised stock exchange or would be so treated if dealt with on a recognised stock exchange."
A bank account (if a s.104(3) security) is probably a security of a company since a bank will be a company.

one hand (call that amount or value A), and

(b) to the market value of the property which remains undisposed of on the other hand (call that market value B),

and accordingly the fraction of the said sums allowable as a deduction in the computation of the gain accruing on the disposal shall be

A÷(A+B)

and the remainder shall be attributed to the property which remains undisposed of....

## 49.14 Concessions for bank account computations in practice

The operation of the CGT rules strictly requires a computation (generally very complex) for every withdrawal from a bank account. This is obviously unworkable, and in the past HMRC took a realistic approach. CG Manual para 25420 provided that any reasonable guess would do:

> ***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.*

In the 7th edition of this work I referred to this passage and said:

> This passage was quietly deleted 31 March 2009, but one hopes that HMRC practice has not changed.

That hope was not fulfilled but HMRC have responded to pressure from the ICAEW by issuing or revising some limited concessions.

### 49.14.1 *Annual accounting*

The CG Manual sometimes allows the option of annual accounting:

> **78316 Identification of disposals with acquisitions** [April 2010]
> ...If the taxpayer agrees, you may adopt a simplified method for

> computing gains or losses on currency[32] 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.

Thus annual accounting is allowed for purchases and sales of investments.

### 49.14.2 *Monthly accounting*

Formerly, the CG Manual sometimes allowed the option of monthly accounting:

> ***CG78333 - Currency: identification of disposals with acquisitions***
> *There are often large numbers of transactions on bank accounts. ... 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...*

On 9 December 2009 HMRC announced slight restrictions on this practice (under the heading "*Simplifying the compliance burden*").[33] The CG Manual now provides:

> **78333 Foreign currency bank accounts: Aggregation of debits and credits** [April 2010]
> There are often large numbers of transactions on bank accounts. It can be a formidable task to compute gains or losses on numerous withdrawals because each withdrawal is a part-disposal of an asset (the debt represented by the credit balance on the account). Providing it is

32 This must include foreign currency bank accounts, not just notes and coins, as notes and coins are not in practice acquired or disposed of in the course of buying and selling overseas investments.

33 Statement first published online 9 Dec 2009 *www.hmrc.gov.uk/cnr/remittance-basis.htm*.

> followed consistently and produces a reasonable overall result, the following practice may be adopted when computing foreign exchange gains and losses on withdrawals from accounts denominated in a currency other than sterling.
>
> The practice involves aggregating debits from and credits to an account over a period. Usually the period of aggregation will be a calendar month, but part of a month will be used at the beginning or end of a tax year, or if the account is opened or closed during the tax year. For these purposes, when the balance on an account becomes negative the account is treated as having been closed because the asset it represents no longer exists, and when an overdrawn account returns to credit it is treated as an account newly opened because an asset - a debt receivable - comes into existence. In what follows we assume the aggregation period is a month.

Thus at least 13 computations are required each year. Assuming the account never goes down to zero or deficit, there are two computations for April 1-5, (one for April 6-31, and one for April 1-5) and one for each other month.

> The foreign exchange gain or loss is computed by taking the consideration as being the total of debits (withdrawals) from the account translated into sterling using the average rate of exchange for the month. The allowable cost to be deducted from this consideration is computed using the part disposal formula A/(A+B) × Total Cost. The Total Cost is the allowable cost of the total foreign currency debt represented by the account at the start of the month (a sterling amount) plus the cost in sterling of credits to the account during the month, derived from the total foreign currency credits translated at the average rate of exchange for the month. In the formula A/(A+B), A is the total withdrawals from the account in the month, expressed in the foreign currency and B is the balance of the account at the start of the month plus the net credits to (or minus the net debits from) the account in the month ie the total credits less the total withdrawals (both in the foreign currency). Note that for these purposes B itself cannot be less than zero because the allowable costs to be deducted would then exceed the Total Cost (the fraction A/(A+B) would be greater than one). In the real world, this would mean the account had become overdrawn: the asset represented by the credit balance would have ceased to exist because it would have been disposed of in full and the part-disposal provisions for apportioning costs would not in fact be applicable.
>
> The allowable cost used in computing the foreign exchange gain is

deducted from the Total Cost and the resulting figure carried forward to form the opening base cost of the balance in the account at the start of the next month.

The example at CG78333A illustrates this.

Monthly average exchange rates may be based on daily rates published or made generally available by any reputable organisation. Weighting of daily rates is not acceptable.

Where this practice is adopted it must be used for all accounts in a particular foreign currency and must be used for the whole of a tax year.

**8333A Foreign currency bank accounts: Aggregation of debits and credits** [April 2010]

*Example*

CG78333 describes an approach to computing gains and losses in connection with a foreign currency bank account where there are many transactions. This paragraph provides a worked example to illustrate that approach.

Consider an account denominated in US dollars to which s252(2) TCGA 1992 (sums representing currency acquired for personal expenditure) does not apply. The account is subject to many credit and debit entries in the course of a year. The monthly totals of credits and debits are as shown below. Also shown is the monthly average exchange rate for sterling to dollars.

| | **Total credits/$** | **Total debits/$** | **Avge exchange rate** |
|---|---|---|---|
| April | 7520 | 5000 | 0.504400 |
| May | 8100 | 6500 | 0.508768 |
| June | 7570 | 7575 | 0.508343 |
| July | 9230 | 6800 | 0.502694 |
| August | 6730 | 9250 | 0.528316 |
| September | 8210 | 5420 | 0.554933 |
| October | 7970 | 6400 | 0.589352 |
| November | 6990 | 7500 | 0.651597 |
| December | 15730 | 17650 | 0.672184 |
| January | 5580 | 4530 | 0.690832 |
| February | 7260 | 7240 | 0.692636 |
| March | 8340 | 7950 | 0.704384 |
| TOTAL | 99230 | 91815 | |

The dollar (credit) balance at the start of April is $75,425 and the total allowable cost of the asset is £49,383.

The period of aggregation is one month. The computation begins with April.

Actually the computation should begin with the period 6 -30 April, with another set of computations for the period 1-5 April in the following year.

The results of computations are rounded to the nearest whole number before being used in further computations.

**April gain/loss**

**Step 1**: Add the total of the dollar credits in April to the opening balance:

\$75,425 + \$7,520 = \$82,945

**Step 2**: Determine the expenditure allowable in respect of this by translating the April credits into sterling using the average exchange rate:

£49,383 + (7,520 × 0.5044) = £53,176

**Step 3**: Determine the dollar balance carried forward by deducting the total of the debits in April:

\$82,945 - \$5,000 = \$77,945

**Step 4**: Determine the allowable expenditure attributable to the debit amount using the A/(A+B) fraction applied to the total allowable expenditure as computed above:

5000/(5000+(75,425 + 7,520 - 5,000)) × £53,176 = £3,205

**Step 5**: Compute the gain or loss on the disposal:

| | | |
|---|---|---|
| Proceeds | £2,522 | (5,000 × 0.5044) |
| Allowable expenditure | £3,205 | see above |
| Loss | £683 | |

**Step 6**: Compute the allowable expenditure in respect of the \$77,945 balance carried forward by deducting the expenditure allowed in this computation:

£53,176 – £3,205 = £49,971

Repeat the process for each successive month, carrying the dollar balance and the remaining allowable expenditure forward to the next month:

**May gain/loss**

**Step 1 (Dollar balance before debits):** \$77,945 + \$8,100 = \$86,045

**Step 2 (total allowable expenditure):** £49,971 + (8,100×0.508768) = £54,092

**Step 3 (Dollar balance carried forward):** \$86,045 – \$6,500 = \$79,545

**Step 4 (apportion allowable exp.):** £54,092 × 6,500/(6,500+ 77,945+8,100–6,500) = £4,086

**Step 5 (compute gain or loss):** (6,500 × 0.508768) – £4,086 = LOSS £779

**Step 6 (allowable expenditure carried forward):** £54,092 – £4,086 = £50,006

The results of the computations are shown in the following table:

| | **Step 1** $ bal. | **Step 2** Total all. exp | **Step 3** $ bal. c/f | **Step 4** Exp. re all disp. | **Step 5** Gain (loss) c/f | **Step 6** All exp. |
|---|---|---|---|---|---|---|
| Apr | $82,945 | £53,176 | $77,945 | £3,205 | (£683) | £49,971 |
| May | $86,045 | £54,092 | $79,545 | £4,086 | (£779) | £50,006 |
| Jun | $87,115 | £53,854 | $79,540 | £4,683 | (£832) | £49,171 |
| Jul | $88,770 | £53,811 | $81,970 | £4,122 | (£704) | £49,689 |
| Aug | $88,700 | £53,245 | $79,450 | £5,553 | (£666) | £47,692 |
| Sept | $87,660 | £52,248 | $82,240 | £3,230 | (£222) | £49,018 |
| Oct | $90,210 | £53,715 | $83,810 | £3,811 | (£39) | £49,904 |
| Nov | $90,800 | £54,459 | $83,300 | £4,498 | £389 | £49,961 |
| Dec | $99,030 | £60,534 | $81,380 | £10,789 | £1,075 | £49,745 |
| Jan | $86,960 | £53,600 | $82,430 | £2,792 | £337 | £50,808 |
| Feb | $89,690 | £55,837 | $82,450 | £4,507 | £508 | £51,329 |
| Mar | $90,790 | £57,205 | $82,840 | £5,009 | £591 | £52,196 |
| TOTAL | | | | | (£1,025) | |

The computation requires six steps for each month or part of month, ie at least 6 × 13 = 78 steps. The reader is invited to speculate the professional cost of these computations (including the time needed to extract the data needed which requires preparation of a spreadsheet of every bank account entry and ascertaining the foreign currency figures) and then to compare it with the amounts involved on the figures of the example.

### 49.14.3 *Ascertaining the acquisition cost of currency*

It will often not be possible to calculate the chargeable gains on foreign currency bank accounts as the base cost information will not be available. HMRC allow the following concession:

> **Acquisition costs of non-sterling bank accounts**
> Difficulties can arise in calculating the base cost for disposals and part disposals of non-sterling bank accounts in situations where it cannot be ascertained which exchange rate was in force at the time the debt was originally acquired or increased.
> To reduce these difficulties, HMRC will permit a simplified approach whereby the acquisition cost, as at 6 April 2008, of a debt represented by a non-sterling account can be calculated by means of an average exchange rate over a period of time up to 6 April 2008. Under this method, individuals can establish the base or acquisition cost of their non-sterling bank accounts by reference to the average foreign currency exchange rates which were in force over the six years up to April 2008. These rates can be found on the HMRC website at Exchange rates.

> For the sake of simplicity[!] HMRC have calculated the average exchange rate for the six years to April 2008 for US dollars and euros, namely £1 = US$0.560275917 and €0.68058106 respectively.

It appears that after ascertaining the rate for two currencies HMRC's resources were exhausted.

> Where such an account has been established for less than six years at 6 April 2008, HMRC will permit individuals to calculate the base or acquisition cost by reference to the average exchange rates in force over the number of years, to the nearest year, that the account has been established.
> This simplified averaging approach is entirely optional: individuals can still calculate base or acquisition costs by using the actual exchange rates which were in force at the date on which the currency was deposited into the bank account in question. However, any approach will always need to be followed on a consistent basis.[34]

It is obvious that this does not go far to meet the difficulty raised in practice.

### 49.14.4 *£500 de minimis concession*

HMRC say:

> Where the amount of net gains from transfers from overseas non-sterling bank accounts which an individual remits to the UK is less than £500 in any tax year, it will not be necessary to report such gains to HMRC.[35]

The reader is invited to speculate what the average accountancy cost will be of ascertaining whether or not an account gives rise to gains of less than £500, in the (I think unlikely) event that serious attempts are made to apply these rules.

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34 Statement first published online 9 Dec 2009 *www.hmrc.gov.uk/cnr/remittance-basis.htm*.

35 Accessible *www.hmrc.gov.uk/cnr/cgt-transfers-fc.htm*.

## 49.15 Foreign currency not in a bank account

Foreign currency is an asset on which a gain may accrue. CG Manual provides:

> **78316 Identification of disposals with acquisitions** [April 2010]
> Foreign currency is subject to the same rules of identification and pooling as unquoted shares and securities. See CG50500+.

Here the share matching rules do apply. In practice this is not important as it would be unusual for a person to hold substantial foreign currency outside a bank account (except perhaps as trading receipts outside CGT.)

## 49.16 Foreign currency for personal expenditure

There are two exemptions for foreign currency needed for personal expenditure abroad. These are not likely to affect remittance basis taxpayers, as gains on disposals of this kind are not likely to be remitted, but it is important for others. Section 269 TCGA provides:

> A gain shall not be a chargeable gain if accruing on the disposal by an individual of currency of any description acquired by him for the personal expenditure outside the UK of himself or his family or dependants (including expenditure on the provision or maintenance of any residence outside the UK).

Section 252(2) TCGA is the corresponding provision for bank accounts:

> Subsection (1) above shall not apply to a sum in an individual's bank account representing currency acquired by the holder for the personal expenditure outside the UK of himself or his family or dependants (including expenditure on the provision or maintenance of any residence outside the UK).

The CG Manual provides:

> **78330 Personal expenditure of individuals** [April 2010]
> The general rule in s.252(1) TCGA 1992 that a debt represented by a foreign currency bank account is a chargeable asset 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 the guidance at CG 78315 applies to it also.

Where an individual receives foreign currency income or gains the exemption is not likely to apply, as one cannot easily say that the currency is acquired for personal expenditure outside the UK. The relief might apply if (exceptionally) the individual could say that the reason they worked was to acquire foreign currency for personal expenditure. The relief would apply if the individual received foreign currency income, and then pays it into a designated personal expenditure account.

## 49.17 Interaction with mixed fund rules and HMRC examples

The CG Manual provides examples of the following:
(1) Remittance of part of FC account holding capital gain (Fatima)
(2) Ditto with previous offshore transfer (example 2)
(3) Remittance of part of FC account holding income & gain (example 3)
The RDR Manual provides examples of the following:
(4) Remittance of part of FC account holding income (Julius).
(5) Remittance of part of FC account holding RFI and RFE (Tom)
(6) Ditto with previous offshore transfer (Gelda)
I set out the examples below but have altered the wording a little for enhanced clarity. However examples (3) to (6) are wrong since
(1) they adopt the HMRC view that the currency conversion date on the remittance of income is the date of remittance; and
(2) they adopt the former HMRC view that there is a double charge to CGT and IT (which HMRC now accept is wrong).
(3) The HMRC method of dealing with bank accounts is also wrong. This is best seen by examining the example of "Fatima".

### 49.17.1 *Example (Fatima): FC account holds capital gain; currency fluctuates; remittance of part of account*

The facts of this example are simple. The CG Manual provides:

**25392. Remittance basis: Accounts denominated in foreign currencies** [April 2010]

...

***Example*** (Fatima)

F is a remittance basis taxpayer in all relevant years.

In March 2007 F bought foreign property for €260,000.

In August 2009 she disposes of the property for €400,000. She banks the proceeds in a new account in Germany.

In November 2010 F transfers €100,000 from the account to a UK account denominated in Sterling.[36]

The Sterling: Euro exchange rates were:

| | |
|---|---|
| March 2007 | 0.571 (ie, £ = € × 0.571) |
| August 2009 | 0.909 (ie, £ = € × 0.909) |
| November 2010 | 0.966 (ie, £ = € × 0.966) |

Thus F has made two disposals and one remittance:

(1) A disposal of the foreign property in August 2009.

(2) A part disposal of the € bank account in November 2010.

(3) A remittance of €100,000 in November 2010.

The disposal of the foreign property gives rise to a gain and the computation is straightforward. HMRC say:

Foreign chargeable gain arising in August 2009:

| | | |
|---|---|---|
| Proceeds | £363,600 | (€400,000 × 0.909) |
| Less cost | -£148,460 | (€260,000 × 0.571) |
| Gain | £215,140 | equivalent to €236,677 (£215,140/0.909) |

This gain is computed once and for all in Sterling at the time of the [disposal][37], but as the foreign currency representing the gain is held in bank account there is the possibility[38] that a further gain or loss will arise when there is a withdrawal from that account.

### 49.17.2 *James Kessler's analysis*

The position is (relatively) simple.

36 [Author's note] In fact, the position is the same if the UK account is denominated in Euros.

37 The original erroneously reads: "at the time of the exchange".

38 [Author's note] In fact, a gain or loss is not a "possibility" but a near-certainty, since it is highly improbable that the rates of exchange will be the same on any two dates.

The amount remitted is £96,600 (€100,000 × 0.966, currency conversion date is date of remittance).

Under the mixed fund rules, that is regarded as gain before tax free capital, and since the gain is more than £96,600, the remitted sum is all gain.

The € account is still a mixed fund, but now holds £215,140 - £96,600 = £118,540 gains which may be remitted on another day.

As will be seen, HMRC will agree with the above two paragraphs.

Next, the part disposal of the bank account. At this point my analysis is different from that of HMRC. The correct approach is that this disposal gives rise to a gain computed thus:

| | | |
|---|---|---|
| Proceeds | £96,600 | (€100,000 × 0.966) |
| Less cost | -£90,900[39] | |
| Gain | £ 5,700 | |

It is considered that applying the mixed fund rules that amount is not remitted since the gain deemed remitted is treated as £96,600. That gain cannot be remitted, since the remaining bank account does not represent the gain (it is not, and is not derived from, that gain).

In reality this gain of £5,700 has actually been remitted. It might seem sensible to say that the £96,600 remitted consists of:

(1) £5,700 capital gain (arising on the withdrawal of funds) plus
(2) £90,900 capital gain (part of the gain in the mixed account) leaving [£215,140 - £90,900] yet to be remitted.

But that is not consistent with the statutory mixed fund rules as s.809Q refers to the amount of income or capital of the individual for the relevant tax year in the mixed fund *immediately before* the transfer.

Also, suppose the facts were that

(1) the bank account held purely income (not gains and clean capital).
(2) (as before) €100,000 = £96,600 was remitted from the account, and a gain of £5,700 arose on that withdrawal.

In that case it might be surprising to find that a remittance consisted in part of capital gain £5,700 and was not wholly income. It would not be in the interests of HMRC to accept that analysis.

39 See s.42 TCGA. The acquisition cost of the entire € account is £363,600 (€400,000 × 0.909) - currency conversion date at time of acquisition.
Multiply that by the part disposal fraction A/(A+B) ie
£96,600/(£96,600 + £289,800) = 1/4

### 49.17.3 *HMRC analysis*

> As at August 2009 the bank account is a mixed fund containing:
> foreign chargeable gains £215,140 (€236,677) and
> Clean capital £148,461 (€163,323, ie €400,000– €236,677).
> By November 2010 this [sterling] gain is equivalent to €222,712 (215,140/0.966)

This is correct.

> ie there is an unrealised foreign exchange loss of £13,490 (ie €(236,677-222,712) = €13,965 expressed in Sterling).

This is not correct. There is no unrealised loss. The taxpayer's asset is the *€ account* which has *appreciated* in value (as against sterling). It is not correct to say that the taxpayer owns an asset (the chargeable gain) which has depreciated in value. The chargeable gain is not an asset. It is merely a figure computed for tax purposes.

> Under the mixed fund rules (see CG25385+) the amount transferred out of the mixed fund is treated as containing only foreign chargeable gains.

This is correct. (Under the mixed fund rules the amount transferred out of the mixed fund is treated as chargeable gains before tax free capital, and since the amount transferred is less than the amount of capital gains, it is treated as wholly chargeable gains.)

> The proportion of the gain remitted is the Sterling equivalent of the amount transferred as fraction of the total foreign chargeable gain: (100,000 × 0.966)/215,140 = 44.9%.

It is of course correct that the gain which has been remitted (£96,600) is 44.9% of the total gain (£215,140). But on my analysis we do not need to know that. All we need to know is the amount of the gain left in the offshore mixed fund, which is obviously the original gain (in sterling, £215,140) less the remitted gain (in sterling, £96,600).

> The same proportion of the loss due to exchange rate movements (ie 44.9% of £13,490) may be an allowable loss: see CG25330+ for information on losses under the remittance basis.

There is no loss. (If there were a loss, it may or may not be allowable, according to the rules for losses but that does not arise.)

> So the amount of the original gain remitted is £96,600 and, going forward, the mixed fund contains £118,540 foreign chargeable gain (£215,140 - £96,600) ...

This is correct.

> giving it an overall composition of €122,712 gains plus €177,288 capital (€300,000 total less the euro equivalent of the remaining gain)....

But on my analysis we do not need to know the equivalent figures in euros, as that has no fiscal significance.

### 49.17.4 *Example: FC account holds capital gain; offshore transfer; remittance of part of account; no currency fluctuation*

The CG Manual provides:

> **25430. Disposal of assets situated abroad** [April 2010]
> ***Example 2***
> An individual resident but not domiciled in the UK has a foreign bank account in a foreign currency, F. The rate of exchange is 2F = £1 throughout this example. The account contains the following entries:

| **Date** | **Item** | **Credit (debit)** | **Balance** |
|---|---|---|---|
| Jan 2009 | - | Nil | |
| Jan 2009 | sale of foreign shares A (cost 48,000F Dec 2005) | 90,000F | 90,000F |
| Feb 2009 | Withdrawal: purchase of foreign shares B | (30,000F) | 60,000F |
| Mar 2009 | Withdrawal: brought to UK | (30,000F) | 30,000F |

Thus F has made three disposals:
(1) A disposal of the foreign shares A in Jan 2009.
(2) A part disposal of the bank account in Feb 2009.
(3) A part disposal of the bank account in Mar 2009.
However no gain or loss arises on the second or third disposal since (on the simplified facts of the example) the currency has not fluctuated.[40]
The first disposal gives rise to a gain and the computation is

40 The reader is invited to contemplate how complicated the analysis would be if the facts were not simplified in this way.

straightforward. HMRC say:

> The gain arising is first calculated in sterling, thus:

| | |
|---|---|
| Proceeds 90,000F | £45,000 |
| less Cost 48,000F | - £24,000 |
| Gain | £21,000 |

### 49.17.5 *James Kessler's analysis*

The bank account is a mixed fund. There have been two transfers:
(1) An offshore transfer from the mixed fund in Feb 2009.
(2) An onshore transfer (remittance) from the mixed fund in Mar 2009.
The offshore transfer contains gain and clean capital pro-rata.

| | Before offshore transfer | Offshore transfer | Remaining in a/c |
|---|---|---|---|
| gain: | £21,000 = 47% | £7,000 | £14,000 |
| clean capital: | £24,000 = 53% | £8,000 | £16,000 |
| total: | £45,000 = 100% | £15,000 | £30,000 |

The remittance is treated as gain before capital, so is treated as £14k gain and £1k clean capital.

HMRC agree, though their method of working is more complicated:

> Next, the account is analysed into capital and gains to give the composition of the balance of the account (90,000F – 30,000F = 60,000F) immediately before the March transfer, turning the gain back into foreign currency thus:

| **Date** | **Item** | **Capital** | **Capital Gain** | **Total** |
|---|---|---|---|---|
| Jan 2009 | Deposit | 48,000F | 42,000F | 90,000F |
| Feb 2009 | Withdrawal to buy foreign shares | 16,000F | 14,000F | 30,000F |
| | Balance | 32,000F | 28,000F | 60,000F |

> The transfer of 30,000F is then split between capital and foreign chargeable gains according to the mixed fund rules (see CG25380+), so it is treated as containing 28,000F (£14,000) of gains and 2000F (£1000) capital. There is therefore a remittance of £14,000 of the gain on foreign shares A.

### 49.17.6 *Example: FC bank account holding income and gain; remittance of part; currency fluctuates*

The CG Manual provides:

**25431. Disposal of assets situated abroad** [April 2010]
***Example 3***
An individual, resident but not domiciled in the UK, has a foreign bank account in a foreign currency, F. The account contains the following entries:

| **Date** | **Item** | **Credit (debit)** | **Balance** |
|---|---|---|---|
| Nov 2008 | | | Nil |
| Dec 2008 | Partnership profits (RFI subject to foreign tax)[41] | 10,000F | 10,000F |
| Jan 2009 | sale of shares (cost 10,560F in Dec 1998) | 15,000F | 25,000F |
| Feb 2009 | Withdrawal – brought to UK | (20,000F) | 5,000F |

The sterling: FC exchange rates are assumed to be:

| | |
|---|---|
| Dec 98: 2.2 | (ie, £ = FC ÷ 2.2) |
| Dec 08: 2.1 | (ie, £ = FC ÷ 2.1)[42] |
| Jan 09: 2.0 | (ie, £ = FC ÷ 2.0) |
| Feb 09: 2.5 | (ie, £ = FC ÷ 2.5) |

Thus the individual has made 2 disposals and one remittance:
(1) a disposal of the shares in Jan 2009.
(2) a part disposal of the bank account in Feb 2009.
(3) a remittance of 20,000F in Feb 2009.
First one computes the chargeable gain on the disposal of the shares, which is straightforward. HMRC say:

... 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 |
| Gain | | £2,700 |

41 Author's note: On the facts of the example, the result would turn out the same if the RFI were not subject to foreign tax.

42 I have added this "fact" as no figure is supplied in the HMRC example (it is not needed on the HMRC analysis).

### 49.17.7 *James Kessler's analysis*

At the time of the remittance the account contains:

| **Type** | **Mixed fund category** | **amount** |
|---|---|---|
| chargeable gains | para (e) | £2700 |
| foreign-taxed RFI | para (g) | £4762 (F10,000 ÷ 2.1)[43] |
| clean capital | para (i) | £2538 |
| Total | | £10,000 (F25,000 ÷ 2.5) |

The remittance is £8,000 (F20,000 ÷ 2.5). Matching in the mixed funds priority order, the remittance consists of:

| **Type** | **amount** |
|---|---|
| chargeable gains | £2,700 |
| foreign-taxed RFI | £4,762 |
| clean capital | £ 538 |
| Total | £8,000 |

There is also a part disposal of the FCBA. A loss accrues, computed thus:

| | | |
|---|---|---|
| Disposal proceeds | 15,000F ÷ 2.0 | £7,500 |
| Less cost | | £9,810[44] |
| Loss | | £2,700 |

### 49.17.8 *HMRC analysis*

> Next, as in Example 2, we analyse the account. But this time we analyse it into income, capital and foreign chargeable gains.
> Sterling is the only appropriate measure of capital gains ... We must therefore decide on the amount of capital gains in the account on the date the remittance is made by converting the sterling figures of gains back into the foreign currency at the rate of exchange applying at the remittance date ([in the] example 2.5F = £1). So the £2,700 gains are represented by 6,750F at this date.
> We then deduct the figures of foreign currency representing income and capital gains from the total foreign currency balance in the account. The

43 Adopting the exchange rate at the time the income arose.

44 Total base cost = (F10,000÷ 2.1) + (F15,000 ÷ 2.0) = £12662.
Apportioned base cost = 12662*20/25 = 9810.

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 Dec 2008 | 10,000F | | | 10,000F |
| Amount of Gains | | | 6,750F | 6,750F |
| Subtotal | | | | 16,750F |
| Figure of capital to balance | | 8,250F | | 8,250F |
| | | | | 25,000F |

The transfer of 20,000F is then matched with the contents of the mixed fund under the rules described in CG25380+:
£2,700 (6,750F) is foreign chargeable gains
£4,000 (10,000F) is relevant foreign income (partnership profits)
£1,300 (3,250F) is capital
The first two components are remittances taxable in the UK.

### 49.17.9 *Example: remittance of part of FC account holding income.*

The RDR Manual formerly provided:

**33580** *Example (Julius)*
J is a UK resident, but is not domiciled within the UK. He has a Euro bank account in a French bank in Paris.
In Year 1 there are two direct credits, in Euro, of RFI (dividend income & investment interest) into that account:

| Date of credit | € | Exchange Rate |
|---|---|---|
| Year 1 30 June | €1,000 | €1=£1 |
| 31 August | €2,000 | €1=£1.20 |

For capital gains purposes the cost of acquisition of the debt will be £1,000 on 30 June and £2,400 on 31 August.
In Year 2, J arranges an electronic transfer of €500 to his UK current (Sterling) bank account.[45] The exchange rate on the date of transfer was €1 = £1.30. J's disposal proceeds are €500 × 1.30= £650.
The market value of the remainder of the debt receivable (€2,500) will also need to be converted to sterling, and using the same exchange rate (£3,250).

45 [Author's note] However the position is the same if the UK account is denominated in Euros.

Applying the p/disposal formula:
J's allowable expenditure = £3,400 × (£650/(£650 + £3,250) = £567
Calculating the gain:
Disposal proceeds less allowable expenditure = £650 - £567 = £83
J has a foreign exchange capital gain of £83.
J now has a credit in his UK bank account (an asset = a debt receivable), the acquisition costs of which will be £650. This is a sterling debt, so there will be no chargeable gain on any future part disposal/withdrawal from the UK account (TCGA92/s251(1) and 252(2)).
If J does not choose to use the remittance basis this foreign gain is simply chargeable in the UK as any other foreign gain.
If J chooses to use the remittance basis then this foreign chargeable gain will be subject to UK tax when it is 'remitted' to the UK. J's disposal proceeds on his part-disposal of his Euro 'debt receivable' were, in this case, received in the form of another 'debt receivable', that is, the debt with his UK bank. In layman's terms the sterling values of the proceeds is the £650 'credit'. The gain is contained therein so has been remitted to the UK.
NOTE: In the above example, assuming J was also a remittance basis user in Year 1 he has also remitted €500 (that is £650) of Relevant Foreign Income and will be liable to income tax on that amount...

This example has been deleted from the current manual.

### 49.17.10 *Account holding RFI and RFE: Remittance of part*

The next example concerns a remittance of part of FC account holding RFI and RFE. The RDR Manual provides:

**33580 Foreign Currency Bank Accounts - Interaction with Mixed Funds Rules**
*Section 809Q – Mixed funds and remittances*
The capital gains rules for foreign currency accounts held by non-domiciled remittance basis users may[46] interact with the mixed fund rules at ITA07/s809Q. Where the foreign currency account is held offshore, any gain arising will be a foreign chargeable gain
Looking at this through an example:

46 [Author's note] In fact the mixed fund rules will always interact.

*Example (Tom):*

T is a UK resident and ordinarily resident, but non-UK domiciled remittance basis user. He has a Euro bank account in a German bank.

Between 6 April and 4 July Year 1 there are Euro credits of

- €4,000 to this account on the 1st of each month, from T's German employer for duties carried out wholly in Germany (Relevant Foreign Earnings)
- Credits paid on 3rd of each month from various investments, which total €3,000 each month (Relevant Foreign Income).

On 5 July, in Year 1, T decides to make an electronic transfer of €15,000 from this account to his UK sterling current account. The relevant exchange rates in Year 1 (assume relevant for the entire month) are:

May € 1 = £0.90
June € 1 = £1.20
July € 1 = £1.10

The account contains both Relevant Foreign Income and Relevant Foreign Earnings, so it is a mixed fund and the rules at ITA07/s809Q apply. These rules require an analysis of the account immediately before the transfer, to identify amounts in each of the s809Q(4) categories for each year.

In T's case, on 5 July immediately before the transfer he has, from Year 1:

- €12,000 credits from his German employment income (para (b)) and
- €9,000 from RFI (para (d))

T's €15,000 remittance of income is subject to UK income tax in the UK; it consists of €12,000 RFE and €3,000 RFI. This amount is translated into sterling on date of remittance (€ 1 = £1.10); so T has remitted £13,200 RFE and £3,300 RFI.

There is also a foreign exchange gain/loss on the withdrawal/transfer which crystallises immediately after the money is withdrawn, because that is the point at which the part disposal of the debt occurs. The gain will be a foreign chargeable gain, arising on the disposal of a non-UK situs 'debt receivable'.

The acquisition costs are computed using the exchange rates applicable on the date of each credit, and the disposal proceeds using the exchange rate applicable on date of disposal. This latter figure will be the sterling 'credit' that appears on T's UK bank account, using that day's rate of exchange (assumed here to be €1 = £1.10). The remainder of the account (€21,000 less €15,000 = €6,000) is translated to sterling market value too, on the same day (€6,000 =£6,600).

T's original 'expenditure' on acquiring the debt/asset is:

May € 7,000 × £0.90 = £6,300
June € 7,000 × £1.20 = £8,400
July € 7,000 × £1.10 = £7,700
£22,400

T's allowable exp = £22,400 × (£16,500/(£16,500 + £6,600) = £16,000
The capital gain computation = £16,500 - £16,000 = £500 gain
So in July, when T brings in his €15,000 he has a taxable remittance of RFE of £13,200 and RFI totalling £3,300. He has also remitted the proceeds of a disposal; which contain a foreign chargeable gain of £500 which is also taxable.

### 49.17.11 *Example: Offshore transfer followed by remittance from transferee account (Gelda)*

G is a UK resident and ordinarily resident, but non-UK domiciled remittance basis user. She has a Euro bank account in a German bank.
Between 6 April and 31 July in Year 1 there are Euro credits of

- €4,000 to this account on the 1st of each month, from G's German employer for duties carried out wholly in Germany (Relevant Foreign Earnings)
- Credits paid on 3rd of each month from various offshore investments, which total €3,000 each month. (Relevant Foreign Income).

There are then no further credits to the account.
The relevant exchanges rates in Year 1 (assume relevant for the entire month) are:
May € 1 = £0.90,
June € 1 = £1.20,
July € 1 = £1.10
On 20 August in Year 2, G decides to make an electronic transfer of €15,000 from this account to another Euro account with another bank in Spain.
This would be an offshore transfer within ITA07/s809R.
Under the rules at section 809R an offshore transfer is treated as containing an appropriate proportion of each kind of income/capital in the transferring mixed fund immediately before the transfer.
As at 20 August in Year 2 G's German account held

- €12,000 RFE and
- €9,000 RFI

The exchange rate for August in Year 2 is €1 = £1.15
So the offshore transfer contains RFE and RFI in a 4:3 proportion, that is €8,571 RFE and €6,429 RFI. There is no remittance to the UK at this point, so no need to translate this income to sterling for income

remittance purposes.
There would also be a chargeable gain in the Spanish account. The €15,000 funds credited are also disposal proceeds as G has made a part disposal of the 'debt receivable' asset she held in Germany in return for another asset – the 'debt receivable' from the Spanish bank.

This would not be the case now because of the extended SP 10/84 concession.

G's original 'expenditure' on acquiring the debt/asset is:
May € 7,000 × £0.90 = £6,300
June € 7,000 × £1.20 = £8,400
July € 7,000 × £1.10 = £7,700
£22,400
G's Allowable exp = £22,400 × (£17,250/(£17,250 + £6,900) = £16,000
The capital gain computation = £17,250 - £16,000 = £1,250 gain
G is a remittance basis user; but there has been no remittance of this gain at the time the transfer occurs. The Spanish account is now regarded as a mixed fund. It has a balance of €15,000, in which is contained the income and now the £1,250 chargeable gain.
There are no further transactions (credits/debits) with the Spanish account. On 31 July in Year 6 G decides to remit €10,000 from the Spanish account to her UK sterling current account. The exchange rate at that time is €1 = £1.45.
The mixed fund rules at ITA07/s809Q now apply. The first step is to analyse the Spanish account immediately before the transfer, to identify amounts in each of the s809Q(4) categories:
Year 2:
s809Q(4) (e) Foreign chargeable gains - £1,250
Year 1.
s809Q(4) (b) RFE - €8,571
s809Q(4) [d][47] RFI - €6,429
Note: This analysis appears to shows the Spanish account/ mixed fund as having more money in it than the balance (€15,000) would suggest it actually contains; this is because of the inclusion of the FOREX gain.
The s809Q mixed-fund rules treat anything remitted as coming from the earliest paragraph first, on a year by year basis and then the next paragraph and so forth.
In G's case, the €10,000 that she remitted in Year 6 consists of a £1,250 chargeable gain, €8,571 RFE (£12,428) and €566 RFI (£822).

47 The original erroneously reads: s809Q(4) (c).

G's remittance of the €10,000 from the Spanish account is also a part disposal of a debt receivable. The cost of acquisition of the Spanish 'debt receivable' is the same as the disposal proceeds of the German 'debt receivable' (£17,250).
The disposal proceeds, in sterling are £14,500 (€10,000 × 1.45).
Applying the p/disposal formula:
Allowable exp = £17,250 × (£14,500/(£14,500 + £7,250) = £11,500
So the capital gain computation = £14,500 - £11,500 = £3,000 gain
This £3,000 gain is a foreign chargeable gain that crystallises when the money leaves the Spanish account; it is 'within' the 'proceeds of disposal (£14,500) and so is regarded as remitted at that time.
So on the occasion of the transfer on 31 July in Year 6, G is subject to income tax on RFE of £12,428 and RFI of £822 and to capital gains tax on her remitted foreign chargeable gain of £1,250 plus her foreign exchange gain of £3,000.

## 49.18 Commentary: solution to foreign currency problems

### 49.18.1 *Problems*

In computing gains on disposals of bank accounts the legislation requires unworkable computations in all but the simplest cases. This is obvious to anyone whose knowledge of financial affairs exceeds that of an undergraduate who has just opened their first bank account.

The examples in the HMRC manuals are fantastic oversimplifications of what may be expected in real life. Yet the analysis runs for pages, HMRC accept that their first set of answers were wrong, and I should be very surprised if the second set of answers is right.

Although the pre-2008 situation was not satisfactory, it became materially worse after 2008 for the following reasons:

(1) Many UK resident foreign domiciliaries are now arising basis taxpayers as they will not make a remittance basis claim. So (subject to the annual exemption) a CGT computation has to be carried out for every withdrawal from a foreign currency bank account.
(2) Remittance basis taxpayers do not now have the benefit of a CGT annual exemption. So (subject to the derisory £500 exemption) a CGT computation has to be carried out for every remittance to the UK derived from foreign currency.
(3) Non-resident trusts with foreign domiciled beneficiaries now need to compute s.2(2) amounts (trust gains) for the purpose of s.87 TCGA so

a CGT computation is needed on every withdrawal from a foreign currency trust bank account.

(4) Until 2010 it was accepted that the share matching rules applied. Matching was (in short) generally to acquisitions in the last year so the records were available. Now, (regardless of whether the share matching or part disposal rules apply) to calculate base costs accurately one will have to have details of the history of the foreign currency bank accounts going back to the date they were opened or 31 March 1982.

(5) Base cost records will not usually be available in the case of individuals who have recently come to the UK, or long term UK resident foreign domiciliaries, or trustees of trusts with foreign domiciled beneficiaries, as they would in no case have been thought necessary.

### 49.18.2 *Solutions*

Foreign currency raises three problems, all of which are soluble.

*Relief for foreign currency bank accounts* The first problem (for arising basis and remittance basis taxpayers) is the vast number of computations required when (almost) every withdrawal from a bank account is a disposal. The solution is to repeal s.252 TCGA so that gains and losses from foreign currency bank accounts cease to be chargeable gains, and allowable losses cease to be allowable losses. This would have no serious cost implications as on balance gains should equal losses.

*Yearly exchange rate averaging* The second problem (for arising basis and remittance basis taxpayers) is the general impracticability when there are a significant number of transactions of converting foreign currency to sterling at a variety of moments during the year: the moment that income arises, the moment that gains arise, and the moment that capital expenditure is incurred. The solution is in the HMRC practice to allow use of an annual average rate in any currency during the year and to average out acquisitions and disposals. HMRC should publish rates each year for every currency. Provided taxpayers are not allowed to switch adventitiously between accurate and average exchange rates, this would have no significant cost implications.

*Currency conversion date* The third set of problems (for remittance basis taxpayers only) arise from HMRC's mistaken view that the currency conversion date for income of a remittance basis taxpayer is the date of remittance. The solution is to recognise the existing law, or (if that is not accepted) to amend the law to the practitioners view. This would have no cost implications.

Until these three changes are made, it will be impossible, for even the most assiduous taxpayers with substantial foreign currency accounts to complete their tax returns accurately.

What happens in practice? Who would stand up and say publically what they do? My impression is this: If the amounts are relatively small, no return is made. If the amounts are large and the advisors assiduous, a very approximate stab may be made. HMRC raise no enquiries.

A sad state of affairs for those who believe that taxation should be governed by law; but there it is.

### 49.18.3 *A new relief from 2012/13*

The remittance consultation paper provides:

> **Foreign currency bank accounts**
> 2.75 Individuals who operate bank accounts denominated in a currency other than sterling face particular issues relating to CGT because foreign currency bank accounts (FCBAs) are chargeable assets for the purposes of CGT.
> 2.76 There is an exemption from CGT where sums are deposited in an individual's FCBA in order to be used for personal expenditure outside the UK. This means that a withdrawal of funds from such an account constitutes a part disposal of the account on which a capital gain or loss can arise.
> 2.77 The calculations of gains and losses can often become extremely complicated and require detailed records to be kept until all deposits in the account have been withdrawn, which may be for very long periods. However, over time capital gains and losses on FCBA transactions tend to broadly balance each other: as a consequence, in many cases the administrative burden is disproportionate to the final tax payable or losses allowable. However, the exemption does not extend to all sums in FCBAs. This means that, whenever a withdrawal is made from a FCBA and the exemption does not apply, fluctuations in exchange rates are almost certain to give rise either to a chargeable gain or an allowable loss.
> 2.78 These problems are particularly relevant to individuals taxed on the remittance basis as they are more likely than other people to make regular use of FCBAs and cannot rely on the Annual Exempt Amount (AEA) to

> cover smaller net chargeable gains arising on the accounts. The Government acknowledges these difficulties and believes they should be addressed.
> 2.79 It therefore proposes a straightforward and comprehensive solution whereby all sums within an individual's FCBA will be removed from the scope of CGT. This would apply to nondomiciled and domiciled individuals alike.
> 2.80 It is likely that such a measure would require some rules to protect the Exchequer, for instance, to counter the effect of arrangements that are neutral in economic terms but result in an exempt gain on an FCBA being matched by an allowable loss on another asset.[48]

Whether the proposed new relief achieves anything useful must remain to be seen, but the text at 2.80 is not altogether encouraging.

48 HMT & HMRC, "Reform of the taxation of non-domiciled individuals: a consultation" (June 2011) accessible *www.hm-treasury.gov.uk/d/consult_condoc_non_domicile_individuals.pdf.*

CHAPTER FIFTY

# DOUBLE TAXATION RELIEFS FOR INCOME TAX AND CGT

## 50.1 DT reliefs - Introduction

The UK has more than 100 double tax treaties. The discussion in this chapter is mainly by reference to the OECD Model Double Taxation Convention on Income and on Capital ("**the OECD model**") though I refer at points to the US treaty and others. This is practical because the OECD model has been the basis for tax treaties between developed countries since it was first published, in draft in 1963 and finally in 1977. In any particular case the DTA concerned would need to be reviewed.

A full discussion of the OECD model would need a volume for every article (except article 7 which would require several volumes).

I only consider the UK side of the matter, ie whether a DT exemption provides exemption from UK tax and whether foreign tax can be used as a credit against UK tax. In any particular case it will also be necessary to consider the foreign tax position.

### 50.1.1 *Cross references*

In this chapter I concentrate on the general aspects of the treaty rules and their interaction with UK tax legislation.

Specific DT exemptions are considered in the chapter on that type of income; see: 13.20 (DT relief for trading income).

See too 5.1 (Treaty-residence); 36.9 (DTA relief for partnership); for the accrued income scheme, see 33.16 (Double Taxation relief); 16.8 (Alimony and maintenance income). For DT reliefs and discretionary trusts, see 22.9 (Discretionary trusts treated as transparent to allow beneficiaries reliefs); 22.11 (UK trust - non resident beneficiary: DTA relief); 22.12 (Are discretionary trusts "beneficial owners" for DTA purposes?). For IP trusts, see 23.3 (DT reliefs). For DT relief and the EU Savings Directive, see 17.15.1 (Credit for special withholding tax).

For the position of charities, see Kessler & Brown, *Taxation of Charities*, (8th ed., 2011), Chapter 15 (Double Taxation Treaties and Charities).

### 50.1.2 *Treaty terminology*

A note on treaty terminology.

The terms DT treaty/convention/arrangement/agreement are synonymous. The OECD Model use the word "convention" and UK tax legislation uses the term "double taxation arrangements". I prefer the word "treaty" as it seems clearest, but I adopt the abbreviation DTA which has become standard usage.

Treaties commonly refer to income (or gains) **"derived by"** a person where the usual UK tax terminology would be that the income (or gains) arise or accrue to the person; but the meaning is the same. Treaties similarly refer to income **"derived from"** a state where the usual UK tax terminology would be income arising in a state. In American English the verb can be used transitively, eg: "*a resident is treated as deriving the income.*"

DTAs refer to "contracting states" but I abbreviate this to **"treaty state"** or just **"state"** and where that state is not the UK, I refer to it as **"the other state"**.

## 50.2 *Types of DT relief*

We need terms for the various types of DT relief, and in this chapter I use the following terminology.

"**DT exemption**" applies where a DTA provides an exemption from tax.

"**Foreign tax credit relief**" arises where foreign tax is set against UK tax. This may be

(a) "**DTA tax credit**" where a DTA confers a credit or
(b) "**Unilateral tax credit**" where UK tax law (not a DTA) confers a credit.

"**IT/CGT computation deduction**" applies where foreign tax is deducted in computing income or gains.

I refer to all these reliefs together as "**DT reliefs**".

### 50.2.1 *Types of residence*

We need terms for the various types of residence, and in this chapter I use the following terminology.

"**Domestic-law residence**" means residence for UK tax purposes. Where a person is resident in the UK for UK law purposes, I describe them as "**domestic-law UK resident**".

"**Treaty-residence**" means residence for the purposes of a DTA.[1] Where a person is a resident of the UK for treaty purposes I describe them as "**treaty-resident in the UK**". Where they are resident in the other state, I describe them as "**treaty-resident outside the UK**". The statutory terminology sometimes used here is *"treaty non-resident"* but I think my term is clearer.

"**Dual residence**" means residence in two countries, but is an ambiguous term until one specifies what type(s) of residence are involved. In its widest sense it means a person who is domestic-law UK resident and also resident in another state for the purposes of foreign tax. A dual resident person in that sense may be:

(a) treaty-resident outside the UK
(b) treaty-resident in the UK or
(c) not treaty-resident anywhere (if there is no applicable DTA).

(The term dual resident is sometimes used specifically to mean a person within (a)[2] but that usage is not adopted in this chapter.)

"**Domestic-law UK resident only**" means a person who is domestic-law UK resident and not resident in another state (ie not dual resident even in the widest sense.) Such a person cannot be treaty-resident outside the UK.

These are clumsy terms but it is difficult to think of better.

### 50.2.2 *Significance of DT reliefs*

DT reliefs matter to all individuals, but different classes of individual are interested in different aspects of the reliefs. The permutations can be summarised thus:

Case (1): Individuals who are domestic-law UK resident only. Where

1 See 5.1 (Treaty-residence).
2 See 45.17 (Dual resident trust).

there is an applicable DTA they will also be treaty-resident in the UK.

Case (2): Individuals who are dual resident.

Case (3): Individuals who not domestic-law UK resident. These may be:
(a) treaty-resident outside the UK
(b) not treaty-resident anywhere (if there is no applicable DTA).

*Case 1: Individuals who are domestic-law UK resident only.* These do not directly qualify for any DT exemption but they may qualify for foreign tax credit relief (or IT/CGT computation deduction). They may also qualify for indirect DT relief if income or gains accruing to a trust or company which is treaty-resident outside the UK are deemed to accrue to them under an anti-avoidance provisions such as s.624, TAA, s.13, etc.
*Case (2)(a): Individuals who are dual resident and treaty-resident outside the UK.* As UK residents they are in principle subject to IT or CGT on all UK and foreign income and gains (subject where applicable to the remittance basis). However as treaty-resident outside the UK they may qualify for DT exemptions from UK and foreign source income and gains. This category has become much more important from 2008/09, for two reasons. First, many individuals who would formerly have simply claimed the remittance basis will now claim treaty relief, as a remittance basis claim will incur the remittance basis charge. Secondly following the withdrawal of IR20 and its replacement by the hopelessly vague HMRC 6, many more individuals find that they may possibly be domestic-law UK resident and since they may be UK resident they claim treaty relief just in case.
*Case (2)(b)(c): Individuals who are dual resident and treaty-resident in the UK or not treaty-resident anywhere.* These are in the same position as case 1.
*Case (3)(a): Individuals who not domestic-law UK resident and treaty-resident outside the UK.* As non-residents they are in principle subject to IT on UK source income only. As treaty-resident outside the UK they may qualify for some DT exemptions (eg the OECD other income article and relief for UK source interest under the some treaties).
*Case (3)(b) Individuals who not domestic-law UK resident and not treaty-resident anywhere.* As non-residents they are in principle subject to IT on UK source income (though the non-residents exemption will mitigate this). They will not qualify for any DT exemptions.

## 50.3 Incorporation of DTAs into UK law

International treaties (including DTAs) do not automatically become part of UK law, but must be incorporated into UK law by statute. Accordingly, s.2 TIOPA provides:

> (1) If Her Majesty by Order in Council declares—
> (a) that arrangements specified in the Order have been made in relation to any territory outside the UK with a view to affording relief from double taxation in relation to taxes within subsection (3), and
> (b) that it is expedient that those arrangements should have effect,
> those arrangements have effect.
> (2) If arrangements have effect under subsection (1), they have effect in accordance with section 6.
> (3) The taxes are—
> (a) income tax,
> (b) corporation tax,
> (c) capital gains tax,
> (d) petroleum revenue tax, and
> (e) any taxes imposed by the law of the territory that are of a similar character to taxes within paragraphs (a) to (d)...

Section 3 TIOPA extends this:

> (1) Section 2(1) gives effect to arrangements even if the arrangements include—
> (a) provision for relief from tax for periods before the passing of this Act, or
> (b) provision for relief from tax for periods before the making of the arrangements.
> (2) Section 2(1) gives effect to arrangements even if the arrangements include—
> (a) provision as to income that is not subject to double taxation,
> (b) provision as to chargeable gains that are not subject to double taxation ...

Under s.2 TIOPA a DTA has effect "in accordance with s.6" so we turn to s.6 TIOPA. Section 6(1) provides that DTAs override domestic legislation:

> Subject to this Part and Part 18 of ICTA, double taxation arrangements

> have effect in accordance with subsections (2) to (4) despite anything in any enactment.

Section 6(2) sets out seven matters which a DTA can achieve:

> (2) Double taxation arrangements have effect in relation to income tax and corporation tax so far as the arrangements provide—
> (a) for relief from income tax or corporation tax,

This is what one would expect. Section 6(2) continues:

> (b) for taxing income of non-UK resident persons that arises from sources in the UK,
> (c) for taxing chargeable gains accruing to non-UK resident persons on the disposal of assets in the UK,

In practice DTAs are not used to impose taxes.

> (d) for determining the income or chargeable gains to be attributed to non-UK resident persons,
> (e) for determining the income or chargeable gains to be attributed to agencies, branches or establishments in the UK of non-UK resident persons,
> (f) for determining the income or chargeable gains to be attributed to UK resident persons who have special relationships with non-UK resident persons, or
> (g) for conferring on non-UK resident persons the right to a tax credit under section 397(1) of ITTOIA 2005 in respect of qualifying distributions made to them by UK resident companies.

Section 6(3) TIOPA provides equivalent rules for CGT:

> Double taxation arrangements have effect in relation to capital gains tax so far as the arrangements provide—
> (a) for relief from capital gains tax,
> (b) for taxing capital gains accruing to non-UK resident persons[3] on the disposal of assets in the UK,
> (c) for determining the capital gains to be attributed to non-UK resident

3 Defined by reference in ss(7): "In subsection (3) 'UK resident person' and 'non-UK resident person' have the meaning given by section 989 of ITA 2007."

persons,

(d) for determining the capital gains to be attributed to agencies, branches or establishments in the UK of non-UK resident persons, or

(e) for determining the capital gains to be attributed to UK resident persons who have special relationships with non-UK resident persons.

### 50.3.1 *Claims*

Section 6(6) TIOPA provides:

> Relief under subsection (2)(a), (3)(a) or (4) requires a claim.

The claim is made on form HS302.

## 50.4 Interaction of DT reliefs and the remittance basis

The commentary to Art.1 of the OECD model treaty provides:

> 26.1 Under the domestic law of some States, persons who qualify as residents but who do not have what is considered to be a permanent link with the State (sometimes referred to as domicile) are only taxed on income derived from sources outside the State to the extent that this income is effectively repatriated, or remitted, thereto. Such persons are not, therefore, subject to potential double taxation to the extent that foreign income is not remitted to their State of residence and it may be considered inappropriate to give them the benefit of the provisions of the Convention on such income. Contracting States which agree to restrict the application of the provisions of the Convention to income that is effectively taxed in the hands of these persons may do so by adding the following provision to the Convention:
>
> "Where under any provision of this Convention income arising in a Contracting State is relieved in whole or in part from tax in that State and under the law in force in the other Contracting State a person, in respect of the said income, is subject to tax by reference to the amount thereof which is remitted to or received in that other State and not by reference to the full amount thereof, then any relief provided by the provisions of this Convention shall apply only to so much of the income as is taxed in the other Contracting State."

Although this text was only added to the OECD Commentary in 2003, some provision of this kind is standard in UK DTAs. A provision of this kind is included in the US/UK DTA, on which the IRS comment:

> For example, if a UK resident who is not domiciled in the UK maintains a brokerage account in Ireland into which is paid $100 in U.S.-source dividend income, the United States may impose withholding tax at the statutory rate of 30% because the dividend income will not be taxed in the UK as it has not been remitted to the UK. If the dividend income instead is paid into a brokerage account in London, the UK resident will be subject to tax in the UK and the United States will reduce the rate of withholding tax to 15%.[4]

Note that it is US tax, not UK tax, which is in issue here. UK tax issues only arise where the UK has a treaty with another state where the *other* state has a remittance basis. The only example of which I am aware is the treaty with Ireland under which DT relief from UK tax is restricted to income/gains remitted to Ireland.[5]

## 50.5 Foreign tax credit relief

### 50.5.1 *DTA tax credit*

For example, art.22 Australia DTA provides (with immaterial exceptions):

> Australian tax payable under the laws of Australia ... on income or chargeable gains from sources within Australia ... shall be allowed as a credit against any UK tax computed by reference to the same income or chargeable gains by reference to which the Australian tax is computed;

### 50.5.2 *Unilateral tax credit*

Section 9(1) TIOPA provides the rule for IT:

> Credit for tax—
> (a) paid under the law of the territory,

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

5 Ireland/UK DTA art.6 (Limitation of relief) and art.14(5) (gains).

(b) calculated by reference to income arising, or any chargeable gain accruing, in the territory,[6] and
(c) corresponding to UK tax,
is to be allowed against any income tax or corporation tax calculated by reference to that income or gain.

Section 9(2) TIOPA is the equivalent for CGT:

(2) Credit for tax—
(a) paid under the law of the territory,
(b) calculated by reference to any capital gain accruing in the territory, and
(c) corresponding to UK tax,
is to be allowed against any capital gains tax calculated by reference to that gain.

Section 8(1) TIOPA provides statutory terminology (not used in this book):

In this Part "unilateral relief arrangements", in relation to a territory outside the UK, means the rules set out in sections 9 to 17.

I prefer the term "**unilateral tax credit**", which seems clearer.

### 50.5.3 *"Corresponding to UK tax"*

Section 9 TIOPA provides:

(4) For the purposes of subsection (1)(c), tax corresponds to UK tax if—
(a) it is charged on income and corresponds to income tax, or
(b) it is charged on income or chargeable gains and corresponds to corporation tax.
(5) For the purposes of subsection (2)(c), tax corresponds to UK tax if it is charged on capital gains and corresponds to capital gains tax.
(6) For the purposes of subsections (4) and (5), tax may correspond to income tax, corporation tax or capital gains tax even though it—
(a) is payable under the law of a province, state or other part of a country, or

6 For the issue of where income arises, see 13.5 (Trading income of non-resident) or the chapters on the type of income concerned.

(b) is levied by or on behalf of a municipality or other local body.

### 50.5.4 *Channel Islands and Isle of Man*

Section 9(7) TIOPA provides:

> If the territory is the Isle of Man or any of the Channel Islands, subsections (1)(b) and (2)(b) have effect with the omission of "in the territory".

Amended as these subsections direct, this provides:

> (1) Credit for tax—
> (a) paid under the law of the territory,
> (b) calculated by reference to income arising, or any chargeable gain accruing, ~~in the territory~~, and
> (c) corresponding to UK tax,
> is to be allowed against any income tax or corporation tax calculated by reference to that income or gain.
> (2) Credit for tax—
> (a) paid under the law of the territory,
> (b) calculated by reference to any capital gain accruing ~~in the territory~~, and
> (c) corresponding to UK tax,
> is to be allowed against any capital gains tax calculated by reference to that gain.

Since the Channel Islands and the IoM do not have a CGT, it is not immediately obvious what is the role of s.9(2).

### 50.5.5 *Quantum of income/gains*

The INT Manual provides:

> **165030 Computation – assessable amount** [January 2011]
> Where credit is claimed against UK Income Tax for foreign tax paid on income from a foreign source, the amount of that income for all UK tax purposes is:
> ***a) Foreign income assessable on the arising basis***
> No direct foreign tax is to be deducted. Where, exceptionally, the double taxation agreement provides for relief for underlying tax on a dividend

(see INTM164410) the underlying tax should be added to the amount of the income. Treat the whole of a foreign pension as chargeable to UK tax notwithstanding the deduction of one tenth under Section 65(2) ICTA 1988.

*Example:*

An individual receives a dividend of 100 from which 15 foreign withholding tax was deducted. The amount of income assessable is 100.

***b) Foreign income assessable on the remittance basis***

Add the amount of direct foreign tax attributable to the amount of income remitted. Where, exceptionally, the agreement provides for relief for underlying tax on a dividend (see INTM164410), the underlying tax should also be added to the amount of the dividend remitted. If you have difficulty in determining the amount of foreign tax attributed to income remitted, refer to the Personal Tax Team International - Advisory (part of Charity, Assets & Residence).

*Example*

| | |
|---|---|
| [Gross foreign income] | £1,000 |
| Foreign tax | £400 |
| Net foreign income | £600 |
| Remitted to UK | £300 |

*UK measure of the income*

| | |
|---|---|
| Income remitted | £300 |
| Plus foreign tax (300/600×400) | £200 |
| Therefore UK measure is | £500 |

This summarises the rules in s. 31, 32 TIOPA. Similarly for CGT. The INT Manual provides:

**169080. Remittance basis** [January 2011]

An individual who is resident or ordinarily resident but not domiciled in the UK and who makes a chargeable gain on the disposal of an asset situated outside the UK is only liable on the amount of the gain received in the UK (Section 12 TCGA 1992 see CG25300 onwards). When such an individual is chargeable on the gain received in the UK and claims credit for foreign tax charged on the same gain, the liability in the UK will be on the sum of the amount remitted to the UK plus the foreign tax attributable to the amount remitted.

Any difficulty in determining the correct addition for the foreign tax, should be referred to the Offshore Personal Tax Team (part of Charity, Assets & Residence).

### *50.5.6 HMRC practice: quantum of relief*

The INT Manual provides:

> **169100. Amount of foreign tax credit relief – general** [January 2011]
> Similar principles to those set out in INTM161210 onwards for Income Tax apply to Capital Gains Tax. The amount of credit for foreign tax is not to exceed the lesser of the foreign tax charged on the foreign gain and the UK tax charged on the doubly taxed gain at the taxpayer's marginal rate.
> If the foreign tax exceeds the UK tax, the excess can neither be deducted from the amount of the gain chargeable to Capital Gains Tax, nor can it be repaid.
> The foreign tax should not be increased by any indexation allowance.
> A taxpayer's marginal rate for Capital Gains Tax is the rate at which the tax is charged for the year of assessment.
> **169110. Amount of foreign tax credit relief – more than one gain** [January 2011]
> The amount of foreign tax credit relief must be calculated separately for each gain. An excess of foreign tax over UK tax on one gain cannot be credited against UK tax on another foreign gain or on the gain on the disposal of a UK asset.
> **169120. Amount of foreign tax credit relief – losses** [January 2011]
> Allowable losses should be set firstly against chargeable gains on which no foreign tax credit relief is due. It would normally be to the taxpayer's advantage to set any balance of losses, in order, against the gains on which the lowest level of foreign tax has been paid. This should secure the maximum amount of foreign tax credit relief.
> **169130. Amount of foreign tax credit relief – exemption from tax** [January 2011]
> Where the total of the chargeable gains in any year of assessment exceeds the exempt amount provided by TCGA 1992 Section 3, the exempt amount should, as far as possible, consist of gains on which no foreign tax has been charged. This will enable credit for foreign tax charged on the gains to be allowed against the UK Capital Gains Tax charged on those gains.
> The following example demonstrates the application of this paragraph and of INTM169120
> In 2002–03, an individual has the following chargeable gains:

| | | |
|---|---:|---|
| UK | £8,000 | |
| Country X | £20,000 | Foreign tax £4,000 |
| Country Y | £6,000 | Foreign tax £2,700 |

He has losses of £6,000 available for deduction. The exemption limit for 2002–03 is £7,700. The computation of his liability is as follows:

| | UK Gain | Country X Gain | Country Y Gain |
|---|---|---|---|
| | £8,000 | £20,000 | £6,000 |
| Less Loss | £6,000 | | |
| | £2,000 | £20,000 | £6,000 |
| Less Exempt Amount | £2,000 | £5,700 | |
| | 0 | £14,300 | £6,000 |
| Tax at 40% | 0 | £5,720 | £2,400 |
| Less Foreign Tax Credit Relief | 0 | £4,000 | £2,400 |
| Tax Payable | Nil | £1,170 | Nil |

The balance of Country Y's tax of £300 (2,700 less 2,400) cannot be set off against the Capital Gains Tax payable on the Country X gain and cannot be repaid.

**169140. Amount of foreign tax credit relief – extent to which a gain is doubly taxed** [January 2011]

As mentioned in INTM169100, credit for foreign tax cannot exceed the UK tax due on the doubly taxed gain. There may be situations where the amount of the UK gain is different from the amount of the gain that is taxed in the other country; or where the period of ownership of the asset that is taken into account in computing the UK gain is different from the period of ownership of the asset that is taken into account in computing the gain in the other country. In either case, the amount of the foreign tax allowable for foreign tax credit relief may need to be restricted. For further details on this, see CG14395 –CG14425.

**169150. Amount of foreign tax credit relief – basis of allowance** [January 2011]

Credit may be claimed for the foreign tax paid on foreign capital gains against the UK tax due on the same gain, irrespective of the tax year in which the foreign tax is charged.

Where credit is claimed on any other basis or where there are difficulties in determining the amount of foreign tax credit relief due, advice may be sought from the Offshore Personal Tax Team (part of Charity, Assets & Residence).

However HMRC changed their minds in Revenue & Customs Brief 17/10:

**Introduction**

The purpose of this brief is to publicise a change to the established practice of restricting the amount of Foreign Tax Credit Relief (FTCR) that can be deducted when calculating the amount of UK tax due on a chargeable gain.

**Background**

Where a gain is chargeable to UK Capital Gains Tax or UK Corporation Tax and the same gain has also been taxed in another country then FTCR can be claimed in respect of the foreign tax paid.

Our practice has been to restrict the amount of FTCR if different periods of ownership of the asset are considered when arriving at the gain assessable in the UK and the foreign gain, or if the amount of the UK gain is less than the foreign gain.

We have reconsidered our view and are revising our practice so that the whole of the foreign tax is allowable as FTCR up to the amount of the UK tax on the gain.

**The current practice**

The established practice has been to restrict the amount of FTCR in the following two situations:

**Situation one**

The amount of gain charged to foreign tax may be calculated by reference to a longer period of ownership than the period on which the gain charged to UK tax is based. The most common instance is where assets were acquired before the 31 March 1982 and the gain chargeable in the UK is based only on the period from 31 March 1982 onwards. In such cases the established practice has been to restrict the FTCR due by the following calculation:

period of time assessed by UK divided by period of time assessed by foreign authority multiplied by foreign tax equals allowable FTCR

For example, where the asset was acquired on 31 March 1971 and disposed of on 31 March 1993, with foreign tax of £10,000 charged then the maximum amount of FTCR would be restricted as follows:

31 March 1993 minus 31 March 1982 equals 11 years divided by 31 March 1993 minus 31 March 1971 equals 22 years multiplied by £10,000 equals £5,000

**Situation two**

Where the gain charged in the UK is less than the gain charged to foreign tax, the established practice has been to restrict the maximum amount of FTCR due by the following calculation:

amount of UK assessment divided by amount of foreign assessment multiplied by foreign tax equals allowable FTCR

For example, where the UK assessed a gain of £55,000, the gain charged to foreign tax was £75,000 and the foreign tax was £15,000 then the FTCR would be restricted as follows:

£55,000 divided by £75,000 multiplied by £15,000 equals £11,000

**How we intend to implement the revised practice**

From 19 March 2010 the practices described above that restrict the allowable FTCR will end. In all cases where FTCR is claimed against UK tax on chargeable gains, the whole of the foreign tax will be allowable up to the amount of the UK tax on the gain, provided that the gain charged in both countries relates to the same disposal.

In the examples above, the maximum allowable FTCR would now be the full £10,000 of foreign tax in the first case and the full £15,000 of foreign tax in the second, provided, in each case, that this amount was less than or equal to the UK tax.

This change will bring the chargeable gains practice in line with the Income Tax practice, which does not restrict the amount of FTCR allowed where the amount assessed in the UK is less than the amount of income assessed to foreign tax.

**Implications**

If tax returns were submitted with a claim to FTCR on the basis that the FTCR should be restricted, and those returns are still open or within the self-assessment window for amendment, they may be amended to reflect the change in practice. In other cases where FTCR has been restricted a claim can be made for additional relief within the normal time limits.

The current time limit for claims and assessments for Income Tax and Capital Gains Tax is five years from the 31 January immediately following the tax year and for assessments to Corporation Tax six years from the end of the accounting period to which the claim relates.

However, following changes announced in the 2008 Budget, from 1 April 2010 there will be a standard limit of four years from the end of the tax year for making claims of repayments to Income Tax and Capital Gains Tax and four years from the end of the accounting period for Corporation Tax.

Under these rules claims resulting from this change of practice that relate to Income Tax and Capital Gains Tax for the tax year 2004-05 would have to be made before 1 April 2010 and claims for the tax year 2005-06 must be made before 6 April 2010. Similarly, companies would have until 31 March 2010 to make claims for accounting periods ending before 1 April 2006, provided such claims are within the current six year time limit.

Because publication of this brief leaves so little time for such claims to be made within the statutory time limits, we will, exceptionally, accept late claims for the tax years 2004-05 and 2005-06 or accounting periods ending on dates between 19 March 2004 and 29 June 2006, provided that those claims are for additional tax credit relief resulting from this change of practice and are made no later than 30 June 2010.

**Further Information**

Guidance on the current practice can be found at CG14380 onwards. The Capital Gains Manual will shortly be updated to reflect the change in practice.

See too 49.10 (Tax credit relief: currency conversion date).

## 50.6 Foreign tax credit relief: property income

The Property Income Manual provides:

**4703. IT cases for 2005-06 onwards** [February 2007]

**Credit for foreign tax**

If the overseas income has suffered foreign tax and a claim to tax credit relief is made, it will be necessary, for the purposes of the source by source rule (see INTM161210) to identify the amount of UK tax attributable to income from each particular property. Where, therefore, tax credit relief is claimed separate computations of profits and losses for each property will be required. For the purposes of calculating tax credit relief, losses should be deducted in the order most favourable to the company's claim. Normally this will mean that losses should be allocated first against the source which has suffered at the lowest rate of foreign tax.

A company's flexibility in deciding how to allocate the deduction set out in Section 797(3) ICTA 1988, subject to the limitations in respect of deficits on non-trading loan relationships set out at Section 797(3)(A) and (B) ICTA 1988, is unaffected by any of the changes.

## 50.7 CGT/IT computation deduction

Section 112 TIOPA provides:

**112 Deduction from income for foreign tax (instead of credit against UK tax)**

(1) The amount of any income arising in any place outside the UK is reduced for the purposes of the Tax Acts—

(a) by any amount which has been paid in respect of non-UK tax on that income in the place where the income arose, or

(b) if subsection (2) applies, by the lesser amount mentioned in that subsection.

(2) This subsection applies if credit would, were it allowable in respect

of the income, be reduced under section 39 (reduction by reference to accrued income losses) to the lesser amount given by section 39(5).

(2A) But if X is less than Y, an amount equal to the difference between X and Y must be subtracted from the amount by which any income of a person ("the relevant income") is reduced under subsection (1)(a).

(2B) In subsection (2A)—

X is the amount of the relevant income that the person would (disregarding this section) be required to bring into account for income tax or corporation tax purposes, less any deduction that the person would be allowed to make for the amount paid in respect of non-UK tax, and

Y is the amount of the relevant income (that is to say, the amount on which the amount in respect of non-UK tax is paid).

(3) If—

(a) income of any person ("P") is reduced under subsection (1) by an amount paid in respect of tax on that income in the place where the income arose, and

(b) a payment is made by a tax authority to P, or any person connected with P, by reference to that tax, the amount of P's income is increased by the amount of the payment.

(4) Subsection (1)—

(a) has effect subject to section 31(2)(a) (no deduction for foreign tax if credit allowed and UK tax calculated otherwise than by reference to the amount received in the UK),

(b) has effect subject to section 143(5) and (6) (no deduction for special withholding tax if UK tax calculated otherwise than by reference to the amount received in the UK),

(c) does not apply to income the tax on which is to be calculated by reference to the amount of income received in the UK, and

(d) does not require any income to be reduced by an amount of underlying tax which, under section 60(3), is to be left out of account for the purposes of section 57.

(5) Subsection (1) has effect for corporation tax purposes despite—

(a) section 464(1) of CTA 2009 (matters to be brought into account in the case of loan relationships only under Part 5 of that Act), and

(b) section 906(1) of that Act (matters to be brought into account in respect of intangible fixed assets only under Part 8 of that Act).

(6) In subsection (1) "non-UK tax" means tax under the law of a territory outside the UK.

(7) For the purposes of subsection (3), whether a person is connected with P is determined in accordance with section 1122 of CTA 2010.

Section 113 TIOPA has the equivalent rule for CGT:

> **113 Deduction from capital gain for foreign tax (instead of credit against UK tax)**
> (1) Subsection (2) applies to tax if it is—
> (a) chargeable under the law of any territory outside the UK on the disposal of an asset, and
> (b) borne by the person making the disposal.
> (2) The tax is allowable as a deduction in the calculation of the gain.
> (3) Subsection (2) is subject to—
> (a) Chapters 1 and 2 so far as they apply for corporation tax purposes (see, in particular, section 31),
> (b Chapters 1 and 2 so far as they apply for capital gains tax purposes (see, in particular, section 31), and
> (c) section 143 (which includes provision about taking account of special withholding tax when calculating a gain for capital gains tax purposes).
> (4) In subsection (1) "asset" and "disposal" have the same meaning as in TCGA 1992 (see, in particular, section 21 and the following provisions of TCGA 1992).

Thus foreign tax credit relief (if claimed) has priority over a CGT computation deduction.

At first sight it is not obvious when a CGT computation deduction would be better than foreign tax credit relief. One case is where foreign CGT is payable but UK CGT is not (because of a difference in valuation rules or because some UK relief applies). In such a case the computation deduction may increase the loss allowable for UK CGT purposes (similarly for IT). But that must be a rare case.

The INT Manual provides:

> **169090. Deduction not credit**
> A deduction for the foreign tax should be made in the computation of the gain or loss when there is no claim to foreign tax credit relief or when no UK tax is chargeable on a gain; for example, when the UK computation shows a loss on the disposal and consequently there is no UK tax against which credit for any foreign tax can be given. No deduction is due, however, when credit relief is claimed, for any part of the foreign tax paid on a gain which does not qualify for credit because it exceeds the UK tax chargeable on the same gain.

INT Manual provides:

> **161050. Deduction instead of credit** [January 2011]
> It may sometimes be to the taxpayer's advantage not to make a claim to tax credit relief, for example where a business's trading profits are wholly covered by capital allowances so that there is no Income Tax or Corporation Tax payable on those profits, or where the trading results show a loss. If, for any reason, tax credit relief is not claimed, the foreign tax paid must be deducted from the income from the foreign source in computing the amount of the income for UK tax purposes (Section 112 ICTA 1988). This may serve to create or increase a loss which can be dealt with under the normal provisions for losses.
> Section 112 refers to 'any sum which has been paid in respect of non-UK tax' on income. This means tax alone and not, for example, interest paid in the foreign country for late payment of the foreign tax. Nor may a deduction be allowed for 'tax spared' (INTM161270) as it is not tax which has been paid; nor for underlying tax (INTM164060 and INTM164360) as it is not paid on the dividend in question; nor for taxes similar to UK VAT (see, however, INTM161080). Refer to Business International (Outward Investment Team), any case where it is not clear that the tax for which a deduction is sought under Section 112 is a tax on income.
> Section 112 allows a deduction for foreign tax paid on income 'in the place where the income arose'. Refer to Business International (Outward Investment Team), any case where a deduction is sought for foreign tax paid on income which arises wholly or partly from work carried out in the UK.
> Some foreign taxes, if not deductible under sections 112 to 115, may still be allowable expenses in computing the profits of a trade or profession (see INTM161080, BIM45900 onwards).
> There are special rules relating to the deduction of foreign tax for life insurance companies, including overseas life insurance companies – see the Life Assurance Manual.

## 50.8 Indirect DT reliefs

### 50.8.1 *Can a third party claim a DT exemption?*

DT exemptions are not in principle restricted to the person who is treaty-resident outside the UK. If (as is standard form) a DT exemption provides that income shall be taxable only in the foreign state, a settlor or transferor in the UK cannot be taxable on that income. Sections 2 and 6 TIOPA authorise DT exemptions to apply in this way, for they simply provide "relief", ie relief for anyone.[7] I refer to this as "**indirect DT exemption**".

This is self-evident, but authority can be cited if necessary. In *Lord Strathalmond v IRC*,[8] US source income arose to Lady Strathalmond. The rule at that time (only repealed in 1988) was that income of a married woman was deemed to accrue to her husband, so in the absence of treaty relief, Lord Strathalmond would have been taxable. The wife was treaty-resident in the US but the husband was not. Nevertheless he was entitled to DT exemption. The treaty exempted the income, not the treaty-resident individual, so a third party otherwise taxed on the income could claim the benefit of treaty relief even though not treaty-resident. Lord Millett summarised the point:

> [*Strathalmond*] shows that the relief from UK tax accorded by a double taxation agreement can enure for the benefit of a third party.[9]

Again, in *Padmore v IRC*[10] a partner was entitled to DT exemption on income of a Jersey partnership where the partnership was a person treaty-resident in Jersey but the partner was not.

I stress this because there is a comment to the contrary by the Special Commissioner in *IRC v Willoughby*[11] but that must be dismissed as erroneous.

Indirect DT exemption is restricted in the case of trading income: see 13.20.2 (Treaty override for trading income).

### 50.8.2 *Can a third party claim foreign tax credit relief?*

The position is the same for DTA tax credit. The position is the same for unilateral tax credit, because s.9(1) TIOPA allows "relief" or "credit" ie relief and credit for anyone.

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7 One might also refer to s.6(2)(f) TIOPA; but DTAs usually take the form of providing relief, rather than the form of disattributing income otherwise attributable to a settlor or transferor.

8 48 TC 537.

9 *Bricom v IRC* 70 TC at p.290.

10 62 TC 352.

11 [1995] STC 143 at p.169.

The former ITH provided:

**Tax charged on different person**
**618. General**
There is no requirement in the credit rules that the person charged to the UK tax is to be the same as the person charged to the foreign tax. The rules simply demand that the income or gains subjected to the foreign tax be the same income or gains as are subject to the UK tax.
**619. Capital gains**
An example of this situation is found in Section 140 TCGA 1992 which deals with the charge on capital gains where a branch or agency overseas is domesticated, that is to say transferred to a non-resident company in exchange for shares. In those circumstances a charge on the gains on branch assets transferred is deferred until either the transferor sells the shares or the transferee sells the assets (in the latter case the sale has to be within six years of the acquisition). In that latter instance where the transferee sells the asset, any foreign tax on the gains is paid by the transferee. But the UK company is charged in respect of the capital gains on those same assets and qualifies for credit relief because the gain has been taxed abroad, although the tax has actually been charged on the transferee.
A similar situation could occur with transfers under Section 171 TCGA 1992 between UK group companies. If the assets involved are situated abroad and the foreign tax authority taxes the UK company making the transfer, the benefit of that tax can be taken by the transferee group company when there is a disposal outside the group generating a UK tax charge on the relevant asset.
**620. Income**
On the income side a similar situation could occur where a UK resident is required to be assessed on income which in fact is the income of some other person and has been taxed abroad.

The INT Manual makes the same point:

**169040. Gain taxed UK/abroad** [January 2011]
In determining whether UK tax is computed by reference to the same gain on which the foreign tax is charged, there is no necessity that the respective tax liabilities should arise at the same time or that they should be charged on the same person. Thus, the same gain is regarded as taxed both overseas and in the UK where, for example:
- overseas tax is payable on a no gains/no loss disposal within a UK group of companies and liability to UK tax arises on the subsequent

disposal of the asset taking in the uplift in value to the date of the first disposal under s.171 TCGA 1992

- where an overseas trade carried on through a UK branch or agency is transferred to a local subsidiary the gain on the related disposal of the chargeable assets may immediately be crystallised for local tax purposes but deferred under s.140 TCGA 1992 until the shares in the local subsidiary are sold (or the subsidiary disposes of the assets within six years) thus giving rise at that point to a gain chargeable to UK tax computed in whole or in part by reference to the earlier uplift in value
- overseas tax is payable by reference to increases in the value of assets although there has been no disposal and there is a subsequent disposal attracting UK liability
- overseas tax is payable in its country of residence by a non-resident company on the disposal of an asset and in the UK the gain is charged on a UK resident individual under s.13 TCGA 1992 (see INTM169060).

In each case, the amount of relief may need to be restricted under the rules set out in INTM169100 onwards.

Where, by contrast, it is not possible to identify the gain subject to overseas tax with that on which UK liability arises, no credit relief is due. Thus, where overseas tax is charged on a disposal covered by rollover relief under s.152 TCGA 1992 and liability to UK tax arises on the disposal of the replacement asset, the gain on that disposal cannot be identified with the gain on the earlier disposal and no credit relief is due. A deduction for the overseas tax may, however, be allowed under s.113 TCGA 1992 (INTM169090) in computing the gain for rollover purposes.

SP 6/88 provides:

**Double taxation relief: chargeable gains**

**General**

[The SP cites the relevant statutory provisions and continues:]

3 The principal requirement for the granting of credit for overseas tax against liability to capital gains tax (or corporation tax on chargeable gains) is therefore that the overseas tax should be computed by reference to the same gain as the UK tax. There is no requirement that the respective tax liabilities should arise at the same time nor that they should be charged on the same person.

**Specific examples**

4 The Revenue's view is that the following sets of circumstances fall within the terms of the standard credit article and TA 1988 s 790 and may therefore give rise to a credit for overseas tax against UK capital

gains tax or corporation tax on chargeable gains.

(i) The overseas tax charges capital gains as income.

(ii) Overseas tax is payable on a disposal falling within TCGA 1992 s 171 (transfers within a group of companies treated as taking place on a no gain/no loss basis) and a liability to UK tax arises on a subsequent disposal.

(iii) An overseas trade carried on through a branch or agency is domesticated (ie transferred to a local subsidiary) and relief is given under TCGA 1992 s 140. There is a subsequent disposal of the securities (or the subsidiary disposes of the assets within six years) giving rise to a liability to UK tax and overseas tax is charged in whole or in part by reference to the gain accruing at the date of domestication.

(iv) Overseas tax is payable by reference to increases in the value of assets although there has been no disposal. There is a subsequent disposal of the assets on which a liability to UK tax arises.

5 It will be seen that relief is conditional upon the subject of the overseas tax being identified with the gains on which the UK tax liability arises. In contrast, where roll-over relief is claimed, for example under TCGA 1992 s 152, the gain on disposal of the old asset is not subjected to UK tax. The gain on realisation of the new asset remains a gain separate from that realised on sale of the old asset and overseas tax payable as a result of the sale of the old asset is not creditable against UK tax payable on the gain realised on sale of the new asset. However, in such circumstances TCGA 1992 s 278 allows the overseas tax to be claimed as a deduction in computing the gain for roll-over relief purposes.

This raises the issue of characterisation.

## 50.9 The characterisation issue

DT reliefs provide relief for particular types of income, and so relief only applies if the taxpayer receives that type of income. The characterisation of income in the hands of the UK taxpayer is a central question. I refer to this as "**the characterisation issue**".

*Hughes v Bank of New Zealand*[12] concerned exemption for interest on FOTRA securities, not a DTA, but the characterisation issue is not

12 21 TC 472.

restricted to DT reliefs: it can arise wherever an exemption applies to a particular type of income. This case concerned a non-resident bank with a UK branch whose profits were taxable. The branch's trading receipts included interest from FOTRA securities (exempt from UK tax in the hands of a non-resident). The interest retained its exemption. Lord Millett summarised:

> [*Hughes*] is authority for the proposition that exempt interest retains its character as interest even when it is taxable as a component element of the recipient's trading profits. ... Interest from exempt securities does not cease to be such by being included as a component element of the recipient's taxable profit.[13]

On the other side of the line, according to Lord Millett, is *IRC v Australian Mutual Provident Society*.[14] This concerned a non-resident life assurance company with a UK branch whose profits were taxable. The taxable profits were calculated in an unusual way: the relevant rule provided that an unidentifiable portion of the world-wide income of the company derived from the investment of its life assurance fund, calculated in accordance with a mathematical formula, should be charged to tax as income derived from business in the UK. It was held that the rule did not tax the company's investment income as such but something different, described as "a conventional sum calculated in accordance with the rule"; the sum to be taxed was not interest, even though interest from FOTRA securities constituted one of the elements in the calculation.

The characterisation issue often arises in cases where indirect DTA exemption is sought (though it is not restricted just to such cases). Assuming the income in the hands of the treaty-resident recipient third party qualifies for DT relief, is the income which the UK taxpayer receives (or better, is deemed to receive) the *same* income? Or has the income "changed its character" (in which case DT reliefs do not apply)?

*IRC v Willoughby* offers an example. Here the transferor ("T") paid a premium to a life assurance company which was treaty-resident in the Isle of Man. Under s.720 T was (in principle) subject to tax on the income

13 *Bricom v IRC* 70 TC 270 at p.290. Nowadays the FOTRA exemption is restricted so as not to apply in this type of case.

14 28 TC 388 "as explained by Lord Radcliffe" in *Ostime v Australian Mutual Society* [1960] AC 459 at p.479, 38 TC 492.

arising to the life assurance company from the premium. The IOM DTA provided relief for the commercial profits of the life assurance company; but the income on which T was subject to tax could not be characterised as the commercial profits of the life assurance company; T's income was merely one (in the context of the whole, trivial) element by reference to which those profits were computed. So for this reason (there could be others) T could not claim indirect DTA exemption.[15]

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.*[16]

### 50.9.1 *The correct approach to characterisation*

Where income accrues to A, and a statutory provision provides that income is deemed to accrue to B, the provision may or may not change the character of the income, that is, B's income may or may not be a different type from A's income. It is a question of construction.

In straightforward cases, where B's deemed income is exactly equivalent to A's actual income, it is suggested that the courts should normally conclude that the legislation does not change the character of the income. That is, if there is a change in the character of the income, the legislation needs to say so directly or by implication. One reason that this is the case is that otherwise there would be a breach of the treaty. DTAs are not construed technically: if a DTA provides income is exempt, Parliament has power to breach the treaty and tax that income; it may do so expressly or by implication. But legislation changing the character of the income is as much a breach of the treaty as directly taxing the income. While the UK can deliberately breach a treaty, tax legislation should be construed consistently with a treaty where possible.

A second reason is that in a simple case where B's deemed income is

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15 Though this is not quite the way that the Special Commissioner dealt with the point: 70 TC 57 at p. 90. The taxpayer wisely did not appeal on the DTA issue.

16 *Bricom v IRC* 70 TC 272 at p.290..

exactly equivalent to A's actual income, there is no rational distinction to be drawn between A's income and B's equivalent income.

This is consistent with a purposive approach. Lord Steyn said:

> The tendency should therefore generally speaking be against literalism. What is literalism? It will depend on the context. But an example is given in The Works of William Paley... the tyrant Temures promised the garrison of Sebastia that no blood would be shed if they surrendered to him. They surrendered. He shed no blood. He buried them all alive. This is literalism. If possible it should be resisted in the interpretative process.[17]

It is worth stepping back to remember that the purpose of double tax treaties is to allocate taxing rights between countries.

### 50.9.2 *Bricom*

*Bricom v IRC* concerned a claim for indirect DT exemption where:

(1) Income accrued to a subsidiary company treaty-resident outside the UK.
(2) The parent company was domestic-law UK resident and not treaty-resident outside the UK.
(3) The parent company was in principle subject to tax under the Controlled Foreign Company ("CFC") provisions.

The CFC provisions operate in three stages:

> Stage 1. *Ascertainment:* the CFC's chargeable profits are ascertained .
> Stage 2. *Apportionment:* the CFC's chargeable profits (less any creditable tax) are apportioned among its shareholders. In *Bricom* the CFC was a wholly-owned by the taxpayer, so all its chargeable profits were attributed to the taxpayer.
> Stage 3. *Assessment:* The taxpayer is assessed on "a sum equal to corporation tax at the appropriate rate on that apportioned amount of profits" (less the apportioned amount of creditable tax) and the sum assessed is recoverable from the taxpayer "… as if it were an amount of

17 *Sirius International Insurance v FAI General Insurance* [2004] 1 WLR 3251 at [19]. But for a defence of Temures see Goldberg, "The Problem is the Perception" GITC Review Vol. 4 No. 2 accessible *www.taxbar.com* ("Of course, the garrison should have been advised by a lawyer before accepting the surrender terms.")

> corporation tax chargeable on the taxpayer".

The Special Commissioners held that interest received by the CFC lost its character as interest at stage 1. Millett LJ disagreed:

> It is ... a reflection of the Revenue's unsuccessful argument in *Hughes,* viz: that interest from exempt securities loses its character as income by being included in the computation of the recipient's trading profits.

So far so good. But the interest lost its character at stage 2:

> The correct analysis is that the interest received by Spinneys [the CFC] is not included in the sum apportioned to the taxpayer on which tax is chargeable. It merely provides a measure by which an element in a conventional or notional sum is calculated, and it is that conventional or notional sum which is apportioned to the taxpayer and on which tax is charged. ...

The CFC case was on the wrong side of the distinction because "the chargeable profits" as defined by s.747(6)(a) are *a notional sum.* Why are they more notional than the profits of any company?

> They do not represent any profits of Spinneys on which UK corporation tax is chargeable, for there are no such profits.

Obviously correct, but not relevant. The question is not whether the CFC income of the taxpayer represents profits of the CFC *on which UK corporation tax is chargeable*. The question is whether it represents the profits of the CFC (or more accurately, whether its type is the same as those profits). The judgment then turns to this:

> Nor do they represent any actual payments or receipts of Spinneys, whether of interest or anything else.

Why not?

> They are merely the product of a mathematical calculation made on a

> hypothetical basis and making counterfactual assumptions.[18] The "chargeable profits" which are defined by s.747(6)(a) exist only as a measure of imputation. What is apportioned to the taxpayer and subjected to tax is not Spinneys' actual profits but a notional sum which is the product of an artificial calculation.

The mere fact that taxable profits are ascertained by a mathematical calculation does not by itself change the character of the profits. The amount of profits on which corporation tax is charged is in every case the product of a mathematical calculation.

The decision in *Bricom* is authority for the following propositions:

(1) The application of DT reliefs requires that the income of the taxpayer is the same income as that which qualifies for relief. (This is right and could not be doubted.)
(2) The characterisation issue is a matter of construction of the relevant provisions.
(3) The CFC provisions did alter the character of the income received by the taxpayer. This decision does not, it is submitted, shed a great deal of light on the question of construction of the other provisions considered in this chapter.

One would like to think that the unfairness of *Bricom* was a factor in the ECJ decision that the CFC legislation was contrary to EU law.[19] That would have been just.

### 50.9.3 *Four types of deeming*

Tax provisions often use the word "deem" or its plain English equivalent, "treated as". When considering the characterisation issue in relation to deeming provisions, it is important to bear in mind that there are several different fictions that deeming provisions may be used to achieve:

(1) *Deeming as to recipient:* Statute may deem that whereas income actually arose to A, it is deemed to arise to B.
(2) *Deeming as to time:* Statute may deem that whereas income actually arose at one time, it is deemed to arise at another time.
(3) *Deeming as to quantum:* Statute may deem that whereas the amount

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18 Millett wisely does not state what the hypothetical and counterfactual assumptions are: one must assume that the CFC is UK resident.

19 See 51.3.3 (Public policy exemption).

of income which actually arose to A was £x, it is deemed to be of a different amount, £y.

(4) *Deeming as to character:*
   (a) Statute may deem that whereas income which actually arose was of type A, the taxpayer is deemed to receive income of another type (type B).
   (b) Statute may deem that whereas what arises is gains, it is deemed to be income.
   (c) Statute may deem that whereas no income or gains arise to anyone, the taxpayer is deemed to receive income or gains.

Case (1) does not by itself change the character of the income. This is (I think) self-evident, but there is authority:

> Exempt income does not change its character or lose its exemption merely because it is deemed to be the income of another person or is imputed to him: *Strathalmond.*[20]

The same applies if the UK provision apportions income to the taxpayer: "apportion" has the same meaning as "deems to accrue to" or "impute".[21] The term "attribute" is also the same.[22]

Likewise in cases (2) and (3) DT reliefs will still apply.

In case (4)(a) DT relief applicable to type A income only (not type B income) will not exempt the taxpayer. Cases (4)(b)(c) need further consideration.

So the mere fact that the legislation uses the terminology or technique of deeming does *not* mean that DT reliefs cease to apply. One must ask what is the deeming, and in particular, is it deeming as to the character of the income?

### 50.9.4 *"An amount equal to" the income*

In Bricom:

> The taxpayer lays stress on the fact that what is apportioned under

20 *Bricom v IRC* 70 TC 272 at p.290.
21 *Bricom v IRC* 70 TC 272 at p.290.
22 The terms "apportion" and "attribute" are used synonymously in s.13 TCGA; see 47.2 (Attribution of gains to participator).

> s.747(3) is not "a sum equal to the chargeable profits" but the chargeable profits themselves; and that the subject of the charge to tax in s.747(4)(a) is not "a sum equal to the apportioned part of the chargeable profits" but the apportioned part of the chargeable profits itself.

The distinction proposed is between the profits and an amount equal to the profits. The taxpayer (it seems) raised this distinction but it did not help. The characterisation of income may be altered even though the statute does not use the expression "an amount equal to". That is, the absence of that expression does not determine the characterisation issue. The issue is one of construction, and must be decided in the context of the provisions as a whole. Conversely, the use of the expression "an amount equal to" does not conclude the characterisation issue. While it is apt to describe a change of character, it does not necessarily do so. The entire provisions must be considered. I identify below some cases where this phrase is used without changing the character of the income. Indeed, a distinction between income and an amount equal to the income strikes me as a distinction without a difference, a foolish distinction to introduce into tax jurisprudence, which is bound to lead to confusion, muddle and uncertainty. This distinction is criticised in *Huitson*:

> [The DTA] issue has spawned a somewhat metaphysical debate as to whether the "notional" income under section 739 is different from the "real" income in the hands of the foreign resident, so that taxation of the "notional" does not conflict with relief of the "real".[23]

## 50.10 DT reliefs and gains of remittance basis taxpayer

After this lengthy theoretical discussion, we can turn to some practical questions. Section 12 TCGA provides:

> (1) This section applies to foreign chargeable gains accruing to an individual in a tax year ("the foreign chargeable gains") if—
> (a) section 809B, 809D or 809E of ITA 2007 (remittance basis) applies to the individual for that year, and
> (b) the individual is not domiciled in the UK in that year.
> (2) Chargeable gains are treated as accruing to the individual in any tax

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23 *R on the application of Huitson v HMRC* [2010] EWHC 97 (Admin) at [64].

> year in which any of the foreign chargeable gains are remitted to the UK.
> (3) The amount of chargeable gains treated as accruing is equal to the full amount of the foreign chargeable gains so remitted in that year.

Art.13(5) OECD Model Convention provides (with immaterial exceptions):

> Gains from the alienation of any property ... shall be taxable only in the Contracting State of which the alienator is a [treaty-resident].

Suppose:
(1) a remittance basis taxpayer is domestic-law UK resident and treaty-resident outside the UK.
(2) the taxpayer gains which are in principle subject to CGT.
Can the individual claim DT relief? This raises a characterisation issue. (The individual is not claiming indirect treaty relief but as noted, the characterisation point is not restricted to that.) However, everyone agrees that DT exemption applies to gains taxable on the remittance basis. Section 12(2) TCGA imposes a deeming as to time, that is, the gains which actually accrue on disposal are deemed to accrue when remitted. Section 12(3) imposes a deeming as to amount. The character of the gains is not altered. That is, the chargeable gains which are "treated as accruing" are the actual gains which accrued to the individual, and not different (notional) gains.

50.10.1 *Timing: interaction with remittance basis*

DT relief requires in principle that the alienator is treaty-resident outside the UK at the time the gain accrues.[24] What if the gain is a foreign gain of a remittance basis taxpayer? The gain is deemed to accrue at the time that the gain is remitted. If that deeming applies for DT purposes, then odd consequences would follow. In the following examples, assume that foreign gains accrue to a remittance basis taxpayer who is domestic-law UK resident throughout. Suppose two cases:
(1) The individual is not treaty-law resident outside the UK when the

24 *Smallwood v HMRC* [2009] STC 1222. This will need to be reviewed when the case is final.

gains accrue but is treaty-law resident when the gains are remitted.
(2) The individual is treaty-law resident outside the UK when the gains accrue but is not treaty-law resident when the gains are remitted.

If the timing rule applies for DT purposes, DT relief applies in case (1) and not in case (2). That is absurd. It would often lead to double taxation or double non-taxation. So it is considered that the timing rule does not apply for DT purposes, so DT relief can apply in case (2) but not in case (1).

## 50.11 DT reliefs: s.624 ITTOIA

This section considers the position of a settlor-interested trust whose settlor is domestic-law UK resident. There are four states potentially involved:

(1) the state where the settlor is resident (here assumed to be the UK)
(2) the state where the trustees are resident
(3) the state where a beneficiary is resident
(4) the state where the source of the income arises

Thus there are many ways s.624 could lead to double taxation. In addition to the settlor's UK tax liability under s.624:

(1) The trustees may be subject to foreign tax in another state
    (a) on income with a source in that state
    (b) on any income if they are resident in that state.
(2) In the case of an IP trust, the life tenant may be subject to foreign tax in another state
    (a) on income with a source in that state
    (b) on any income if they are resident in that state.

### 50.11.1 *Foreign tax credit relief*

Where trust income is subject to a foreign tax, foreign tax credit relief in principle applies for the benefit of a settlor within s.624. That follows from first principles but if authority were needed, see s.623 ITTOIA.[25]

The INT Manual considers the position where a beneficiary is taxed in the UK and a settlor is taxed in some other country under a foreign equivalent of s.624:

25 See 24.2.7 (Settlor's deductions and reliefs).

**161040. Same income** {January 2011]
The credit Article in an agreement and the corresponding provision for unilateral relief in s.9 TIOPA 2010 are concerned with relief from double taxation on income or gains. For credit to be allowed, it is not a requirement that the foreign tax on income or gains has to be borne by the same person who is liable to UK tax on the same income or gains. For example, if the foreign country taxes a settlor on the income of a UK resident beneficiary, who is chargeable to UK tax on that income, credit may be given to the beneficiary for the foreign tax paid by the settlor. However, it must be the same income which is being taxed in both countries. ...

50.11.2 *Trustees treaty-resident outside UK*

This section considers whether DT exemptions are available where:
(1) income accrues to a settlor-interested trust whose trustees are treaty-resident outside the UK.
(2) the settlor is domestic-law UK resident and not treaty-resident outside the UK.

The settlor is subject to tax under s.624. It is considered that the settlor can claim indirect DT exemption.

Section 619 and 624 ITTOIA must be read together:

**619(1)** Income tax is charged on ... (a) income which is treated as income of a settlor as a result of section 624 (income where settlor retains an interest) ...
**624(1)** Income which arises under a settlement is treated for income tax purposes as the income of the settlor and of the settlor alone...

Section 624 imposes a deeming as to the recipient, that is, the income which actually arises to the trustees is deemed to accrue to the settlor. The character of the income is not altered. That is, the income which is "treated as the income of the settlor" is the actual income of the trustees, and not different (notional) income.[26]

It follows that the settlor can in principle claim indirect DT exemption provided that the income is of a type which qualifies for DTA relief.

Why in fact is there a charge to tax under s.619? If the settlor is treated

26 See 50.8.1 (Can a third party claim a DT exemption?).

as receiving (say) interest income, the income would be chargeable to tax under the charging provisions relating to interest. No separate charge to tax is needed. The drafter is in my view slightly muddled as to whether the income of the settlor is the settlement income or notional income. The confusion is understandable, for it is not rational to try to draw a distinction between the two, they amount to exactly the same thing.

It might be argued that since the income is deemed to be the income of the settlor and of the settlor alone, it is deemed not to be the income of the trustees, so the deeming disapplies the DT exemption. But that construction would put the UK in breach of the treaty, so it should not be regarded as correct. In any case, in the HMRC view, s.624 is not a defence to trustees from an assessment.

### 50.11.3 *Settlor treaty-resident outside UK*

This section considers whether DT exemptions are available where:

(1) income accrues to a settlor-interested trust whose trustees are not treaty-resident outside the UK (so the settlor cannot claim indirect treaty relief).

(2) The settlor is domestic-law UK resident but treaty-resident outside the UK.

The settlor is in principle subject to tax under s.624. It is considered that the settlor can claim DT exemption directly.

In some cases, DT exemption only applies if the income is "beneficially owned" by the settlor. In the case of a common form settlor-interested discretionary trust, the income is not "beneficially owned" by the settlor as a matter of property law. But since for tax purposes it is deemed to be the income of the settlor, this requirement is deemed to be satisfied. The OECD Commentary is helpful here:

> 12 ... The term "beneficial owner" is not used in a narrow technical sense, rather, it should be understood in its context and in light of the object and purposes of the Convention, including avoiding double taxation and the prevention of fiscal evasion and avoidance.[27]

In the US/UK DTA, this is expressly dealt with: see 50.21.1 (Section 624, 720 income; s.13, 86 gains).

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27 See 22.12.2 (Discretionary trusts: beneficial owners for DTA purposes).

## 50.11.4 *HMRC view*

The TSE Manual provides:

> **3665. Relief for overseas tax: trust income deemed not to be the beneficiary's**
> For tax purposes, income may be deemed to be that of someone other than a beneficiary. For example, the anti-avoidance provisions may treat trust income as that of the settlor. The trustees can claim tax credit relief on the income.
> If the trustees do not claim relief, the overseas income chargeable is the net amount after deduction of overseas tax.

The International Manual raises some of these questions but does not tell us what HMRC regard as the answers:

> **339550 - DT applications and claims: Applicants/claimants - Trusts** [March 2007]
> **Claims by non-resident trustees of discretionary trusts**
> You may receive a claim or application from non-resident trustees of a discretionary trust. For specific information about claims by non-resident trustees see the country specific pages. If the trust's entitlement to claim is not clear from previous papers, you will need to ask for details of the trust to establish whether relief is due. The necessary information is requested on the form 4467(trustee)/FD.
> **What to do if the settlor of a discretionary trust is not excluded from benefit under the trust**
> Where the settlor of a non-resident discretionary trust is not excluded from benefit under the trust, the trust may be subject to the provisions of ICTA88/S660. In this situation the trust may be described as a 'caught settlement'. The settlor will be chargeable on the income of the trust as their own personal income, regardless of whether the income is accumulated or distributed.
> Where we have a claim or application from trustees of a discretionary trust from which the settlor is not excluded from benefiting, Technical Advice Group will need to refer the papers to CNR (Non-resident trusts) in Bootle for advice. They will also consider whether the settlor or the trustees need to make a UK tax return.
> If the settlement is caught, a claim by the trustees will not be valid.
> (This text has been withheld because of exemptions in the Freedom of Information Act 2000)

## 50.12 DT reliefs: section 720 ITA

### 50.12.1 *Foreign tax credit relief*

Where income of the person abroad is subject to foreign tax, foreign tax credit relief in principle applies for the benefit of the transferor. That follows from first principles but if authority were needed, see s.746 ITA.[28]

### 50.12.2 *Person abroad treaty-resident outside UK*

This section considers whether DT exemptions are available where:
(1) Income accrues to a person abroad who is treaty-resident outside the UK.
(2) The transferor is domestic-law ordinarily UK resident and not treaty-resident outside the UK.
(3) The transferor is in principle subject to tax under s.720.[29]
Under the pre-ITA wording, it is considered that the s.739 ICTA deemed income of the transferor was the same as the income of the person abroad.[30] It follows that the transferor could in principle claim DT exemptions provided that the income qualifies for the relief.[31]

What is the position now under ITA? Sections 720(2) and 721(1) ITA must be read together:

> **720(2)** Income tax is charged on income treated as arising to such an individual under section 721 (individuals with power to enjoy income as a result of relevant transactions).
> **721(1)** Income is *treated as arising* to such an individual as is mentioned in section 720(1) in a tax year for income tax purposes if

28 See 24.2.7 (Settlor's deductions and reliefs); 26.9.3 (Transferor's deductions and reliefs).

29 Similar points apply to s.727; see 26.11.1 (Nature of s.727 charge).

30 This was view for which *HMRC* argued, and which was accepted by the Special Commissioners, in *Carvill v IRC* [2000] STC (SCD) 143, 75 TC 477 at [100] - [102], cited at 25.14.1 (Dividend income of person abroad: net or grossed up?).

31 See the quote from 26.9.1 (Power to enjoy part of income of person abroad). David Goy QC agrees: "Double Tax Treaties and ss.739 and 740 ICTA 1988", GITC Vol. V no.2, accessible *www.taxbar.com*. See too Venables, "Double Taxation Treaties: the Antidote to Anti-avoidance Provisions" (1996) OTPR Vol. 6 p.151.
This view is adopted in *R on the application of Huitson v HMRC* [2010] EWHC 97 (Admin) at [64] though the position will need to be reviewed when the case is final.

conditions A and B are met.

I refer to income treated as arising under s.721 as "**s.720 deemed income**". The question is whether this is the same as the income of the person abroad.

At first sight the reference to income being *treated* as income of the transferor might be taken to suggest that the s.720 deemed income is different from the income of the person abroad. However this is not the case: the expression "treated as" is neutral, and the deeming may simply be a deeming as to recipient: that the transferor is (contrary to the actual position) treated as entitled to the actual income of the person abroad. The wording is the same as s.624 where that is indeed the position. One needs to review all the provisions to see if there is a deeming as to the character of the income.

HMRC have argued that the s.720 deemed income is *not* the same income as that arising to the person abroad, so treaty relief is in principle not available for s.720. The former provided:

> [1] The anti-avoidance provisions of [sections 720 and 731 ITA] go in that direction, but not far enough to get within the credit rule [foreign tax credit relief], either because
> [a] the income which is assessed on the UK resident cannot be identified with any particular part of the income which the non resident has received or
> [b] because the resident is charged by reference to a benefit received out of the assets rather than on the income itself.
> [2] We take the view that where the UK charge is made on deemed income or gains, such income or gains are not the same income or gains charged abroad.

The argument at [1][a] is not convincing because the s.720 deemed income can easily be identified with the particular part of the income of the person abroad which arises from as a result of the transfer. The argument at [1][b] relates only to s.731, considered below. The argument at [2] is based on the use of the word "deemed" in s.739 (or "treated" in s.720) and is clearly invalid.

I refer to this as the official HMRC view, but it appears that HMRC accept that their position is wrong, at least in relation to the pre-ITA legislation.[32]

It is necessary to look at the entire TAA code to see if the s.720 deemed income is the same as the income of the person abroad.

Rebecca Murray[33] refers to s.721 ITA which continues:

> (2) Condition A is that the individual has power in the tax year to enjoy *income of a person abroad* as a result of … a relevant transfer …
> (3) Condition B is that *the income* would be chargeable to income tax if it were the individual's and received by the individual in the UK.
> (4) For the purposes of subsection (2), it does not matter whether *the income* may be enjoyed immediately or only later.
> (5) It does not matter for the purposes of this section—
> (a) whether *the income* would be chargeable to income tax apart from section 720 …
> (Emphasis added)

She argues:

> ... s.721(5) ... appears to close the issue. If the income chargeable under s.720 were only an amount equal to income, it would be impossible to ask the question whether it would be chargeable apart from s.720, since it would just be an amount equal to income only chargeable by virtue of s.720. It must be the same income in order to ask this question.[34]

The references in s.721(2)(3)(4) and (5) are to the actual income of the person abroad, but this does not show that the reference to the s.720 deemed income is the same income.

The pre-2008 s.726 ITA (foreign domicile defence) is more helpful. This provided:

> *(1) An individual is not chargeable to income tax under section 720 in respect of any income treated as arising to the individual under section 721 if conditions A and B are met. ...*

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32 The author of "Technical Exchange" - Issue 63 of 31 July 2002 (a HMRC document) thought that it was "extremely unlikely" that HMRC could apply s.739 where the person abroad was treaty non-resident; see *R on the application of Huitson v HMRC* [2010] EWHC 97 (Admin) at [61]. The HMRC's "Technical Exchange" is not public; an interested person might try a FOI application to obtain it.

33 Murray, "Tax Avoidance: Transfers Abroad" Taxation 7 Jun 2007 p. 638.

34 *Taxation* Vol. 159, 7 June 2007 at p.640.

*(3) Condition B is that if the income had in fact been the individual's income, because of being so domiciled the individual would not have been chargeable to income tax in respect of it.*

This did seem to equate the income treated as arising with the actual income of the person abroad. However, the post-2008 s.726 does distinguish between the income of the person abroad and the deemed income:

(1) This section applies in relation to income treated under section 721 as arising to an individual in a tax year ("the deemed income") if—
(a) section 809B, 809D or 809E (remittance basis) applies to the individual for the year, and
(b) the individual is not domiciled in the UK in the year.
(2) For the purposes of this section the deemed income is "foreign" if (and to the extent that) the income mentioned in section 721(2) would be relevant foreign income if it were the individual's.
(3) Treat the foreign deemed income as relevant foreign income of the individual.

Section 726(3) is drafted on the assumption that the s.720 deemed income is different from the original income of the person abroad.

Does s.746 ITA (set out above) shed any light on the issue? This supports the argument that DT reliefs to apply to s.720 deemed income because if the income is different the deductions and reliefs would not apply. Section 743(4) ITA also assumes that the s.720 deemed income is the same as the income of the person abroad.

My conclusion is that under the former ICTA 1988 and under the pre-2008 ITA the deemed s.720 income is the same as the actual income of the person abroad. The 2008 reforms move one step towards separating the two types of income, based no doubt on the HMRC official (but in their own view mistaken) position of the pre-2008 legislation. The current legislation is for this reason confused and inconsistent on the issue of whether the income treated as arising to the transferor is the actual income of the person abroad or fictional income.

### 50.12.3 *Transferor treaty-resident outside UK*

This section considers whether DT reliefs are available where:
(1) income accrues to a person abroad who is not treaty-resident outside

the UK

(2) the transferor is domestic-law ordinarily resident in the UK but treaty-resident outside the UK

(3) the individual is in principle subject to tax under s.720.

As the person abroad is not treaty-resident outside the UK the transferor cannot claim indirect treaty relief. Can the transferor claim DT exemptions directly? If the official HMRC view is correct, the transferor may do so under the "other income" article, regardless of the type of income which accrued to the person abroad; even if, say, the income of the person abroad is of a type which would not normally qualify for DT exemption.[35] If my view is correct, the DT exemption is available if the type of income of the person abroad qualifies for the exemption.

In some cases DT exemption only applies if the income is "beneficially owned" by the transferor. The point is the same as for s.624.[36] In a s.720 case the income is not "beneficially owned" by the transferor as a matter of property law. But since for tax purposes it is deemed to be the income of the transferor, this requirement is deemed to be satisfied.

In the US/UK DTA, this is expressly dealt with: see 50.21.1 (Section 624, 720 income; s.13, 86 gains).

## 50.13 DT reliefs: s.731 ITA

### 50.13.1 *Person abroad treaty-resident outside UK*

This section considers whether DT reliefs are available where:

(1) income accrues to a person abroad who is treaty-resident outside the UK

(2) an individual (not the transferor) is domestic-law ordinarily resident in the UK and not treaty-resident outside the UK

(3) the individual is in principle subject to tax under s.731.

DT exemption is not applicable for s.731 ITA. ITA EN provides:

> 2170. The method statement [s.733 ITA 2007] makes it clear that "relevant income" in relation to an individual is not actually taxable income of the individual, but is an element in the calculation of taxable income. "Relevant income" is actual income arising to a person abroad;

35 See 50.13.2 (Individual treaty-resident outside UK).

36 See 50.11.3 (Settlor treaty-resident outside UK)

> the income charged under section 731 is income treated as arising to the individual in question. This deemed income may be more or less than "the relevant income of the tax year" in relation to the individual and the tax year identified at Step 3.

That was also the position under the pre-ITA wording. The former ITH passage cited above showed that HMRC took this view. Section 731 may be regarded as a charge on a benefit, or a charge on fictional income, but it is not a charge on the income arising to the person abroad.

There is no foreign tax credit relief. However, income used to pay foreign tax is not relevant income as it cannot be used to benefit a beneficiary.

### 50.13.2 *Individual treaty-resident outside UK*

This section considers whether DT reliefs are available where
(1) an individual (not the transferor) is domestic-law UK ordinarily resident and treaty-resident outside the UK
(3) the individual is in principle subject to tax under s.731.
Can the individual claim treaty relief directly? It is considered that exemption is available under OECD Model Convention Art.21(1) (other income):

> Items of income of a resident of a Contracting State, wherever arising, not dealt with in the foregoing Articles of this Convention shall be taxable only in that State.

Most UK treaties restrict this relief by adding: *other than income paid out of trusts or the estates of deceased persons in the course of administration*. That exclusion does not prevent relief for s.731 deemed income. It has an entirely different purpose.[37] S.731 deemed income is fictional income and not "paid out of trusts" even if relevant income accrues to a trust.

Some DTAs restrict this relief to income *beneficially owned* by a resident of a Contracting State.[38] That restriction does not prevent relief for s.731 deemed income for one of two reasons:
(1) As a matter of property law, s.731 deemed income is not

37 See 22.11.2 (DTAs with restriction on "other income" article).
38 Eg art.22 US/UK DTA.

"beneficially owned" by the individual or anyone else: it is fictional income which does not exist. But since for tax purposes it is deemed to be the income of the individual, this requirement is deemed to be satisfied.[39]

(2) Section 731 deemed income is "beneficially owned" by the individual because s.731 is a tax by reference to a benefit which is beneficially owned by the individual.[40]

Suppose s.731 deemed income arises where a beneficiary enjoys the benefit of occupying land in the UK. Article 6 OECD Model provides (so far as relevant):

> 1. Income derived by a resident of a Contracting State from immovable property ... situated in the other Contracting State may be taxed in that other State...
> 3. The provisions of paragraph 1 shall apply to income derived from the direct use, letting, or use in any other form of immovable property

It is considered that s.731 deemed income is not "income derived from immovable property" even if the charge is by reference to the occupation of UK land.

## 50.14 DT relief: s.13 TCGA

In the following discussion I distinguish between 3 types of company residence:

| **Type of residence** | **Domestic-law UK resident** | **Treaty-resident in State with DTA with CG article** |
|---|---|---|
| Treaty non-resident | No[41] | Yes |
| Simple non-resident | No | No |
| UK resident | Yes | No |

In this terminology, for instance, a Jersey resident company is *simple* non-resident (the Jersey DTA has no CG article) but a US resident company is *treaty* non-resident.

39 See 27.11.1 (Benefit giving rise to s.731 charge in year of receipt)

40 This point is the same as for s.624. See 50.11.3 (Settlor treaty-resident outside UK).

41 A treaty non-resident company must be domestic law non-UK resident so only three types of residence need to considered.

### 50.14.1 *Close company treaty non-resident*

Suppose an individual (or a company) owns a treaty non-resident company which realises a gain:

| | |
|---|---|
| Individual (or company) ("A") | *UK resident* |
| B Ltd | *Treaty non-resident* |

Section 13(2) TCGA provides that A:

> shall be treated for the purposes of this Act as if a part of the chargeable gain had accrued to him.

The sidenote to s.13 calls this "attribution" of gains. The text of s.13 refers to gains "apportioned" to participators. Section 13(10A) TCGA (repealed) used the words "treated as".[42] It all comes to the same thing. This is a deeming as to recipient, and the gain treated as received by A is the same gain as the gain received by B Ltd. A can claim DT relief for gains accruing to B Ltd (deemed to accrue to A) under s.13 TCGA.

HMRC agree. The CG Manual provides:

> **57380 Double taxation agreements**
> You should always check whether there is a double taxation agreement between the UK and the country in which the company making the gain is resident. If there is no double taxation agreement any TCGA 1992, s.13 charge is unaffected. Similarly if the agreement does not refer to capital gains or CGT the charge under TCGA 1992, s.13 is unaffected. But, if the agreement provides that gains of the type realised by the non-resident company are only taxable in that company's country of residence TCGA 1992, s.13 cannot apply. For example, Article 15(4) of the Kenya/UK Double Taxation Agreement[43] 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

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42 Section 13(10A) provided: *A gain which is treated as accruing to any person by virtue of this section shall not be eligible for taper relief.*

43 The Kenyan DTA follows the OECD Model, so what is stated here of Kenya is generally true for DTAs which have a capital gains article.

particular types of asset differently.[44]

The FA 2008 introduced new terminology. Section 14A(2) TCGA provides:

> The part of the chargeable gain treated as accruing to the individual *("the deemed chargeable gain")* is a foreign chargeable gain within the meaning of section 12 if (and only if) the asset is situated outside the UK.

This does not alter the DTA position: the use of the expression "deemed chargeable gain" does not show that the gain changes its character. The wording reflects the deeming as to recipient and in that sense the gain accruing to the participator can be called a deemed gain. The character of the gain is not altered. That is, the gain deemed to accrue to the participator is the actual gain accruing to the company, and not a different (notional) gain.

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44 Likewise INT Manual provides:

> **169060 Resident shareholders in non-resident companies - Section 13 TCGA 1992** [January 2011]
>
> This Section enables the UK, in certain circumstances, to tax a UK resident in respect of gains made by a non-resident company in which he is a shareholder (participator where the gains accrue on or after 28 November 1995 - Section 174 FA 1996)(see CG57200 onwards). However the Capital Gains Articles in double taxation agreements may override it.
>
> If the non-resident company disposes of immovable property; for example, land, buildings etc, in the UK, double taxation agreements normally provide that any gain can be taxed in UK. Although UK domestic law may prevent a capital gains tax charge on the non-resident company (see Section 10 TCGA 1992), Section 13 TCGA 1992 can be applied to tax the UK resident shareholder.
>
> If the asset disposed of is not immovable property in the UK; for example, immovable property situated outside the UK, shares etc, then the Capital Gains Article will normally prevent a charge to tax under Section 13 TCGA 1992 being made on the shareholder.
>
> The text of the Capital Gains Article in the agreement with the country concerned will need to be examined to see whether there are any variations from the general principles outlined above.
>
> See Statement of Practice D23, where liability arises under Section 13 TCGA 1992 and the non-resident company pays overseas tax on its gains in the country where it is resident.

The wording does perhaps suggest that the drafter was not conscious of the distinction between the actual gain and an equivalent notional gain, but that is understandable since it is a distinction without a difference.

50.14.2 *Participator treaty non-resident*

Suppose an individual who is domestic-law UK resident but treaty non-resident owns a simple non-resident company which realises a gain:

| | |
|---|---|
| Individual ("A") | *UK resident treaty non-resident* |
| B Ltd | *Simple non-resident* |

The gain treated as received by A is the same gain as the gain received by B Ltd. But art.13(5) OECD Model Convention provides (with immaterial exceptions):

> Gains from the alienation of any property ... shall be taxable only in the Contracting State of which the *alienator* is [treaty-resident].

It appears that A does not qualify for treaty relief on a gain accruing to B Ltd. A (though treaty non-resident) is not the alienator. B Ltd is the alienator but (on the facts of this example) B Ltd is not treaty resident in another state which confers DT reliefs. So the terms of art.13(5) are not satisfied. The US treaty is wider and DT exemption applies to individuals who are treaty-resident in the US.[45] Even under the OECD Model, the same result is arguable on the grounds that the gain is treated as accruing to A, so A should be deemed to be the alienator; or the word "alienator" does not require that one must alienate property, only that the gain on the alienation accrues to the person.

50.14.3 *Chain of companies*

Suppose there is a chain of companies:

45 See 50.21.1 (Section 624, 720 income; s.13, 86 gains).

Individual (or company) ("A") - *UK resident*

B Ltd

C Ltd

Suppose a gain accrues to C ("C's gain"). We have the following possibilities:

| | **Case 1** | **Case 2** | **Case 3** |
|---|---|---|---|
| B Ltd | UK resident | simple non-resident | treaty non-resident |
| C Ltd | treaty non-resident | treaty non-resident | simple non-resident |

*Case 1:* If B Ltd is UK resident, and C Ltd is treaty non-resident:

(1) C's gain is deemed to accrue to B Ltd; B Ltd may claim DT relief, as noted above.

(2) A does not need to claim relief, as
- (a) C's gain is not deemed to accrue to A under s.13(9) and
- (b) apparently C's gain is not deemed to accrue to A under s.13(2) (but if it did, DT relief would be available.)

*Case 2:* If B Ltd is simple non-resident and C Ltd is treaty non-resident, C's gain in principle accrues to A. Section 13(9) TCGA provides:

> [a] If a person who is a participator in the company at the time when the chargeable gain accrues to the company is itself a company which
> [i] is not resident in the UK but which
> [ii] would be a close company if it were resident in the UK,
> [b] [i] *an amount equal* to the amount apportioned under subsection (3) above out of the chargeable gain to the participating company's interest as a participator in the company to which the gain accrues
> [ii] shall be further apportioned among the participators in the participating company according to the extent of their respective interests as participators, and
> [c] subsection (2) above shall apply to them accordingly in relation to the amounts further apportioned,
> [d] and so on through any number of companies.

HMRC accept that A can claim DT relief. This is so even though s.13(9) refers to "an amount equal to" the gain. The words do not show there is a change in the character of the gain (though they do perhaps show some confusion on the point).

If C Ltd is simple non-resident, but B Ltd is treaty non-resident, C's gain is deemed to accrue to A, but A cannot claim DT relief.

### 50.14.4 *Disallowance of DT relief for trust participator*

Section 79B TCGA provides:

> (1) This section applies where the trustees of a settlement are participators[46]—
> (a) in a close company, or
> (b) in a company that is not resident in the UK but would be a close company if it were resident in the UK...
> (2) Where this section applies, nothing in any double taxation relief arrangements shall be read as preventing a charge to tax arising by virtue of the attribution to the trustees under s.13, by reason of their participation in the company mentioned in subsection (1) above, of any part of a chargeable gain accruing to a company that is not resident in the UK.

Suppose a UK trust owns a treaty non-resident company which realises a gain:

| | |
|---|---|
| Trust | *UK resident* |
| B Ltd | *Treaty non-resident* |

DT relief is disallowed under s.79B(1)(b) and the trustees are taxable.

Similarly if a non-resident trust within s.86 owns a treaty non-resident company which realises a gain: DT relief is disallowed under s.79B(1)(b) and the settlor is taxable.

In these circumstances the UK is in breach of the treaty, but there it is.

I am unable to see the point of s.79B(1)(a). If the trustees are participators in a *close* company, gains accrue to that company and are not

46 Section 79B(1) provides: "For this purpose 'participator' has the same meaning as in section 13".

attributed to the trustees. I would be grateful if any reader could offer an explanation.

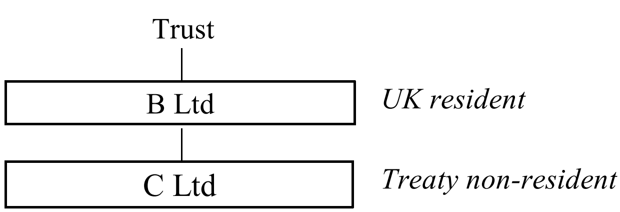
Section 79B(3) TCGA provides:

> Where this section applies and—
>
> (a) a chargeable gain accrues to a company that is not resident in the UK but would be a close company if it were resident in the UK, and
>
> (b) all or part of the chargeable gain is treated under section 13(2) as accruing to a close company which is not chargeable to corporation tax in respect of the gain by reason of double taxation arrangements, and
>
> (c) had the company mentioned in para (b) (and any other relevant[47] company) not been resident in the UK, all or part of the chargeable gain would have been attributed to the trustees by reason of their participation in the company mentioned in subsection (1) above,
>
> section 13(9) shall apply as if the company mentioned in para (b) above (and any other relevant company) were not resident in the UK.

Section 79B(3) addresses the more challenging case where:

(1) a trust owns a holding company ("B Ltd") which is UK resident;

(2) B holds a treaty non-resident subsidiary ("C Ltd"):




B Ltd is not taxed under s.13 on C's gain as B can claim DT relief. In the absence of s.79B(3), C's gain apparently cannot be apportioned to the trust under s.13(9) or s.13(2). The trust does not need DT relief. Section 79B(3) treats B Ltd as non-resident, so that the gain accruing to C can be attributed to the trust under s.13(9).

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47 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."

## 50.15 oreign tax credit: s.13 TCGA

SP D23 provides:

**Non-resident company: TCGA 1992 s 13**

[1] Where a UK participator in a non-resident company which would be a close company if resident in the UK is chargeable to CGT on a proportion of a capital gain accruing to that company, tax credit relief may be given against UK CGT for the appropriate proportion of any overseas tax payable by the company in the country where it is resident in respect of its gain TCGA 1992 s 277;

[2] alternatively, under TCGA 1992 s 278, the appropriate proportion of the overseas tax may be deductible in computing the shareholder's gains to the extent that the overseas tax has not qualified for relief under TCGA 1992 s 277.

This relates to two reliefs:
(1) Foreign tax credits
(2) CGT computation deduction
The CG Manual summarises these two reliefs and gives a worked example:

**57381. Overseas tax payable by NR SP D23**
The non-resident company may have to pay tax on the gain in its country of residence. UK residents to whom the gain is apportioned will get relief for this tax. The two methods of giving relief are set out in SP D23.

- Either the UK resident can claim tax credit relief, see CG57382 or
- a proportionate part of the tax can be claimed in computing the apportioned gain, see CG57383.

**57382. Tax credit relief**
The UK resident can claim tax credit relief under TCGA 1992, s.277. Relief is given on a proportion of the foreign tax equal to the proportion of the total gain attributable to the UK resident. This amount is set-off against the charge to CGT or Corporation Tax on the relevant chargeable gains. See the example at CG57384. If tax credit relief is allowed no deduction under TCGA 1992, s.278 can be allowed in computing the chargeable gain. See CG57383.

**57383. Tax deducted in computing gain**
If the UK resident does not want to claim tax credit relief, the tax can be

deducted in computing the gain, TCGA 1992, s.278. The foreign tax paid does not qualify for indexation allowance. Although it is an allowable deduction in computing the gain it is not a deduction within TCGA 1992, s.38(1)(a) or TCGA 1992, s.38(1)(b). This means it is not relevant allowable expenditure for indexation allowance purposes, see CG17240. In all other respects you compute and apportion the gain in the usual way allowing the foreign tax paid as a deduction. See the example in CG57384. For further guidance on TCGA 1992, s.278 see CG14410+.

The Manual gives a worked example:

**57384. Foreign tax paid by a NR company**
This example illustrates the differences between allowing any foreign tax paid by the non-resident company as tax credit relief or as a deduction in computing the gain.
Facts

- The non-resident company realises a gain of £20,000 computed under the normal CGT rules.
- It has to pay £5,000 tax on this gain in its country of residence.
- 75 % of the gain is attributable to a UK resident.

**CGT treatment**
A TCGA 1992, s.13 [gain][48] of £20,000 @ 75 % = £15,000 is apportioned to the UK resident. Relief for the tax paid can be claimed in two ways.
- TAX CREDIT RELIEF, SEE CG57382.
Suppose the UK resident is liable to CGT at 40 %. The tax payable would be £6,000. The UK resident can claim tax credit relief on the foreign tax of £5,000 paid by the company in the same proportion as the gain is apportioned. £5,000 @ 75 % = £3,750. The total tax payable by the UK resident becomes £2,250.
- DEDUCTION IN COMPUTING THE GAIN, SEE CG57383.
The foreign tax paid of £5,000 can be deducted in computing the gain. No indexation allowance is due on this deduction. The gain to be apportioned becomes £20,000 –£5,000 = £15,000. The taxpayer's share is £15,000 @ 75 % = £11,250. At a rate of 40 % the tax payable would be £11,250 @ 40 % = £4,500.
In this example you would expect the taxpayer to claim tax credit relief.

48 The original erroneously says: charge.

## 50.16 DT reliefs: offshore income gains

### 50.16.1 *OIGs accruing directly to treaty-resident individual*

Suppose an individual who is UK resident and treaty-resident outside the UK disposes of offshore funds so that OIGs accrue directly to them.

Article 13(5) OECD Model Convention provides (with immaterial exceptions):

> Gains from the alienation of any property ... shall be taxable only in the Contracting State of which the alienator is a [treaty-resident].

Article 21(1) OECD Model Convention provides:

> Items of income of a resident of a Contracting State, wherever arising, not dealt with in the foregoing Articles of this Convention shall be taxable only in that State.

It is an interesting question whether the individual claims relief under Art.13 or Art.21. At first sight OIGs are "gains" which arise from the alienation of property, even though not chargeable gains and even though subject to income tax rather than CGT. But OIGs are also "income" if that word is given its normal UK tax meaning. Of course it does not normally matter which of the articles apply, if the treaty has both. But if a particular treaty has an equivalent of art.21 (other income) but no capital gains article, then it is considered that treaty relief is still in principle available.

### 50.16.2 *s.13 OIGs: close company treaty-resident outside UK*

Suppose OIGs accrue to a company which is treaty-resident outside the UK and so are deemed to accrue to a UK resident participator under s.13 TCGA. In principle, DT reliefs apply to OIGs deemed to accrue under OIG s.13 just as they do for chargeable gains deemed to accrue under CGT s.13.[49]

I have considered reg. 24(6) OFTR which provides:

> If this regulation applies, the person to whom the offshore income gain

49 For this terminology, see 32.13 (OIG s.13 charge).

arises is treated as the person making the disposal.

This does not disapply treaty relief, either because it has no application for the purposes of the treaty or because (while deeming the participator to be the disponor) it does not say that the non-resident company is not the alienator.[50]

### 50.16.3 *s.13 OIGs: participator treaty-resident outside UK*

In the case of CGT s.13 gains, the participator has a difficulty in obtaining relief under a CG article, in that they are not at first sight the "alienator". See 50.14.2 (Participator treaty non-resident). However it is considered that the other income article provides relief, in the case of OIGs. If the capital gains article is in point, it is arguable that reg. 24(6) OFTR deems the participator to be the alienator.

### 50.16.4 *s.87 OIGs: beneficiary treaty-resident outside UK*

In the case of CGT s.87 gains, the beneficiary has a difficulty in obtaining relief, in that they are not at first sight the "alienator" and the gain is not "from the alienation of any property". See 50.19.2 (Beneficiary treaty-resident outside the UK). However in the case of OIGs it is considered that the other income article provides relief. If the capital gains article were in point, it is arguable that reg.20(5) OFTR deems the beneficiary to be the alienator but the problem remains that the gain is not "from the alienation of any property".

## 50.17 DT reliefs: s.86 TCGA

### 50.17.1 *Trustees treaty-resident outside UK*

Assume the fundamental conditions in s.86(1) TCGA are satisfied. Section 86(4) TCGA provides:

> Where this section applies—
> (a) chargeable gains of an amount equal to that referred to in subsection (1)(e) above shall be treated as accruing to the settlor in

50 For the reason for this provision, see 32.12.4 (Deemed disposal).

the year ...

The HMRC view is the fact that the trustees are resident in another state with standard form DTA CGT relief does not allow the settlor to claim relief from s.86. HMRC raise two arguments in the manuals. The first is a categorisation, *Brikom*-type argument. The CG Manual provides:

> **38313 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 [TCGA] Schedule 5.

I think this argument is very doubtful. However HMRC have a better argument, at which the CG Manual provides a hint. The Manual first explains why DTA relief applied to the former s.77 TCGA when trustees were treaty-resident in a state with a CGT DTA article

> **34912. Double taxation relief** [August 2007]
> A settlor may be able to claim exemption [from s.77 TCGA] on some or all of the attributed trust gains, but this depends on the terms of the particular double taxation agreement. The gain which is chargeable on the settlor is not the same as the gain which accrues to the trustees. Therefore Articles which exempt trustees from UK tax on gains accruing on the disposal of particular property do not necessarily operate to exempt the settlor from liability under Section 77. However section 77(1)(b) requires there to be an amount on which the trustees would have been chargeable for the year in respect of the gains in question. So if the correct interpretation of the Double Taxation Agreement by reference to the relevant acts is that the trustees would be exempt if they were chargeable then there is no liability.[51]

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51 Section 77(1) TCGA (now repealed) provided, so far as relevant:
(1) Where in a year of assessment—
(a) chargeable gains accrue to the trustees of a settlement from the disposal of any or all of the settled property,
(b) after making any deduction provided for by section 2(2) in respect of disposals of the settled property there remains an amount on which the trustees would be

This argument does not run for s.86 because the legislation is differently worded:

> This is by way of contrast with section 86 where there is a hypothesis in subsections (1)(e)(i) and (3) that the trustees are in fact resident in determining whether the section applies and therefore one cannot take into account the actual non-residence. Compare *Bricom Holdings v CIR* 70 TC 272.

The point is that s.86(3) envisages a charge in a case where trustees are dual resident in the sense of being domestic-law UK resident but treaty-resident outside the UK. In that case the treaty is intended to be overridden. By implication the same should apply where the trustees are treaty-resident outside the UK and not UK resident at all.

HMRC accept that foreign tax credit relief is available. The CG Manual provides:

> **38313 Double taxation relief**
> ... 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.

### 50.17.2 *Settlor treaty-resident outside UK*

Suppose the settlor is domestic-law UK resident but treaty-resident outside the UK. Can the settlor claim direct relief? The point is the same as for s.13 gains. Art.13(5) OECD Model Convention provides (with immaterial exceptions):

> Gains from the alienation of any property ... shall be taxable only in the

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chargeable to tax for the year in respect of those gains ... , and
(c) at any time during the year the settlor has an interest in the settlement,
[i] the trustees shall not be chargeable to tax in respect of those gains but
[ii] instead chargeable gains of an amount equal to that referred to in para (b) shall be treated as accruing to the settlor in that year.

Contracting State of which the *alienator* is [treaty-resident].

It appears that the settlor does not qualify for treaty relief because (though treaty non-resident) the settlor is not the alienator. The trustees are the alienator but (on the facts of this example) the trustees are not treaty non-resident. So the terms of art.13(5) are not satisfied. The US treaty is wider and DT exemption applies to a settlor who is treaty-resident in the US.[52] Even under the OECD model, the same result is arguable on the grounds that the gain is treated as accruing to the settlor, they should be deemed to be the alienator; or the word "alienator" does not require that one must alienate property, only that the gain on the alienation accrues to the person.

### 50.17.3 *Trust owns company which is treaty-resident outside UK*

If a non-resident trust within s.86 owns a treaty non-resident company which realises a gain DT relief is disallowed and the settlor is taxable; see 50.14.4 (Disallowance of DT relief for trust participator).

## 50.18 Restriction on DTR for gains of trustees and settlors

It is easiest to understand the legislation if one bears in mind the tax avoidance schemes it was intended to block. Suppose a non-resident settlor-interested trust within s.86 TCGA. The trustees would take two steps:

(1) arrange to dispose of an asset at a time when they are treaty-resident in another state with a DTA with a CGT article and

(2) become UK resident later in the same tax year.

In the absence of anti-avoidance rule, this works as s.86 does not apply and the trustees (although with the charge to CGT) claimed DTR.[53]
This arrangement is counteracted by s.83A TCGA.

> (1) This section applies if a chargeable gain accrues to the trustees of a

52 See 50.21.1 (Section 624, 720 income; s.13, 86 gains).

53 The reader may have considered a similar arrangement where the non-resident trust was not within s.86 but is within s.87. In the absence of an anti-avoidance provision, the same steps would be taken in order to avoid a s.2(2) amount. But this is caught by s.88 TCGA; see 45.17 (Dual resident trust)

> 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[54] in that year of assessment, but
> (b) are non-UK resident at the time of the disposal.

The expression "non-UK resident" in (b) is defined in s.83A(4) TCGA:

> For the purposes of this section the trustees of a settlement are non-UK resident at a particular time if, at that time,—
> (a) they are neither resident nor ordinarily resident in the UK, or
> (b) they are resident or ordinarily resident in the UK but are Treaty non-resident.

This is a slightly artificial definition, but it is difficult to think of a better label.

If these conditions are satisfied, s.83A(2) TCGA overrides DT 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.

EN FA 2005 explains the words in brackets:

> 4. Subsection (2) of section 83A has effect to provide that where section 83A applies, nothing in the terms of any Double Taxation Agreement (DTA) can be read as preventing the trustees being chargeable to capital gains tax, or of preventing a charge to tax arising (whether on the trustees or another person), by virtue of the accrual of the gain.
> 5. The reason for the reference to "another person" in paragraph 4 above is that, in certain circumstances where the trustees of a settlement are within the charge to capital gains tax in a tax year, the rules in section 77 TCGA provide that the trustees do not actually suffer a tax charge in respect of chargeable gains which arise to them on the disposal of settled

54 Section 83A(3) gives this expression a commonsense definition:

"(3) For the purposes of this section the trustees of a settlement are within the charge to capital gains tax in a year of assessment—
(a) if, during any part of that year of assessment, they are resident and ordinarily resident in the UK and not Treaty non-resident".

> property which originates from a UK resident or ordinarily resident settlor who has an interest in the settlement at any time in the year. Chargeable gains are instead treated as arising to the settlor, who is then chargeable to tax in respect of them.

Now that s.77 has been repealed, the words in brackets in s.83A(2) should be repealed, as they can never apply, but they do not do any harm. Section 83A is still needed in order to deal with the s.86 scheme.

Section 83A is somewhat wider than it needed to be in order to deal with these two schemes, and considerable care is needed where trustees become or cease to be treaty non-resident, but in practice difficulties are fairly rare.

## 50.19 DT reliefs: s.87 TCGA

### 50.19.1 *Trustees treaty-resident outside UK*

This section considers whether DT reliefs are available where:

(1) Gains accrue to a trust which is treaty-resident outside the UK.

(2) A UK resident beneficiary receives a benefit so a s.87 deemed gain accrues to them.

The DTA offers no defence to the charge on the beneficiary. The gain accruing to trustees meets the requirements for DTR but the s.87 deemed gain accruing to the beneficiary under s.87 TCGA is not the same gain as the gain accruing to the trustees. Section 87 may be regarded as a charge on the capital payment or a charge on fictional gains but it is not a charge on the gains accruing to the trustees.

This has always been a potential cause of injustice, but since the extension of s.87 to foreign domiciliaries in 2008 it has become a major cause of injustice, indeed a national embarrassment.

### 50.19.2 *Beneficiary treaty-resident outside UK*

Suppose now the beneficiary is UK resident but treaty-resident outside the UK, in another state with a DTA with a common form CGT article. Can the beneficiary claim treaty relief directly? Art.13(5) OECD Model Convention provides (with immaterial exceptions):

> Gains from the alienation of any property ... shall be taxable only in the Contracting State of which the alienator is a [treaty-resident].

It is suggested that the beneficiary cannot claim DT relief because:
(1) The beneficiary is not the alienator.[55]
(2) The gain is not "from the alienation of any property".
However, a CGT computation deduction is available so foreign tax paid by the trustee is deducted in computing the s.2(2) amount. This is because:
(1) The s.2(2) amount is the amount on which trustees would have been chargeable to tax if UK resident; and
(2) UK resident trustees would qualify for a CGT computation deduction, which reduces the amount on which trustees would be chargeable to tax.

## 50.20 US/UK DTA

The US/UK DTA follows the US model which differs significantly from the OECD model. A full discussion would require a book to itself.

For the US/UK DTA definition of treaty residence, see 5.17 (US/UK treaty).

### 50.20.1 *US/UK DTA: savings clause*

Article 1(4) US/UK DTA provides:

> Notwithstanding any provision of this Convention except paragraph 5 of this Article, a Contracting State may tax its residents (as determined under Article 4 (Residence), and by reason of citizenship may tax its citizens, as if this Convention had not come into effect.

This is called **"the savings clause"**.

So subject to the art 1(5) exceptions:
(1) US may tax US citizens and US treaty-residents ignoring treaty relief.
(2) UK may tax UK treaty-residents ignoring treaty-relief.
On the other hand, UK must allow treaty relief to US treaty-residents, and US must allow relief to UK treaty-residents who are not US citizens.

The US Department of the Treasury Technical Explanation of the

55 See 50.14.2 (Participator treaty non-resident).

Convention[56] provides:

> Paragraph 4 contains the traditional saving clause found in U.S. tax treaties. The Contracting States reserve their rights, except as provided in paragraph 5, to tax their residents and citizens as provided in their internal laws, notwithstanding any provisions of the Convention to the contrary. For example, if a resident of the UK performs professional services in the United States and the income from the services is not attributable to a permanent establishment in the United States, Article 7 (Business Profits) would by its terms prevent the United States from taxing the income. If, however, the resident of the UK is also a citizen of the United States, the saving clause permits the United States to include the remuneration in the worldwide income of the citizen and subject it to tax under the normal Code rules (i.e., without regard to Code section 894(a)). However, subparagraph 5(a) of this Article preserves the benefits of special foreign tax credit rules applicable to the U.S. taxation of certain U.S. income of its citizens resident in the UK. See paragraph 6 of Article 24 (Relief from Double Taxation).
>
> For purposes of the saving clause, "residence" is determined under Article 4 (Residence). Thus, an individual who is a U.S. resident under the Internal Revenue Code but who is deemed to be a resident of the UK under the tie-breaker rules of Article 4 would be subject to U.S. tax only to the extent permitted by the Convention. For example, if an individual who is not a U.S. citizen is a resident of the United States under the Code, and is also a resident of the UK under its law, and that individual has a permanent home available to him in the UK and not in the United States, he would be treated as a resident of the UK under Article 4 and for purposes of the saving clause. The United States would not be permitted to apply its statutory rules to that person if they are inconsistent with the treaty.[57]

56 Accessible *www.treasury.gov/resource-center/tax-policy/treaties/Documents/teus-uk.pdf*

57 The treaty continues with a comment that UK treaty-residence does not preclude US domestic-law residence, a point only relevant to the US (though a comparable rule applies in the UK): " However, the person would be treated as a U.S. resident for U.S. tax purposes other than determining the individual's U.S. tax liability. For example, in determining under Code section 957 whether a foreign corporation is a controlled foreign corporation, shares in that corporation held by the individual would be considered to be held by a U.S. resident. As a result, other U.S. citizens or residents might be deemed to be United States shareholders of a controlled foreign corporation subject to current inclusion of Subpart F income recognized by the corporation. See Treas. Reg. section 301.7701(b)-7(a)(3). The application of the

### 50.20.2 *Article 1(5) exceptions*

The list of exceptions in art 1(5) is quite limited:

> The provisions of paragraph 4 of this Article shall not affect—
> (a) the benefits conferred by a Contracting State under
> [i] paragraph 2 of Article 9 (Associated Enterprises),
> [ii] sub-paragraph (b) of paragraph 1 and paragraphs 3 and 5 of Article 17 (Pensions, Social Security, Annuities, Alimony, and Child Support),
> [iii] paragraphs 1 and 5 of Article 18 (Pension Schemes) and
> [iv] Articles 24 (Relief From Double Taxation),
> [v] [Art] 25 (Non-discrimination), and
> [vi] [Art] 26 (Mutual Agreement Procedure) of this Convention; ...

The US Department of the Treasury Technical Explanation of the Convention[58] provides:

> Some provisions are intended to provide benefits to citizens and residents even if such benefits do not exist under internal law. Paragraph 5 sets forth certain exceptions to the saving clause that preserve these benefits for citizens and residents of the Contracting States.
> Subparagraph (a) lists certain provisions of the Convention that are applicable to all citizens and residents of a Contracting State, despite the general saving clause rule of paragraph 4:
> (1) Paragraph 2 of Article 9 (Associated Enterprises) grants the right to a correlative adjustment with respect to income tax due on profits reallocated under Article 9.
> (2) Subparagraph 1(b) and paragraphs 3 and 5 of Article 17 (Pensions, Social Security, Annuities, Alimony, and Child Support) provide exemptions from source or residence State taxation for certain pension distributions, social security payments and child support.
> (3) Paragraph 1 of Article 18 (Pension Scheme) provides an exemption for certain investment income of pension schemes located in the other State, while paragraph 5 provides benefits for certain contributions by

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saving clause to former citizens and long-term residents is addressed not in paragraph 4 but in paragraph 6."

58 Accessible *www.treasury.gov/resource-center/tax-policy/treaties/Documents/teus-uk.pdf*

> or on behalf of a U.S. citizen to certain pension schemes established in the UK.
> (4) Article 24 (Relief from Double Taxation) confirms the benefit of a credit to citizens and residents of one Contracting State for income taxes paid to the other, even if such a credit may not be available under the Code.
> (5) Article 25 (Non-Discrimination) requires one Contracting State to grant national treatment to nationals of the other Contracting State in certain circumstances. Excepting this Article from the saving clause requires, for example, that the United States give such benefits to a national of the UK even if that person is a citizen of the United States.
> (6) Article 26 (Mutual Agreement Procedure) may confer benefits on residents or nationals of the Contracting States. For example, the statute of limitations may be waived for refunds and the competent authorities are permitted to use a definition of a term that differs from the internal law definition. As with the foreign tax credit, these benefits are intended to be granted by a Contracting State to its citizens and residents.

The list of exceptions in art 1(5) continues:

> The provisions of paragraph 4 of this Article shall not affect ...
> (b) the benefits conferred by a Contracting State under
> [i] paragraph 2 of Article 18 (Pension Schemes) and
> [ii] Articles 19 (Government Service),
> [iii] Art 20 (Students),
> [iv] Art 20A (Teachers), and
> [v] Art 28 (Diplomatic Agents and Consular Officers)
> of this Convention, upon individuals who are neither citizens of, nor have been admitted for permanent residence in, that State.

The US Department of the Treasury Technical Explanation of the Convention[59] provides:

> Subparagraph (b) of paragraph 5 provides a different set of exceptions to the saving clause. The benefits referred to are all intended to be granted to temporary residents of a Contracting State (for example, in the case of the United States, holders of non-immigrant visas), but not to citizens or to persons who have acquired permanent residence in that

59 Accessible
*www.treasury.gov/resource-center/tax-policy/treaties/Documents/teus-uk.pdf*

> State. If beneficiaries of these provisions travel from one of the Contracting States to the other, and remain in the other long enough to become residents under its internal law, but do not acquire permanent residence status (i.e., in the U.S. context, they do not become "green card" holders) and are not citizens of that State, the host State will continue to grant these benefits even if they conflict with statutory rules. The benefits preserved by this paragraph are: the host country exemptions for the following items: government service salaries and pensions under Article 19 (Government Service); certain income of visiting students, trainees, teachers, professors, and researchers under Articles 20 (Students) and 20A (Teachers); the income of diplomatic agents and consular officers under Article 28 (Diplomatic Agents and Consular Officers); and the beneficial tax treatment of pension fund contributions under paragraph 2 of Article 18 (Pension Schemes).

Green card holders are at a disadvantage compared to US citizens since they pay US taxes but do not have the same benefits under the treaty. HMRC say:

> HMRC explained that the UK was not obliged to give credit where the US taxed a green card holder on a world wide basis and the taxpayer was not tax resident in the US, but where we see a recharge to the US for US workdays we will accept the US has the primary taxing rights in the same way as for US citizens and we will give credit for the US tax paid on those US workdays by green cardholders. In the US a green card holder is debarred from claiming relief under a treaty. HMRC suggested that an individual who is taxed in the US on their world wide income because he retains his green card and so is treated as a resident of the US for the purposes of Article 1(4) even though they would be treaty resident in the UK may not have taken all reasonable steps to minimise their US liability, as required by s.795A ICTA if he were to qualify for credit relief. As such, although strictly Article 24(6) may not apply to green card holders in these circumstances, the effect of the minimisation requirement is that the UK will limit relief given in the UK under the treaty to that which would be given if Article 24(6) did apply. Representatives pointed out that giving up the green card might trigger expatriation taxes in the US.
>
> The HMRC position is that we will not give relief in the UK for tax paid in the US as a result of Article 1(4). We believe that the US will give unilateral relief for the UK tax paid on their income at least to the extent it arises in the UK so as far as we know this should not lead to double taxation although it could lead to higher tax payable in the US as a result

of the alternative minimum tax provisions.[60]

## 50.21 US/UK DTA: fiscally transparent bodies

Article 1(8) of the US/UK DTA provides:

> An item of income, profit or gain derived through a person that is fiscally transparent under the laws of either Contracting State shall be considered to be derived by a resident of a Contracting State to the extent that the item is treated for the purposes of the taxation law of such Contracting State as the income, profit or gain of a resident.

It is essential to have in mind which state is which; the paragraph is easier to follow if it is expanded to read:

> An item of income./gain derived through a person that is fiscally transparent under the laws of either Contracting State shall be considered
> [i] to be derived by a resident of the UK to the extent that the item is treated for the purposes of the taxation law of the UK as the income/gain of a resident of the UK and
> [i] to be derived by a resident of the US to the extent that the item is treated for the purposes of the taxation law of the US as the income/gain of a resident of the US.

This is not in the OECD Model Treaty but it is in the US Model Income Tax Convention from 1996 and is now standard in US treaties.

If both the UK and the USA regard an entity as transparent (eg a partnership) then this provision is not needed, for (say) partnership income would in any event be regarded as income of the partners. The provision is needed for a hybrid entity, ie an entity which is regarded as transparent in one state but not in the other. The IRS explain:[61]

> Paragraph 8 addresses special issues presented by fiscally transparent entities such as partnerships and certain estates and trusts. In general, paragraph 8 relates to entities that are not subject to tax at the entity level, as distinct from entities that are subject to tax, but with respect to

60 Accessible at http://www.hmrc.gov.uk/consultations/expat-mins-160409.htm

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

> which tax may be relieved under an integrated system. This paragraph applies to any resident of a Contracting State who is entitled to income derived through an entity that is treated as fiscally transparent under the laws of either Contracting State. Entities falling under this description in the United States include partnerships, common investment trusts under section 584 and grantor trusts. This paragraph also applies to US limited liability companies ("LLCs") that are treated as partnerships for US tax purposes.
> Under paragraph 8, an item of income, profit or gain derived by such a fiscally transparent entity will be considered to be derived by a resident of a Contracting State if a resident is treated under the taxation laws of that State as deriving the item of income.

The IRS give some examples:

> [1] For example, if a UK company pays interest to an entity that is treated as fiscally transparent for US tax purposes, the interest will be considered derived by a resident of the US only to the extent that the taxation laws of the United States treats one or more US residents (whose status as US residents is determined, for this purpose, under US tax law) as deriving the interest for US tax purposes. In the case of a partnership, the persons who are, under US tax laws, treated as partners of the entity would normally be the persons whom the US tax laws would treat as deriving the interest income through the partnership.
> [2] Also, it follows that persons whom the United States treats as partners but who are not US residents for US tax purposes may not claim a benefit for the interest paid to the entity under the Convention, because they are not residents of the United States for purposes of claiming this treaty benefit. (If, however, the country in which they are treated as resident for tax purposes, as determined under the laws of that country, has an income tax convention with the UK, they may be entitled to claim a benefit under that convention.)
> [3] In contrast, if, for example, an entity is organized under US laws and is classified as a corporation for US tax purposes, interest paid by a UK company to the US entity will be considered derived by a resident of the United States since the US corporation is treated under US taxation laws as a resident of the United States and as deriving the income.
> [4] The same result obtains even if the entity were viewed differently under the tax laws of the UK (e.g., as not fiscally transparent in the first example above where the entity is treated as a partnership for US tax purposes). Similarly, the characterization of the entity in a third country is also irrelevant, even if the entity is organized in that third country. The

results follow regardless of whether the entity is disregarded as a separate entity under the laws of one jurisdiction but not the other, such as a single owner entity that is viewed as a branch for US tax purposes and as a corporation for UK tax purposes. These results also obtain regardless of where the entity is organized (i.e., in the United States, in the UK, or, as noted above, in a third country).
[5] For example, income from US sources received by an entity organized under the laws of the United States, which is treated for UK tax purposes as a corporation and is owned by a UK shareholder who is a UK resident for UK tax purposes, is not considered derived by the shareholder of that corporation even if, under the tax laws of the United States, the entity is treated as fiscally transparent. Rather, for purposes of the treaty, the income is treated as derived by the US entity.
[6] These principles also apply to trusts to the extent that they are fiscally transparent in either Contracting State. For example, if X, a resident of the UK, creates a revocable trust in the United States and names persons resident in a third country as the beneficiaries of the trust, X would be treated under US law as the beneficial owner of income derived from the United States. In that case, the trust's income would be regarded as being derived by a resident of the UK only to the extent that the laws of the UK treat X as deriving the income for UK tax purposes by application of the UK "settlor trust" rules.

An Exchange of Notes between the Governments of the UK and USA discusses the relation of of para 1(8) (transparency) and para 1(4) (savings clause):

*With reference to paragraph 8 of Article 1 (General scope)—*
[1] it is understood that where an item of income, profit or gain is derived through a person which is a resident of a Contracting State the provisions of the paragraph shall not prevent that Contracting State from taxing the item as the income, profit or gain of that person.

The IRS continue:[62]

[7] Paragraph 8 is not an exception to the saving clause of paragraph 4.[63] Accordingly, the notes confirm that paragraph 8 does not prevent a

62 US Department of the Treasury Technical Explanation of the Convention, accessible *www.treasury.gov/resource-center/tax-policy/treaties/Documents/teus-uk.pdf*
63 See 50.20.1 (US/UK DTA: Savings clause).

Contracting State from taxing an entity that is treated as a resident of that State under its tax law. For example, if a US LLC with UK members elects to be taxed as a corporation for US tax purposes, the United States will tax that LLC on its worldwide income on a net basis, without regard to whether the UK views the LLC as fiscally transparent. The portion of the notes relating to Article 24 (Relief from Double Taxation) provides rules for determining which Contracting State has the primary right to tax and which State must provide a credit in such circumstances.

I do not find this easy to follow, but think one can draw out 6 examples from the 7 paragraphs of the IRS explanation (my numbering):

| | **Entity** | | | | | | **resid. of person with interest in ent'y** | | | **For DT, item derived by:** | | **IRS para** |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| *eg no.* | *Transparent* | | | *Resid, (if opaque)* | | *example* | *UK* | *US* | *3rd state* | *person* | *entity* | |
| | in UK | in US | 3rd state | in US | | | | | | | | |
| 1 | n/r | y | n/r | | | p'ship | | y | | y | | [1],[4] |
| 2 | n/r | y | n/r | | | | | | y | n | | [2],]4] |
| 3 | n/r | n | n/r | y | | corp'n | | | | | | [3],[4][64] |
| 4 | n | | | | | corp'n | y | | | n | y | [5] |
| 5 | y[65] | | | | | revoc. trust | y | | | y[66] | | [6] |
| 6 | n[67] | | n/r | | | revoc. trust | y | | | n[68] | n/r | [6] |

The Exchange of Notes continues:

[2] It is further understood that, where, by virtue of [para 1(8)],
[a] an item of income, profit or gain is considered by a Contracting State to be derived by a person who is a resident of that Contracting State, and
[b] the same item is considered by the other Contracting State to be

64 US will tax corporation under savings clause.
65 So far as s.624 applies.
66 So far as s.624 applies.
67 So far as s.624 applies.
68 So far as s.624 applies.

> derived [by that person or][69] by a person who is a resident of that other Contracting State,
>
> the paragraph shall not prevent either Contracting State from taxing the item as the income, profit or gain of the person considered by that State to have derived the item of income, profit or gain.

It is essential to have in mind which state is which; the paragraph is easier to follow if it is expanded to read:

> It is further understood that, where, by virtue of para 1(8),
> [a] an income/gain is considered by the UK to be derived by a person who is a resident of the UK, and
> [b] the same item is considered by the US to be derived by that person or by a person who is a resident of the US,
> the paragraph shall not prevent
> [i] the UK from taxing the item as the income/gain of the person considered by the UK to have derived the item;
> [ii] the US from taxing the item as the income/gain of the person considered by the US to have derived the item.

50.21.1 *Section 624, 720 income; s.13, 86 gains*

The Exchange of Notes continues:

> [3] It is further understood that, in applying [para 1(8)], the UK shall, exceptionally, regard an item of income, profit or gain arising to a person as falling within the paragraph where another person is charged to UK tax in respect of that item of income, profit or gain—
> (a) under [what is now s.624 ITTOIA & s.720 ITA]; or
> (b) under section [77][70] or 86, TCGA 1992.
> [4] It is further understood that, in applying the paragraph, a person shall be regarded as fiscally transparent under the laws of the UK in relation to an item of income, profit or gain where a charge is made on another person on that item either—
> (a) by virtue of section 13, TCGA 1992; or
> (b) because that other person has (or, under [what is now s.464 ITA[71]],

69 I do not understand the words in brackets and would be grateful to any reader who could explain.

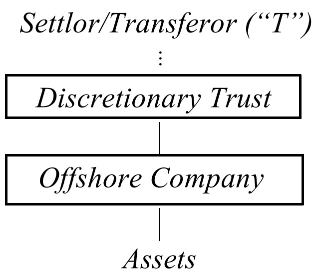
70 [Author's note. Section 77 is now repealed.]

71 See 23.1.4 (Scots trusts).

is treated as having) an equitable right in possession in a trust.

Thus trusts within s.624 and companies within s.720 are regarded as fiscally transparent for IT; trusts within s.86 and companies within s.13 are regarded as fiscally transparent for CGT.

Take a standard structure:




Suppose:

(1) T is domestic-law ordinarily UK resident but treaty-resident in the US.

(2) The entities are transparent for US tax so T regarded for US purposes as receiving OC's income.

(3) S.720 applies so T is taxed for UK tax purposes on OC's income

This is a straightforward case within example 1 of my table. For US/UK treaty purposes, T is treated as receiving OC's income.

### 50.21.2 *Relationship to art.24 (foreign tax credit )*

The Exchange of Notes continues:

> *With reference to Article 24 (Relief from double taxation)—*
> it is understood that, under paragraph 4 or 8 of Article 1 (General scope), the provisions of the Convention may permit the Contracting State of which a person is a resident (or, in the case of the United States, a citizen), to tax an item of income, profit or gain derived through another person (the entity) which is fiscally transparent under the laws of either Contracting State, and may permit the other Contracting State to tax
> (a) the same person;
> (b) the entity; or
> (c) a third person
> with respect to that item. Under such circumstances, the tax paid or accrued by the entity shall be treated as if it were paid or accrued by the first-mentioned person for the purposes of determining the relief from

> double taxation to be allowed by the State of which that first-mentioned person is a resident (or, in the case of the United States, a citizen), except that, in the case of an item of income from real property to which paragraph 1 of Article 6 (Income from real property) of the Convention applies, or a gain from the alienation of real property to which paragraph 1 of Article 13 (Gains) applies, the tax paid or accrued by the person who is a resident of the Contracting State in which the real property is situated shall be treated as if it were paid or accrued by the person who is a resident of the other Contracting State.
> In the case where the same item of income, profit or gain derived through a trust is treated by each Contracting State as derived by different persons resident in either State, and
> (a) the person taxed by one State is the settlor or grantor of a trust; and
> (b) the person taxed by the other State is a beneficiary of that trust,
> the tax paid or accrued by the beneficiary shall be treated as if it were paid or accrued by the settlor or grantor for the purposes of determining the relief from double taxation to be allowed by the State of which that settlor or grantor is a resident (or, in the case of the United States, a citizen), except that, in the case of an item of income from real property to which paragraph 1 of Article 6 (Income from real property) of the Convention applies, or a gain from the alienation of real property to which paragraph 1 of Article 13 (Gains) applies, the tax paid or accrued by the person who is a resident of the Contracting State in which the real property is situated shall be treated as if it were paid or accrued by the person who is a resident of the other Contracting State.
> It is further understood that paragraphs 2 and 5 of Article 24 shall apply to such an item of income, profit or gain to the extent necessary to provide relief from double taxation.

### 50.21.3 *US partnerships and LLCs*

In the Double tax guidance note 3: Partnerships and LLCs claiming relief under the 2002 UK/USA DTC, HMRC say:

> **How the DTC treats US partnerships and LLCs**
> [HMRC set out Art.1(8) of the DTC and continue:] A transparent concern itself is therefore not given the right to found a claim for relief.

The reason that a transparent entity does not claim DT relief is that it is not "liable to tax" in a state which regards it as transparent, and so is not treaty-resident in that Contracting State.[72]

> Instead, that right is given individually to those 'qualifying persons' defined by the General Definitions Article [4][73]; and as further qualified by the Limitation on Benefits Article [23][74], who have derived their beneficial entitlement to income, profit or gain through their participation in the transparent concern.[75]

The text throughout erroneously refers to "qualifying persons;" the correct expression is *qualified* persons. HMRC continue with a concession:

> **What this would mean for partners and LLC members**
> Strictly speaking, HMRC should accept claims only from those partners and members who themselves fall to be regarded as 'qualifying persons' in their own right.
> In practice, this would mean as many separate claims for one item of UK-source income paid to a transparent concern such as a partnership or LLC[76] as there are beneficial owners to whom it is then being paid on or distributed.
> HMRC recognises that applying the DTC provisions in such a literal way would be unwelcome to its customers and could possibly hamper the business interests of both countries. It would be a retrograde step in customer service terms, and would not be justified on either an assessment of risk to the UK Exchequer or on compliance grounds. HMRC wants to keep a proper balance between the ease with which US residents should be able to claim relief with the administrative procedures and paperwork that must be employed by the UK Revenue to verify and give effect to such a claim.
> **HMRC's approach to partnerships and LLCs**
> Accordingly, HMRC intends to continue its previous practice of taking claims in the names of both partnerships and LLCs.
> These concerns should use the form US/Company 2002, and should provide (as before) a list of the names and addresses of the partners or members, with details of their respective shares of income. This is covered by the second bullet of the form's own Guidance Note 2.
> This form is tailored for use by the majority of those non-individual businesses and concerns which are covered by detailed provisions of the DTC - most notably by the Limitations on Benefit Article 23, which lays down very specific

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72 See 5.13 (Treaty Residence: Partnerships).
73 The original erroneously refers to article 3.
74 The original erroneously refers to article 27.
75 HMRC add: "It will be noted that this is not so very different from the situation that obtained under Article 4(1)(b)(i) of the 'old' 1980 DTC." I am not sure about that, but the point does not now arise.
76 The manual is considering a LLC which is transparent under US law.

tests for defining the 'qualified persons' who can benefit under the treaty. There is therefore no separate section for transparent concerns such as partnerships or LLCs.

**What partnerships and LLCs are asked to do**

HMRC Residency ask partnerships and LLCs to complete the US/Company 2002 as follows

* Parts A and B in full
* Part C in full, as appropriate
* Part D if repayment of UK tax is claimed
* Part E if appropriate
* Part F in full, with the general or managing partner/member signing the declaration
* With the additional details as requested in the US-Company 2002 Notes, which is part of the claim form.

Claimants are also free to attach any statement or schedule in support of the claim, as they believe would help explain their circumstances or the basis of the claim.

**What HMRC will do**

HMRC will consider the replies to all the above, and the information supplied. Consistent with previous practice, where the facts allow the reasonable conclusion that all beneficial owners of the income for whose shares relief is being claimed are 'qualifying persons' within the meaning of the DTC, then HMRC will process things in the normal way. This will more often than not involve a reference to the tax office for the UK payer, under normal internal liaison arrangements.

If the information given in with the claim form does not allow this conclusion, considering in particular the tests set out in Article 23, HMRC will probably have to contact claimants with further specific questions and requests for information before it can consider finalising processing of things.

HMRC do not want to add to the time taken to resolve matters. Where possible, it will start processing the claim, on a 'without prejudice' basis and pending satisfactory conclusion of any correspondence.

HMRC will be as quick as possible, with due consideration for customers' business needs, and with sympathy and understanding for any compliance difficulties that the process might cause them.

As with any claim, letting HMRC have an advance copy of the form US/Company 2002 (at the time it is submitted to the IRS for certification) may allow it to flag up any points of difficulty at an early stage, and opens up the possibility of anticipating what is needed or might be done before the certified form arrives.

No doubt some high level lobbying has taken place. In relation to claims for relief from deduction at source, HMRC say (inconsistently) that they adopt a strict approach.[77]

## 50.22 "Subject to tax"

Some treaties provide exemption for income which is "subject to tax". So far as the issue concerns foreign tax it would ultimately be decided by foreign tax authorities and courts, but the HMRC view may well represent an international consensus. So it is relevant to note that INT Manual provides:

> **162020. 'Subject to tax'** [January 2011]
> The terms of some agreements provide that a resident of the UK will be entitled to exemption or relief from the foreign tax on certain types of income only if he is subject to tax on that income in the UK.
> A person is regarded as subject to tax if, for example ...
> e) the remittance basis applies (see RDRM30005 onwards): he is subject to tax only on the sums remitted.

Similarly, in the context of the lower-paid employee exemption, the RDR Manual provides:

> **32070 - Remittance Basis: Accessing the remittance basis: Claiming the remittance basis: Calculation of income tax liability - exemption for non-domiciles with small amounts of foreign employment income**
> ...*Subject to Foreign Tax*
> Although 'subject to a foreign tax' might in some circumstances mean that the individual has actually paid some tax on the foreign income to a foreign tax authority, actual payment is not a necessary requirement to take advantage of this exemption.
> For example, given the levels of foreign income involved there might be nothing due to be paid on part or all of the income, as a result perhaps of a foreign countries' own personal allowances systems, or similar tax provisions which are akin to such allowances, such as a tax rate band of 0 per cent. Such income would still be considered to be 'subject to a foreign tax' in the context of this exemption.

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77 See 17.10.3 (Relief when borrower is a partnership).

CHAPTER FIFTY ONE

# EU LAW AND UK TAXATION

## 51.1 EU law and UK taxation – Introduction

This chapter considers the effect of EU law on UK tax law and in particular whether three anti-avoidance provisions are consistent with EU law:

(1) s.13 TCGA
(2) s.720 ITA
(3) s.86 TCGA

A full discussion would require a book to itself, but it would never be up to date because of constant new case law, and almost everything in this chapter will need review when the cases discussed here become final.

In this chapter I refer to a company established in another Member State as a "**MS company**".

It may be helpful to set out the former and present article numbers in a table:[1]

| Subject | EC Treaty | TFEU | EEA agreement |
|---|---|---|---|
| Freedom of establishment | 43 | 49 | 31 |
| - public policy exception | 45 | 51 | 32 |
| - for companies | 48 | 54 | 34 |
| Free movement of capital | 73b | 63 | 40 |
| - justification | 73d | 65 | |

See too 7.9 (EU restriction on exit taxes).

For further discussion, see Mullen and Harriet, *The Application of EU*

1 For a complete table, see A Comparative Table of the Current EC and EU Treaties as Amended by the Treaty of Lisbon, Cm7311, accessible *www.official-documents.gov.uk/document/cm73/7311/7311.pdf*.

*Law to UK Direct Taxes* (forthcoming 2011).

### 51.1.1 *Relationship of EU law and UK law*

There is a "tension, if not an inconsistency between national jurisdiction over direct taxation and EC Treaty freedoms, at least once those freedoms are interpreted as prohibiting unjustified differential tax treatment of national and foreign EU companies."[2]

In the legal battle EU law will prevail. The primacy of EU law over UK domestic law hardly needs to be stated, but to begin at the beginning: in *Thoburn v Sunderland City Council*, Laws LJ stated the fundamental proposition:

> All the specific rights and obligations which EU law creates are by the 1972 Act[3] incorporated into our domestic law and rank supreme: that is, anything in our substantive law inconsistent with any of these rights and obligations is abrogated or must be modified to avoid the inconsistency. This is true even where the inconsistent municipal provision is contained in primary legislation.[4]

The ECJ put it this way:

> although direct taxation falls within the competence of the Member States, the latter must none the less exercise that competence consistently with Community law.[5]

### 51.1.2 *Nature of ECJ case law*

ECJ case law is unlike case law in common law jurisdictions such as the UK.[6] The ECJ gives one short, single judgment. This contains a set of

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2 *Thin Cap Claimants v HMRC* [2011] STC 738 at [7].

3 The reference is to s.2 European Communities Act 1972 which provides:
"All such rights, powers, liabilities, obligations and restrictions from time to time created or arising by or under the Treaties, and all such remedies and procedures from time to time provided for by or under the Treaties, as in accordance with the Treaties are without further enactment to be given legal effect or used in the UK shall be recognised and available in law, and be enforced, allowed and followed accordingly."

4 [2003] QB 151 at [69].

5 *Stauffer* at [15].

6 In this respect Scotland is like a common law jurisdiction.

short, broad propositions repeated verbatim from earlier cases.[7] There is little detailed consideration of earlier cases. There is little consideration of the precise words of the EU treaties. The language of the treaties is of course different from UK statutory drafting, and typically contains vague evaluative terms which give the ECJ freedom to develop its own principles. Decisions are based on policy considerations, to a far greater extent than is the case, or at least than is expressed to be the case, in the common law. Because the judgment is translated into English, the prose is unidiomatic and sometimes contains errors of translation.

## 51.2 EC infringement proceedings

The European Commission has formally requested the UK to amend two anti-avoidance rules: the TAA provisions and s.13 TCGA. The requests take the form of Reasoned Opinions (the second step of the infringement procedure (Art.258 TFEU). In the absence of a satisfactory response the Commission may refer the UK to the ECJ.

The text of the request is not published, but its content is not hard to guess. An EC press release provides the essential details. The first point relates to s.720 ITA:

> The first infringement relates to the UK's "transfer of assets abroad" legislation. Under this legislation, if a UK resident individual invests in a company by transferring assets to it, and if this company is incorporated and managed in another Member State, then the investor is subject to tax on the income generated by the company to which he/she contributed the assets. However, if the same individual invested the same assets in a UK company, only the company itself would be liable for tax.

The second point relates to s.13 TCGA:

> The second infringement relates to the attribution gains to member of non-UK resident companies regime. Under this legislation, if a UK-resident company acquires more than a 10% share of a company in another Member State, and the latter company realises capital gains from the sale of an asset, the gains are immediately attributed to the UK

7 A large number of cases are then cited for the propositions. I do not set out the cases in the quotations in this book as they can be found by referring back to the original case.

company, which becomes liable for corporation tax on these capital gains. If, on the other hand, the UK company had invested in another UK resident company, only the latter would be taxable on its capital gains.

The EC analysis is as follows:

> In both cases, the Commission considers there to be discrimination, seeing as investments outside the UK are taxed more heavily than domestic investments. The difference in tax treatment between domestic and cross-border transactions restricts two fundamental principles of the EU's Single Market, namely of the freedom of establishment and the free movement of capital contrary to Articles 49 and 63 TFEU and Articles 31 and 40 of the EEA Agreement.
> The Commission is of the opinion that both restrictions are disproportionate, in the sense that they go beyond what is reasonably necessary in order to prevent abuse or tax avoidance and any other requirements of public interest.[8]

The invalidity of these important anti-avoidance rules ought to be a matter of considerable public concern. It should not however be a matter of surprise, since practitioners have taken this view for some years, and the CIOT have publically lobbied the European Commission to take this step.[9]

Where the EU defence is in point taxpayers should not pay the tax, and where they have paid tax in the past they should now put in repayment claims.

## 51.3 Freedom of establishment

Article 49 TFEU provides:

> [1] 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.

### 51.3.1 *What is "establishment"?*

Article 49 TFEU continues:

8 IP/11/158, 16 February 2011.

9 Letters from CIOT to EC dated 6 Feb 2009 (s.720) and 10 Feb 2009 (s.13).

> [2] 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.
> [3] Freedom of establishment shall include
> [a] the right to take up and pursue activities as self-employed persons and
> [b] to set up and manage undertakings, in particular companies or firms within the meaning of the second paragraph of Article 48,
> under the conditions laid down for its own nationals by the law of the country where such establishment is effected, subject to the provisions of the chapter relating to capital.

In *Stauffer*[10] an Italian charity (tax exempt in Italy) received rent from property in Germany. German law allowed charity tax exemption only for charities established in Germany. Accordingly the German authorities sought to impose German tax on the rental income.

The ECJ held that there was no breach of freedom of establishment:

> 18 According to the case-law of the Court, the concept of establishment within the meaning of the Treaty is a very broad one, allowing a Community national to participate, on a stable and continuous basis, in the economic life of a Member State other than his State of origin and to profit therefrom, so contributing to economic and social interpenetration within the Community in the sphere of activities as self-employed persons.[11]
> 19 However, in order for the provisions relating to freedom of establishment to apply, it is generally necessary to have secured a permanent presence in the host Member State and, where immovable property is purchased and held, that property should be actively managed. It is clear from the account provided by the national court that the foundation does not have any premises in Germany for the purposes of pursuing its activities and that the services ancillary to the letting of the property are provided by a German property management agent.
> 20. It must therefore be concluded that the provisions governing freedom of establishment are not applicable in circumstances such as those in the dispute in the main proceedings.

10 *Centro di Musicologia Walter Stauffer v Finanzamt München für Körperschaften* [2008] STC 1439.

11 The ECJ referred to case law not set out here.

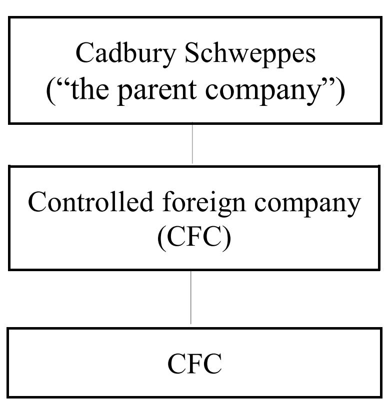
The charity did not have or seek to have an "establishment" in Germany: it did not carry out any charitable work in Germany and did not actively manage its German investment property. Had it wanted to, it could no doubt have done so.

While the premiss seems correct, the conclusion that FoE is not applicable is far from self-evident. There was a restriction of Stauffer's freedom to establish itself *outside* Germany. Because the foundation was established in Italy, it incurred a German tax burden which would not have been paid if it had been established in Germany. However the argument was not put on this basis and the ECJ did not consider it.

Suppose the foundation had had an establishment in Germany - for instance if it ran a college there or provided services to its tenant rather than using a German property management agent. In that case it would have had an establishment in Germany. Assuming Germany would have denied the charity exemption, would it then have succeeded under this head? Since it succeeded under free movement of capital, the point seems somewhat academic.

### 51.3.2 *What is a restriction on freedom of establishment?*

*Cadbury Schweppes v IRC* [2006] STC 1908 concerned this corporate structure:




The ECJ summarised the CFC legislation thus:

> 44 Where the resident company has incorporated a CFC in a Member State in which it is subject to a lower level of taxation within the meaning of the legislation on CFCs, the profits made by such a

> controlled company are, pursuant to that legislation, attributed to the resident company, which is taxed on those profits. Where, on the other hand, the controlled company has been incorporated and taxed
> [1] in the UK or
> [2] in a State in which it is not subject to a lower level of taxation within the meaning of that legislation,
> the latter is not applicable and, under the UK legislation on corporation tax, the resident company is not, in such circumstances, taxed on the profits of the controlled company.

It is not self-evident that the CFC legislation restricted the parent company's FoE, but the ECJ held that it did:

> 45 That difference in treatment creates a tax disadvantage for the resident company to which the legislation on CFCs is applicable. Even taking into account ... the fact ... that such a resident company does not pay, on the profits of a CFC within the scope of application of that legislation, more tax than that which would have been payable on those profits if they had been made by a subsidiary established in the UK, the fact remains that under such legislation the resident company is taxed on profits of another legal person. That is not the case for a resident company with
> [1] a subsidiary taxed in the UK or
> [2] a subsidiary established outside that Member State which is not subject to a lower level of taxation.
> 46 ... the separate tax treatment under the legislation on CFCs and the resulting disadvantage for resident companies which have a subsidiary subject, in another Member State, to a lower level of taxation are such as to hinder the exercise of freedom of establishment by such companies, dissuading them from establishing, acquiring or maintaining a subsidiary in a Member State in which the latter is subject to such a level of taxation. They therefore constitute a restriction on freedom of establishment within the meaning of Articles [49 & 54 TFEU].

The CFC rules only applied to companies in some member states, namely, those subject to a lower level of taxation (as defined). Because of this selective operation the CFC rules clearly restricted FoE, since given the choice in siting a subsidiary in:
(1) a MS with a lower level of taxation or
(2) a MS with a higher level of taxation (but less than the UK)
one would in principle prefer to choose the latter. But the point made at

44[1] and 45[1] shows that the CFC rules would restrict freedom of establishment even if they applied to every MS, regardless of the level of taxation just because they did not apply to a UK subsidiary. At first sight that seems surprising. But the income of the CFC is subject to foreign tax as well as UK tax. Although UK tax allows a credit for the foreign tax, the burden of dealing with two tax systems is a significant one.[12] This may be a deterrent against a UK parent establishing a CFC in any other MS.

### 51.3.3 *Who is entitled to claim freedom of establishment?*

Article 49 prohibits restrictions on the freedom of establishment of "nationals of a Member State" ie establishment of non-nationals may be restricted.

Article 54 TFEU extends the right to companies and firms:

> [1] 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.

Article 54 goes on to define "companies or firms":

> "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.

### 51.3.4 *Public policy exemption*

Article 52 TFEU provides an exception for public policy:

> The provisions of this Chapter and measures taken in pursuance thereof shall not prejudice the applicability of provisions laid down by law, regulation or administrative action providing for special treatment for foreign nationals on grounds of public policy, public security or public health.

12 DTA relief was (unfairly) denied: see 50.9.2 (*Bricom*).

### 51.3.5 *Abuse and justification compared*

In *Cadbury Schweppes* the ECJ considered separately (1) whether there was abuse of EU law and (2) whether the CFC legislation was justified. I would have thought that the two questions were linked, for provisions to prevent abuse would necessarily be justified.

Perhaps the distinction is:

(1) in cases of abuse, the EU law defence fails (even if UK provisions are unlawful in EU law);

(2) in the absence of abuse, the EU law defence succeeds (assuming the UK's provisions are contrary to EU law).

### 51.3.6 *Abuse*

*Cadbury Schweppes* dealt with abuse quite shortly:

> 35 It is true that nationals of a Member State cannot attempt, under cover of the rights created by the Treaty, improperly to circumvent their national legislation. They must not improperly or fraudulently take advantage of provisions of Community law.[13]

Here of course everything depends on the meaning of the elastic term "improperly". ("Fraudulently" adds nothing since anything which is fraudulent must also be improper.)

> 37 As to freedom of establishment, the Court has already held that the fact that the company was established in a Member State for the purpose of benefiting from more favourable legislation does not in itself suffice to constitute abuse of that freedom ...[14]
> 38 ... it follows that the fact that in this case Cadbury Schweppes decided to establish [its CFCs] in [Ireland] for the avowed purpose of benefiting from the favourable tax regime which that establishment enjoys does not in itself constitute abuse.

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13 The ECJ refers to Case 115/78 *Knoors* [1979] ECR 399, para 25; Case C-61/89 *Bouchoucha* [1990] ECR I-3551, para 14; and Case C-212/97 *Centros* [1999] ECR I-1459, para 24.

14 The ECJ refers to *Cadbury Schweppes at* [27], and Case C-167/01 *Inspire Art* [2003] ECR I-10155, para 96.

We do not know what abuse is, but we know what it is not, and if this is not abuse then use of a MS company for tax avoidance is never an abuse.

### 51.3.7 *Justification*

The ECJ next considered whether there was a justification for the CFC legislation:

> 55 ... in order for a restriction on the freedom of establishment to be justified on the ground of prevention of abusive practices, the specific objective of such a restriction must be to prevent
> [1] conduct involving the creation of wholly artificial arrangements which do not reflect economic reality,
> [2] with a view to escaping the tax normally due on the profits generated by activities carried out on national territory.

There are two requirements for justification: [1] is a conduct requirement and [2] is an intention requirement. Both must be present but the conduct requirement is the more important because if there are "wholly artificial arrangements which do not reflect reality" then the intention requirement is likely to be satisfied. "Artificial" is of course vague.[15] What is the conduct requirement?

> ... objective circumstances showing that, despite formal observance of the conditions laid down by Community law, the objective pursued by freedom of establishment, as set out in paras 54 and 55 of this judgment, has not been achieved.[16]

When is the objective of FoE not achieved?

> 65 In those circumstances, in order for the legislation on CFCs to comply with Community law, the taxation provided for by that legislation must be excluded where, despite the existence of tax motives, the incorporation of a CFC reflects economic reality.

What is economic reality?

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15 See 29.17.2 (Artificial transactions and devices).

16 The ECJ refers to Case C-110/99 *Emsland-Stärke* [2000] ECR I-11569, paras 52 and 53, and Case C-255/02 *Halifax and Others* [2006] ECR I-0000, paras 74 and 75.

> 66 That incorporation must correspond with an actual establishment intended to carry on genuine economic activities in the host Member State, as is apparent from the case-law recalled in paras 52 to 54 of this judgment.

The expression "genuine economic activities" does not take us much further.

> 67 ... that finding must be based on objective factors which are ascertainable by third parties with regard, in particular, to the extent to which the CFC physically exists in terms of premises, staff and equipment.
> 68 If checking those factors leads to the finding that the CFC is a fictitious establishment not carrying out any genuine economic activity in the territory of the host Member State, the creation of that CFC must be regarded as having the characteristics of a wholly artificial arrangement. That could be so in particular in the case of a "letterbox" or "front" subsidiary.[17]

The metaphors of "letterbox" and "front" and the epithet "fictitious" and "artificial" are conclusions rather than indications or useful tests of what is "economic reality". The use of the words "genuine", "reality" and "artificial" is normally a sign of intellectual desperation. The ECJ offers a comment on "artificial":

> 69 On the other hand, as pointed out by the Advocate General in point 103 of his Opinion, the fact that the activities which correspond to the profits of the CFC could just as well have been carried out by a company established in the territory of the Member State in which the resident company is established does not warrant the conclusion that there is a wholly artificial arrangement.

On the other hand, "premises, staff and equipment" are easily understood. The question is: how large a premises, how many staff and how much equipment is needed?

My conclusion is that what constitutes "genuine economic activities" is

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17 The ECJ refers to Case C-341/04 *Eurofood* IFSC [2006] ECR I-0000, paras 34 and 35).

still at present a fairly open question.[18] The answer should become clearer when the *Cadbury Schweppes* litigation is complete.

## 51.4 Free movement of capital

Article 63 TFEU provides:

> 1. Within the framework of the provisions set out in this Chapter, all restrictions on the movement of capital between Member States and between Member States and third countries shall be prohibited.
> 2. Within the framework of the provisions set out in this Chapter, all restrictions on payments between Member States and between Member States and third countries shall be prohibited.

### 51.4.1 *Meaning of "movement of capital"*

The TFEU does not define "movement of capital" or "payments between member states". In practice the ECJ has regard to the list in directive

18 For HMRC views see "Taxation of the foreign profits of companies: a discussion document" (June 2007) accessible *www.hm-treasury.gov.uk/consult_foreign_profits.htm*:

"In *Cadbury Schweppes,* the ECJ confirmed that there is a legitimate role for CFC rules under the Treaty, so long as the rules do not tax the profits of genuine economic activities in overseas subsidiaries.
The Government considers that, in making this judgment, the Court intended to draw a meaningful distinction between profits from a genuine commercial activity and profits that have been artificially divorced from the activity that creates them. So CFC rules should not be protectionist: but at the same time they may permit the fair allocation of taxing rights between Member States, so respecting the Treaty.
Commentators who have criticised the changes the Government has made in [s.751A ICTA] 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."

But the EC did not agree with HMRC: Reference: IP/11/606, 19 May 2011:

"Despite the corrective measures taken by the UK, the Commission considers that the UK is still not fulfilling its obligations under Articles 49 and 63 (freedom of establishment and free movement of capital) of the Treaty on the Functioning of the EU and Articles 31 and 40 of the European Economic Area Agreement. Indeed, UK provisions may lead, in certain cases, to an additional taxation of profits made by subsidiaries engaged in genuine economic activities in other EU Member States or EEA countries.."

88/361/EEC (now repealed).[19] The list - too long to set out here - is not exhaustive.[20]

51.4.2 *What is a restriction on free movement of capital?*

In *Stauffer*[21] the ECJ held that the rule exempting only German charities from German income tax constituted a restriction on free movement of capital (which one might have thought a clear case).

Similarly in *Persche*, an income tax relief for gifts to German charities only constituted a restriction on free movement of capital. This was just a rerun of the arguments in *Stauffer* and the conclusion was inevitable.

The point was followed again in *Missionswerk* at [24]- [26] where the Belgian succession duty relief restricted to Belgian non-profit organisations was held to be a restriction on free movement of capital.

51.4.3 *Free movement of capital to non-EU countries*

Free movement of capital applies not just between member states but also between member states and non-EU countries. There is however a transitional relief in the case of non-EU countries. Article 64 provides:

> 1. The provisions of Article 63 shall be without prejudice to the application to third countries of any restrictions which exist on 31 December 1993 under national or Union law adopted in respect of the movement of capital to or from third countries involving direct investment — including in real estate — establishment, the provision of financial services or the admission of securities to capital markets. ...

The UK rules discussed in this chapter existed in 1993, so this would preclude relief for a non-EU country.

## 51.5 Justification

Article 65 TFEU provides an exception to the general principle of free

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19 24 June 1988, Directive for the implementation of Article 67 of the Treaty.

20 See *Missionswerk Werner Heeukelbach eV v 'État belge* Case C-25/10 at [15].

21 *Centro di Musicologia Walter Stauffer v Finanzamt München für Körperschaften* [2008] STC 1439.

movement of capital:

> 1. The provisions of Article 63 shall be without prejudice to the right of Member States
> (a) to apply the relevant provisions of their tax law which distinguish between taxpayers who are not in the same situation
> [i] with regard to their place of residence or
> [ii] with regard to the place where their capital is invested.
> (b) to take all requisite measures to prevent infringements of national law and regulations, in particular in the field of taxation and the prudential supervision of financial institutions, or to lay down procedures for the declaration of capital movements for purposes of administrative or statistical information, or to take measures which are justified on grounds of public policy or public security.
> 2. The provisions of this Chapter shall be without prejudice to the applicability of restrictions on the right of establishment which are compatible with this Treaty.

One might have thought that article 65.1 must be in point, as UK and non-UK entities are not "in the same situation with regard to their place of residence." However the provision is limited by what follows:

> 3. The measures and procedures referred to in paragraphs 1 and 2 shall not constitute a means of arbitrary discrimination or a disguised restriction on the free movement of capital and payments as defined in Article 63.

It is not the case that *any* discrimination on the ground of residence is permitted as restrictions must not be "arbitrary" or "disguised restrictions on free movement of capital". These vague and evaluative terms have left the ECJ free to devise its own principles and that has been the main issue in the ECJ case law.

*Stauffer* states where the ECJ draw the line:

> 32. According to the case law, for national tax legislation such as that at issue in the main proceedings, ... to be regarded as compatible with the Treaty provisions on the free movement of capital, the difference in treatment must concern situations which are not objectively comparable...

The ECJ are fond of the word "objectively" but it adds rather little.

"Comparable" is a vague and evaluative word. The ECJ continue:

> ... or be justified by overriding reasons in the general interest, such as the need to safeguard the coherence of the tax system or effective fiscal supervision ... In order to be justified, moreover, the difference in treatment between charitable foundations with unlimited tax liability [ie qualifying for tax exemption] in Germany and foundations of the same kind established in other member states must not go beyond what is necessary in order to attain the objective of the legislation in question.[22]

### 51.5.1 *Excessive tax cost of abolishing restrictions on free movement of capital*

The ECJ does not think much of this argument. In *Thin Cap Claimants v HMRC:*

> It is settled law that reduction in tax revenue does not constitute an overriding reason in the public interest which may justify a measure which is in principle contrary to a fundamental freedom.[23]

### 51.5.2 *Need to prevent tax avoidance*

The need to prevent avoidance is accepted as a reason for a restriction on EU freedoms only if the legislation is targeted so that it is limited to cases of tax avoidance. The idea that tax avoidance legislation should be limited in this way is something to which the government have paid lip-service but but it has not been reflected in practice:

> ... at the moment [anti-avoidance] works like a drive-by shooting. You might hit your objective but you also hit a lot of other people.[24]

It will be no surprise to tax practitioners that when legislation is put to this test, it regularly fails. This is not just a UK problem:

> 37. As regards more specifically the justification based on the risk of tax

22 *Stauffer* at [32].
23 [2007] STC 326 at [36].
24 Ussher and Walford, *National Treasure* (Demos, 2011) accessible *www.demos.co.uk/files/National_treasure_-_web.pdf?1299511925*.

> evasion,[25] it is important to note that the legislation at issue here does not have the specific purpose of preventing wholly artificial arrangements, designed to circumvent German tax legislation, from attracting a tax benefit, but applies generally to any situation in which the parent company has its seat, for whatever reason, outside the Federal Republic of Germany. Such a situation does not, of itself, entail a risk of tax evasion, since such a company will in any event be subject to the tax legislation of the State in which it is established ....[26]

### 51.5.3 *Need for effective supervision of taxpayers/to prevent fraudulent evasion*

This has not helped national governments. The ECJ takes the view that the mutual assistance directive, now 2010/24/EU allows national governments "to obtain all the information that may be necessary to effect a correct assessment of a taxpayer's liability to tax".[27]

### 51.5.4 *Ensuring a balanced allocation between members states of the power to tax*

This was recognised as a possible justification in the *Thin Cap* case [2011] STC 738 at [55].

### 51.5.5 *Cohesion*

In *Stauffer* the ECJ said:

> 52 In that regard, the Court has acknowledged that the need to safeguard the cohesion of a tax system may justify a restriction on the exercise of the fundamental freedoms guaranteed by the Treaty.[28]

I am not sure what is meant by the terms "coherence" or "cohesion" of the tax system, if it is anything other than a general term for the more specific needs set out above: the need to collect enough tax, and to prevent

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25 The meaning is "avoidance": see

26 *Lankhorst-Hohorst GmbH v. Finanzamt Steinfurt* [2003] STC 607.

27 *Centro di Musicologia Walter Stauffer v Finanzamt München für Körperschaften* [2008] STC 1439 at [50].

28 The ECJ refers to (Case C-204/90 *Bachmann* [1992] ECR I-249, paragraph 28, and Case C-300/90 *Commission v Belgium* [1992] ECR I-305, paragraph 21).

avoidance and evasion. However the concept does not justify much. It did not help the German government in *Stauffer*. In *Thin Cap Claimants v HMRC* the Court of Appeal concluded:

> The permissible scope of the justification of the need to maintain the coherence of the tax system was held to be very narrow indeed, so narrow as to approach vanishing point.[29]

## 51.6 Freedom to provide services

Article 56 TFEU provides:

> Within the framework of the provisions set out below, restrictions on freedom to provide services within the Union shall be prohibited in respect of nationals of Member States who are established in a Member State other than that of the person for whom the services are intended.

In *Cadbury Schweppes* the Advocate General considered and dismissed arguments based on this:

> 34 The applicants submit that the provisions of the Treaty on freedom to provide services also apply in this case. They claim that the legislation at issue makes the supply of financial services by [the CFCs] to their UK resident parent company more difficult. ...
> 35 I am not convinced by the applicants' argument....
> 36. Admittedly, if the legislation at issue has the result that a resident company is dissuaded from establishing a subsidiary in another Member State, it also has the result that the supply of services by such a subsidiary out of that Member State is prevented. However, that latter restriction is a consequence of the hindrance to establishment. In the present case, it is exactly the freedom to establish a subsidiary in that Member State which is at the core of the proceedings. I do not therefore see the relevance of reliance on the rules on freedom to provide services as well. In any event, I do not believe that examination of the legislation at issue in the light of that freedom, in addition to freedom of establishment, can change the result of my analysis.

29 [2011] STC 738 at 26. The point will need to be reviewed when the case is final.

## 51.7 Other aspects of EU law

### 51.7.1 *Free movement of persons*

Article 45 TFEU provides:

> 1. Freedom of movement for workers shall be secured within the Union.
> 2. Such freedom of movement shall entail the abolition of any discrimination based on nationality between workers of the Member States as regards employment, remuneration and other conditions of work and employment..."

### 51.7.2 *Discrimination on grounds of nationality*

Article 18 TFEU provides:

> Within the scope of application of the Treaties, and without prejudice to any special provisions contained therein, any discrimination on grounds of nationality shall be prohibited...

State Aid rules may also need consideration.

### 51.7.3 *Generalising from CFCs to other anti-avoidance rules*

The CFC legislation attributes income of a non-resident to a UK resident. The attribution of income or gains of a non-resident to a UK resident is also a feature of all the anti-avoidance rules discussed in this chapter.

## 51.8 Section 13 TCGA

Section 13 TCGA is a restriction on FoE of an individual who owns a non-resident company established in a MS. That is less than self-evident, since:

(1) A UK company pays tax on its chargeable gains at the corporation tax rate;
(2) An individual setting up a foreign company, pays tax on its gains at the personal CGT rate.

From 2010/11 the personal CGT rate is lower than the mainstream corporation tax rate.[30] Far from being a restriction on FoE, the rule is one which may encourage foreign establishment! But if one focuses on the individual alone and not on the structure as a whole, there is a FoE restriction.

What if the individual owns less than 100% of the MS company? FoE confers only a right to "set up and manage".

What if the company is owned by a trust? The right to FoE is a right of nationals of a MS (extended to companies and firms). What is the nationality of a trust? One might look to the nationality of the trustees in their private capacities, or treat the trust as an entity with a nationality.

There can be no question of justification, because the CFC legislation has a motive exemption[31] but s.13 TCGA has none.

## 51.9 Transfer of assets abroad

Section 720 ITA restricts FoE where:
(1) the transferor is a national of a MS.
(2) the person abroad is a MS company.
In fact (unlike the CFC case) the restriction on FoE is self-evident: if an individual sets up a foreign company within s.720 they would pay income tax on the profits of the company, and the amount of tax was more than would have been if the company had been UK resident because income tax rates generally exceed corporation tax rates.

Is the restriction justified? Only if one can construe the motive defence in a manner compatible with the ECJ guidelines. Obviously by ordinary principles of construction that is not possible, but that did not stop the Court of Appeal in *Vodafone 2 v HMRC (No 2)* [2009] STC 1480.

If the person abroad is a trust in another MS, s.720 is incompatible only if the trust is an undertaking within the meaning of Article 49 TFEU. But in such cases s.624 ITTOIA will usually apply, and as that applies to UK as well as non-resident trusts, it does not restrict freedom of establishment.

## 51.10 Section 86 TCGA

Section 86 TCGA constitutes a restriction on FoE where the settlor is a

30 Though that was not so before 2008/09 when the top personal CGT rate was 40%.

31 Which might be stretched to meet the conduct requirement; see *Vodafone 2 v HMRC* [2009] STC 1480.

MS national, provided the trust is an undertaking within the meaning of Article 49 TFEU.[32]

## 51.11 IHT and EU law

IHT is gradually becoming EU law compliant, with recent changes including the extension of agricultural property relief to land in the EU (recognised by IHT domestic law in 2009) and the extension of IHT relief to EU charities.[33]

The EU provide a helpful summary of case law relevant to IHT as at August 2010 of which the following may be noted here.

*Barbier*:[34] Free movement of capital and persons apply to inheritance taxes.

*Van Hilten-Van Der Heijden*:[35] Member State taxes the estate of a national who dies within 10 years of ceasing to be resident in that MS: rule compatible with free movement of capital, particularly if the legislation in question allowed relief for inheritance taxes levied by other States. Thus the IHT deemed domicile rules are EU law compliant.

*Maria Geurts and Dennis Vogten*:[36] Member States denies an exemption to inheritances of family undertakings which employed at least five workers in another MS when it would allow such an exemption from inheritance tax if the five workers had been employed in the same Member State: rule not compatible with FoE.

*Jager*:[37] Member States allows a favourable valuation and partial exemption for assets located in that MS while calculating the value of assets situated in other Mss according to market value: rule not compatible

32 As to whether a trust is an "undertaking" see Dennis Weber, *Tax Avoidance and the EC Treaty Freedoms*, Kluwer Law International, (2005), p.27.

33 See Kessler & Brown, *Taxation of Charities and Non-profit Organisations* (8th ed, 2011) para 2.4 (New tax definition of charity).

34 Case C-364/01.

35 Case C-513/03.

36 Case C-464/05.

37 Case C-256/06.

with tree movement of capital.

*Eckelkamp*:[38] a Belgian rule disallowing a deduction for charges on immovable Belgium property owned by non-resident was held in breach of EU free movement of capital.

*Arens-Sikken*:[39] For the purposes of assessing the compatibility with EC law of domestic inheritance tax legislation, the existence of a tax advantage (ie tax credit) granted unilaterally by another Member State is not relevant.

*Mattner*:[40] A gift tax provision according to which the tax allowance for non-residents is smaller than for residents: rule not compatible with free movement of capital.

38 Case C-11/07.
39 Case C-43/07.
40 Case C-510/08.

CHAPTER FIFTY TWO

# DEEMED DOMICILE FOR IHT

## 52.1 Three classes of domicile for inheritance tax

In principle, an individual must have either a UK domicile or a foreign domicile; there is no middle way.[1] But a foreign domiciliary could often secure effective exemption from inheritance tax and live almost indefinitely in the UK without acquiring a UK domicile of choice. The inheritance tax code therefore seeks to identify foreign domiciliaries who have close UK connections and provides that for most (but not all) purposes, such individuals are treated as if they were UK domiciliaries. The IHTA does not supply suitable terminology. In this book I refer to three classes of individuals as:

(1) actual UK domiciliaries;
(2) deemed UK domiciliaries (or deemed domiciliaries); and
(3) actual foreign domiciliaries.

For visiting forces, see App. 3.5 (Deemed domicile).

## 52.2 Deemed UK domicile

Section 267(1) IHTA provides:

> A person not domiciled in the UK at any time (in this section referred to as "the relevant time") shall be treated for the purposes of this Act as domiciled in the UK (and not elsewhere) at the relevant time if—
> (a) he was domiciled in the UK within the three years immediately preceding the relevant time, or

1 See 2.1 (Domicile).

(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**".

### 52.2.1 *3-year domicile rule*

The first rule concerns the person who is actually UK domiciled and who loses their UK domicile. Such a person is deemed domiciled in the UK for three years from the date of their change of domicile. Unlike rule (b) this period is not related to years of assessment.

### 52.2.2 *17-year residence rule: time of acquisition of deemed domicile*

The second rule concerns the person who is not actually UK domiciled but who becomes resident here. Once they have been resident in the UK for 17 out of the last 20 years of assessment they become deemed domiciled here under the 17-year residence rule. In the discussion below I abbreviate "years of assessment" to "tax years".

Note that the immigrant foreign domiciliary does not need to be present in the UK for 17 full years. In an extreme case, fifteen years and two days may suffice. An individual who arrives in the UK on 5 April 1983 may arguably be resident in the UK in the tax year 1982/83. (Although this seems surprising, this would be the HMRC view, if the individual came to the UK to live here permanently or intending to stay for three years or more.) If they were still here on 7 April 1998 they may be resident in the tax year 1998/99. The 17-year residence condition would then be satisfied.

### 52.2.3 *17-year residence rule: time of loss of deemed domicile*

Once an individual is UK resident continuously for a block of 17 tax years, the individual must reach their fourth year of non-residence before ceasing to be deemed domiciled under the 17-year residence rule. The matter is best illustrated by a table:

| **Year** | **Resident Years** | **20 years ending year where transfer made in:** | | | | |
|---|---|---|---|---|---|---|
| | | 1999/00 | 2000/01 | 2001/02 | 2002/03 | 2003/04 |
| 1980/81 | *Not relevant* | 1 | | | | |
| 1981/82 | *Not relevant* | 21 | | | | |
| 1982/83 | *Not relevant* | 3 | 21 | | | |
| 1983/84 | Resident 1 | 4 | 3 | 2 | 1 | |
| 1984/85 | Resident 2 | 5 | 4 | 3 | 2 | 1 |
| 1985/86 | Resident 3 | 6 | 5 | 4 | 3 | 2 |
| 1986/87 | Resident 4 | 7 | 6 | 5 | 4 | 3 |
| 1987/88 | Resident 5 | 8 | 7 | 6 | 5 | 4 |
| 1988/89 | Resident 6 | 9 | 8 | 7 | 6 | 5 |
| 1989/90 | Resident 7 | 10 | 9 | 8 | 7 | 6 |
| 1990/91 | Resident 8 | 11 | 10 | 9 | 8 | 7 |
| 1991/92 | Resident 9 | 12 | 11 | 10 | 9 | 8 |
| 1992/93 | Resident 10 | 13 | 12 | 11 | 10 | 9 |
| 1993/94 | Resident 11 | 14 | 13 | 12 | 11 | 10 |
| 1994/95 | Resident 12 | 15 | 14 | 13 | 12 | 11 |
| 1995/96 | Resident 13 | 16 | 15 | 14 | 13 | 12 |
| 1996/97 | Resident 14 | 17 | 16 | 15 | 14 | 13 |
| 1997/98 | Resident 15 | 18 | 17 | 16 | 15 | 14 |
| 1998/99 | Resident 16 | 19 | 18 | 17 | 16 | 15 |
| 1999/00 | Resident 17 | **20** | 19 | 18 | 17 | 16 |
| 2000/01 | Non-resident 1 | | **20** | 19 | 18 | 17 |
| 2001/02 | Non-resident 2 | | | **20** | 19 | 18 |
| 2002/03 | Non-resident 3 | | | | **20** | 19 |
| 2003/04 | Non-resident 4 | | | | | **20** |
| **Deemed domicile in 2003/04** | | **Yes** | **Yes** | **Yes** | **Yes** | **No** |

Suppose an individual is resident in the UK throughout the block of 17 tax years from 1983/84 to 1999/00. We have to identify a relevant time. We then have to identify the tax year in which the relevant time falls. The table considers transfers of value in each of the 5 years 1999/00 to 2003/04.

We then have to identify "the twenty years of assessment ending with the year of assessment in which the relevant time falls". For each of the years 1999/00 to 2003/04 those 20 years include the 17-year block (shaded in the table), so the individual is deemed UK domiciled.

### 52.2.4 *Comparison of the two rules*

It is easy to envisage cases where a person is caught by one rule and not by the other.

For instance, consider a person who has always been UK resident and domiciled and who ceases to be UK domiciled on 1 August 1998. They cease to be caught by the 3-year domicile rule on 1 August 2001. However, as they were UK resident in 1998/99, they will still be deemed UK domiciled under the 17-year residence rule until 6 April 2002 (the start of the year 2002/03).

Again, a UK domiciled person may reside outside the UK for twenty years and then acquire an actual foreign domicile. Such a person is not affected by the 17-year residence rule. But three more years must pass before they cease to be UK domiciled under the 3 year domicile rule.

### 52.2.5 *Meaning of "residence" for 17-year residence rule*

Section 267(4) IHTA provides:

> For the purposes of this section the question whether a person was resident in the UK in any year of assessment shall be determined as for the purposes of income tax.

Thus in this context "residence" has its normal income tax meaning, whatever that is.

For years prior to 1993/94 s.267(4) IHTA provided:

> For the purposes of this section the question whether a person was resident in the UK in any year of assessment shall be determined as for the purposes of income tax *without regard to any dwelling house available in the UK for his use*.

This excluded the (supposed) available accommodation rule but it went further and disregarded available accommodation for all residence purposes.[2] This remains significant when determining residence for the years up to 1992/93 which will feature as part of the 17-year calculation until 2010. IHT Manual provides:

> **13024. Deemed Domicile**
> We follow any residency rulings made by CNR with one qualification. For the tax years before 6 April 1993, someone was

2 See 3.6 (Accommodation in the UK).

considered to be resident in the UK if they set foot here during the year and had a dwelling house in the UK, which was available for their use. However, availability of a dwelling house was ignored for the purposes of our 17/20 rule (Section 267(4) IHTA 1984). In the absence of any information, you should assume that residency rulings for Income Tax made prior to 93/94 were **not** made on the basis of this rule alone.

It is considered that the split year concession (ESC A11) does not apply, so years of arrival and departure are counted as full years of residence.

## 52.3 Deemed domiciliary leaving the UK

Suppose:
(1) A person who is not actually UK domiciled becomes deemed UK domiciled, having spent 17 tax years resident here.
(2) They then cease to be resident in the UK. In the fourth tax year after departure, they cease to satisfy the 17-year residence rule.

Is the person still treated as domiciled here for three years under the 3-year domicile rule? In other words, does the deemed domicile rule in (a) apply to a person who was only a deemed domiciliary under (b)? The answer is, no. It is considered that (a) and (b) are independent rules dealing with separate circumstances. If that were wrong, then the following absurdity arises. Suppose T, non-resident for many years, ceases to be UK domiciled. In year 1 T becomes deemed domiciled. In year 4 T ceases to be deemed domiciled. HMRC could argue that since T was (deemed) domiciled in year 3, T must wait three more years before T can cease to be deemed domiciled. Then, of course, three years later T is still deemed domiciled. T can never throw off the deemed domicile. This shows that "domicile" in s.267(1)(a) means actual domicile and not deemed domicile. The word should have the same meaning throughout the section.[3]

## 52.4 Domicile of child of a deemed domiciliary

A child usually acquires the domicile of their father at the time of their birth as a domicile of origin; and if the father's domicile changes while the

3 This is consistent with *Russell v IRC* [1988] STC 195.

child is under 16, the child acquires the father's new domicile as a domicile of dependency. Does one have regard to the deemed domicile rule for this purpose? Suppose:

(1) F is actually foreign domiciled but deemed UK domiciled when a child is born; or
(2) F is not deemed UK domiciled when the child is born but becomes deemed UK domiciled while the child is under 16.

It is suggested that the deemed domicile rule does not affect the child's domicile: in each case the child is not deemed UK domiciled (until the child has spent 17 yeas resident in the UK. Applying s.267, it is only the person actually resident in the UK who is deemed UK domiciled. The deemed domicile of the father does not affect the domicile of the child. Of course, the question will not often arise, since the domicile of children and young persons only rarely needs to be ascertained.

## 52.5 When deemed domicile does not matter: FOTRA securities and DTAs

There are two situations where a deemed domicile rule does not apply:
(1) exempt gilts and qualifying certificates of Islanders (discussed here);
(2) pre-CTT double tax treaties.[4]
Section 267(2) IHTA provides:

> Subsection (1) above shall not apply for the purposes of section 6(2) or (3) or 48(4) above ...

That is, the deemed domicile rules do not apply for the purposes of the exemptions conferring excluded property status on FOTRA securities[5] and qualifying certificates of Islanders.[6]

The reason is historical. The concept of deemed domicile was introduced with CTT in 1974. At that time gilts had been issued free from taxation (including Estate Duty) if the owner was not (actually) UK domiciled. The deemed domicile rule could not have been applied to those gilts. All that the drafter needed to do was to disapply the deemed domicile rule to exempt gilts in issue at the time of the introduction of

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4 See 60.4 (Domicile requirement of treaty IHT exemption).
5 See 53.4 (Non-settled property: FOTRA securities) and 53.10 (Trusts: FOTRA Securities).
6 See 53.7 (Individual domiciled in Channel Islands or Isle of Man).

CTT (now IHT). It was not necessary to disapply the deemed domicile rule to gilts issued later. But that is the rule. Presumably the intention was to avoid having two classes of exempt gilts governed by different rules; or to encourage foreigners to continue to invest in exempt gilts issued after 1975.

No doubt the same reasoning applied to qualifying certificates of Islanders.

This rule gives some scope for IHT planning by individuals who are deemed UK domiciled but who qualify for these exemptions (ie non-UK ordinarily residents and Islanders).

## 52.6 1974 transitional rules

Section 267(3) contains five transitional rules:

> Para (a) of subsection (1) above shall not apply in relation to a person who (apart from this section) has not been domiciled in the UK at any time since 9th December 1974 ...

This disapplies the 3-year domicile rule only. It would only apply in a relatively rare case of someone who was actually UK domiciled and ceased to be so before 9 December 1974.

> and para (b) of that subsection shall not apply in relation to a person who has not been resident there at any time since that date ...

This disapplies the 17-year residence rule only. It would only apply to someone who had been UK resident for 17-years and ceased to be so before 9 December 1974.

> and that subsection shall be disregarded—
> (a) in determining whether settled property which became comprised in the settlement on or before that date is excluded property,

This applies to pre-9 December 1974 settlements.

> that subsection shall be disregarded— ...
> (b) in determining the settlor's domicile for the purposes of section 65(8) above in relation to settled property which became comprised in the settlement on or before that date, and

(c) in determining for the purpose of section 65(8) above whether the condition in section 82(3) above is satisfied in relation to such settled property.

This applies to the exemption for exempt gilts.

## 52.7 Tax planning for the deemed domiciliary

(1) The emigrant deemed domiciliary
An individual who has emigrated from the UK (ie acquired a foreign domicile of choice) remains an "emigrant" deemed domiciliary for three years. The individual's inheritance tax planning, if in good health, is simple; they should refrain from making any gifts until they have ceased to be deemed UK domiciled. If they wish to make substantial gifts before then, they might consider purchasing exempt gilts or some other property which qualifies as excluded property. Deathbed planning would be the same. In addition they might consider taking out a loan to purchase excluded property: see 56.6 (Individual borrows and acquires excluded property).

(2) The immigrant deemed domiciliary
The immigrant deemed domiciliary is the foreign domiciliary who has resided for a long period in the UK and become deemed UK domiciled. Their scope for planning is greatly restricted; they should really take proper steps before the statutory deadline when their deemed domicile arises.

If the individual is actually domiciled in the Isle of Man or in the Channel Islands then he has some scope for acquiring excluded property in the form of exempt saving certificates.[7] Otherwise it may be possible to cease to be UK resident for the necessary period of three tax years so that the deemed domicile rules cease to apply.

7 See 53.7 (Individual domiciled in Channel Islands or Isle of Man).

CHAPTER FIFTY THREE

# EXCLUDED PROPERTY FOR IHT

## 53.1 Excluded property – Introduction

"Excluded property" is broadly[1] outside the scope of inheritance tax.

There are nine classes of excluded property:

(1) Non-settled property:[2]
  - (a) foreign situate property;
  - (b) AUTs and OEICs;
  - (c) FOTRA securities.

(2) Settled property:
  - (a) foreign situate property;
  - (b) AUTs and OEICs;
  - (c) FOTRA securities.

(3) Qualifying certificates of Islanders (Channel Islands/Isle of Man domiciliaries).

(4) Property of visiting forces.[3]

(5) Reversionary interests in settled property.

Thus with an economy of language the exemptions for excluded property are used to serve several purposes:

(1) A territorial exemption.

(2) Limiting the scope of IHT:
  - (a) in order to encourage UK investment by foreigners (FOTRA securities, UK funds);
  - (b) to fit the scheme of the Act or avoid double taxation (relief for

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1 See 53.14 (Occasions where excluded property is relevant for IHT).

2 A note on terminology. I use the term "non-settled property" to describe property which is not comprised in a settlement for IHT purposes. The term used in the IHT Manual is "unsettled property".

3 See App. 3.4 (Excluded property).

reversionary property, etc).

This chapter sets out the definitions of excluded property. It also considers works of art, foreign bank accounts and foreign pensions, which (though not excluded property) qualify for some similar exemptions.

See too 55.1 (IHT consequences of transfers between trusts).

## 53.2 Non-settled property: foreign situate property

Section 6(1) IHTA provides:

> Property situated outside the UK is excluded property if the person beneficially entitled to it is an individual domiciled outside the UK.

Excluded property status depends on the domicile of the individual at the time the disposition 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 their property out of the UK the moment before they die, or the moment before they make a gift of the property, they obtain 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 70.1 (Concepts of situs).

### 53.2.1 *Gift from foreign bank account to UK account*

What is the position if a foreign domiciled donor makes a gift from their foreign bank account (ie, not a UK situate asset) to a UK bank account of the donee? In general, as a matter of banking law, the donor's cheque or other instruction to the bank to transfer funds from the donor's account to another account is revocable until it is carried out (though in any particular case it would be relevant to consider the documentation and proper law concerned.) So the gift will be regarded as taking effect when completed, namely when the money is credited to the donee's UK account. Nevertheless the gift is not a transfer of value for IHT purposes. When funds are held in A's account, A has an asset (a debt). When funds are transferred from A's account to B's account, A's asset comes to an end and B acquires a new asset (a debt). "It is something of a misnomer to speak of the transfer of funds, as there is no actual transfer of coins and bank notes from the payer to the payee, and no assignment of the debt owed to the payer by their own bank."[4]

Section 3 IHTA provides:

> (1) ... 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.

The terms of section 3(2) are met, so the gift is not a transfer of value. I stress this because the contrary has been suggested, but the position is perfectly clear.

## 53.3 Non-settled property: authorised unit trusts and OEICs

Section 6(1A) IHTA provides:

> [a] A holding in an authorised unit trust[5] and
> [b] a share in an open-ended investment company[6]
> is excluded property if the person beneficially entitled to it is an individual domiciled outside the UK.

AUTs and OEICs will generally be UK situate assets. I refer to them together as **"UK funds"**. These are excluded property for all IHT purposes.

The relief only applies to a *holding* in an AUT or a *share* in an OEIC so other interests in AUTs and OEICs (for instance, options) are not excluded

4 Brindle & Cox, *The Law of Bank Payments* (4th ed 2010), para 3-002. See *R v Preddy* [1996] AC 815.

5 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."

6 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."

property. Perhaps that does not arise in practice.

The exemption for UK funds uses the expression “beneficially entitled” and the exemption for FOTRA securities uses the expression “beneficial ownership” but it is considered that the two have the same meaning; for a discussion see 53.5 (Beneficial ownership).

## 53.4 Non-settled property: FOTRA securities

The next category of excluded property consists of FOTRA securities[7] (certain UK government securities popularly called exempt gilts). FOTRA securities are UK situate assets. Section 6(2) IHTA provides:

> Where securities have been issued by the Treasury subject to a condition authorised by section 22 of the F(No.2)A 1931 (or section 47 of the F(No. 2)A 1915) for exemption from taxation so long as the securities are in the beneficial ownership of persons of a description specified in the condition, the securities are excluded property if they are in the beneficial ownership of such a person.

FOTRA securities issued from 1 April 2005 are titled “Treasury Gilts”. Earlier securities have one of the following names:

– Treasury Loan/Stock
– Conversion Loan/Stock
– Exchequer Loan/Stock
– Consolidated Loan/Stock
– War Loan

The different names have only historic significance.

Products issued by National Savings and Investments are not FOTRA securities.

### 53.4.1 *Conditions for exemption*

FOTRA securities were first issued under s.47 F(No 2)A 1915. This was a temporary measure:

> The Treasury may, if they think fit, during the continuance of the present

7 “Free of Tax to Residents Abroad”.

> war and a period of twelve months thereafter, issue any securities which they have power to issue for the purpose of raising any money or any loan with a condition that neither the capital nor the interest thereof shall be liable to any taxation, present or future, so long as it is shown in manner directed by the Treasury that the securities are in the beneficial ownership of persons who are neither domiciled nor ordinarily resident in the UK, and securities issued with such a condition shall be exempt accordingly.

This section was repealed in 1927, but the repeal did not affect tax exemptions for securities previously issued and War Loan 1952 Or After is still in existence.

Section 22(1) F(No.2)A 1931 provides:

> Any securities issued by the Treasury under any Act may be issued with the condition that -
> (a) so long as the securities are in the beneficial ownership of persons who are not ordinarily resident in the UK, the interest thereon shall be exempt from income tax; and
> (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.

Subsequent statutory provisions do not specify the condition for exemption: they give the Treasury a discretion to specify the condition in the terms of the issue. Section 60 FA 1940 provides:

> The power of the Treasury under s.22 F(No.2)A 1931 to issue securities with the condition as to exemption from taxation specified in that section shall extend to the issuing of securities with that condition so modified, whether as to the extent of the exemption or the cases in which the exemption is to operate, as the Treasury may specify in the terms of the issue.

So the details must be found in the prospectus for each gilt concerned.[8] Section 154(1) FA 1996 provides:

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8 Prospectuses can be found on *www.dmo.gov.uk/rpt_parameters.aspx?rptCode=D8E&page=Prospectuses*

> 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 is hard to see the need for this, but it does no harm.

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[9] 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.
> [(2)(3) are transitional provisions now spent]
> (4) In this section "FOTRA conditions" means any such conditions about exemption from taxation as are authorised in relation to the issue of a gilt-edged security by virtue of section 22 of the Finance (No 2) Act 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.[10]
> (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.

So all UK government securities have had FOTRA status, irrespective of the original terms of issue but there are two classes of FOTRA securities with different conditions attached:

9 "Gilt-edged securities" has the CGT definition: see s.161(6) FA 1998.

10 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".

(1) Gilts where the condition requires the individual to be domiciled[11] and ordinarily resident outside the UK. These include:
    (a) 3½% War Loan 1952 Or After, issued under s.47 F(No.2)A 1915.
    (b) Gilts issued under s.22 F(No.2)A 1931, where this was the condition set out in the prospectus.
(2) Where the condition requires the beneficial owner to be ordinarily resident outside the UK but domicile is irrelevant. This applies to:
    (a) Gilts issued before 6 April 1998 without FOTRA conditions; these now have the benefit of "post-1996 Act conditions" under s.161 FA 1998.
    (b) Gilts issued after 1996, where the prospectus set out this condition. I understand that all gilts issued after 29 April 1996 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.

## 53.5 Beneficial ownership of FOTRA securities

The gilts must be in the "beneficial ownership" of the individual. The expression here has its English law/trust law meaning.[12] In the following discussion I abbreviate the term to "ownership".

There have been many cases discussing "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.[13] 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 ownership of a person even if they have granted

11 Deemed domicile is irrelevant for this purpose: see 52.5 (When deemed domicile does not matter: FOTRA securities and DTA).

12 See 22.12.1 (Meaning(s) of "beneficial ownership").

13 The expression "beneficial ownership" is used in DTAs, but there it has an international fiscal law sense distinct from the usual English law sense. See John F. Avery Jones et al, "The Origins of Concepts and Expressions used in the OECD Model" [2006] BTR 695 at p.747. It is considered that discussion of the DTA meaning is no assistance to ascertain the meaning in the present context, or generally in English law.

a mortgage or charge.[14] Gilts are not in the ownership of a person if they have entered into a contract of sale, even a conditional contract.[15]

Gilts remain in the ownership of an individual even if they have granted put and call options, according to *Sainsbury v O'Connor* 64 TC 208.

Ownership is not a precise term in English law and is used with a variety of meanings. Its common meaning is to denote the sum of all the rights which a person has over an asset; that is, ownership is a bundle of rights, or if you prefer, ownership has a number of incidents.[16] In the case of gilts the bundle (or incidents) consists of the right to dividends, capital on redemption and rights of disposal.

Clearly, one can make some dent in the usual array of rights or incidents and still be regarded as an owner. This explains why one remains beneficial owner after granting a charge or licence. Where does one draw the line? The courts answer to this question has been confused because they insist that ownership must (with limited exceptions) be regarded as vested in one person or another.

This causes artificial results when property is subject to a contract of sale and it is said that ownership must be vested in either the vendor or purchaser. There is no reason why that should be so, if one remembers that ownership is no more than a convenient term for a bundle of rights. The better analysis is that ownership rights are split between vendor and purchaser. Neither should be regarded as "the" beneficial owner.[17] 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 Supreme Court.

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14 *English Sewing Cotton v IRC* [1947] 1 All ER 679.

15 *Wood Preservation v Prior* 45 TC 112.

16 See Turner, "Some Reflections on Ownership in English Law" (1941) 19 Can. Bar Review 342; Harris *Property and Justice* (1996) p.125.

17 Likewise the courts have come to reject the dogma that "where ownership is vested in a trustee, equitable ownership must necessarily be vested in someone else because it is an essential requirement of a trust that it confers upon individuals a complex of beneficial legal relations which may be called 'ownership'". See *CPT Custodian Pty Ltd v Commissioner of State Revenue* [2005] 2 ALR 196 at [25] accessible *www.austlii.org*. Of course, the context in which the expression "beneficial owner" is used should always be considered.

### 53.5.1 *Beneficial ownership in Scotland*

The IHT Manual at 04031 discusses the expression "beneficially entitled", in a passage which sheds a little light on beneficial ownership:

> The use of the words 'beneficially entitled' means broadly that the estate includes only property
> - to which a person is entitled, or
> - in which they have an interest for their own benefit.
>
> In England, Wales and Northern Ireland this includes property which a person owns either legally or beneficially (IHTM04441).

So far, the text is unexceptionable. The discussion then turns to Scotland:

> In Scotland, the term 'ownership' does not necessarily equate to beneficial entitlement, for example where the land that is being transferred is subject to missives of sale [or][18] 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.

The text raises the interesting suggestion that the position in Scots law is not the same as in English law.[19] The passage concludes:

> A person is not beneficially entitled to property held
> - purely in a fiduciary capacity (for example as a trustee)
> - in a representative capacity (for example as an executor or a trustee in bankruptcy), or
> - by way of security (for example as a mortgagee prior to foreclosure).
>
> ...

This is clearly right.

18 The original reads "of". The emendation to "or" makes sense, though it might be that some text is missing here.

19 I would be grateful to any Scots reader who could direct me to relevant authority. Barr and Eden, *Inheritance Tax in Scotland* (Butterworths), or McDonald and Pagan, *Inheritance Tax in Scotland: Tax Annual* (Bloomsbury) may help here.

### 53.5.2 *Registration*

IHTM04294 [September 2008] provides:

> If a government security is a FOTRA gilt (IHTM04291) you will have to consider who is beneficially entitled (IHTM04031) to that security to work out whether it is excluded property for IHT purposes..
> If a worthwhile amount is at stake[20] you should investigate the possibility of a last-minute purchase. Except where the available information (e.g. inclusion of sufficient income/interest) reasonably rules out that possibility, you should seek specific confirmation that the securities concerned were in fact registered in the transferor's, or the trustee's, name(s) at the date of the relevant transfer.
> (This text has been withheld because of exemptions in the Freedom of Information Act 2000)

I do not think that the IHT Manual means to say that relief only applies if the securities are registered in the name of the individual or the trustees. The point is that no relief applies if the securities are purchased but not paid for. The purchaser is not the beneficial owner until payment, or even if they were, securities not paid for have no value because of the vendor's lien. So if the gilts are not registered in the name of the individual, further evidence may be needed to show that the individual actually is the beneficial owner.

In practice, register the gilts in the name of the individual or the trustees to avoid possible dispute. Perhaps the withheld text instructs Inspectors how to identify false claims for relief.

### 53.5.3 *Interest on FOTRA securities*

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:

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20 Understandably, the HMRC view on what is "worthwhile" in this context is not in the public domain.

> [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.[21]

### 53.5.4 *Practical use of FOTRA securities*

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).

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21 For completeness, 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. But now interest is paid without deduction of tax (unless the owner asks for tax to be deducted) so this point will not arise.

## 53.6 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 remittance basis taxpayer will prefer a foreign fund to a UK one, so that income and gains from the fund will be taxed on the remittance basis.[22] Likewise a settlor-interested trust whose settlor is a remittance basis taxpayer will prefer a foreign fund to a UK one; similarly if the transfer of asset rules may apply, as UK source income from the fund may be taxed where foreign source income in principle will not.

(2) A non-resident non-domiciled individual will not mind (for IHT, CGT or IT) whether they purchase a UK or a foreign fund. However, taxation at fund level is another matter, and the additional burden on UK funds, particularly SDRT, has encouraged fund managers to set up new funds offshore.[23]

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 consistency or joined-up thinking.[24]

## 53.7 Individual domiciled in Channel Islands or Isle of Man

Section 6(3) IHTA provides:

> Where the person beneficially entitled to the rights conferred by any of the following, namely—
> (a) war savings certificates;
> (b) national savings certificates (including Ulster savings certificates);
> (c) premium savings bonds;
> (d) deposits with the National Savings Bank or with a trustee savings bank;

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22 If the individual plans to remit income from the fund, it may be better to have a UK fund. But that is a special case.

23 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.

24 See 1.2.2 (Attitudes to the economic argument).

> (e) a certified SAYE savings arrangement within the meaning of section 703(1) ITTOIA;
>
> is domiciled in the Channel Islands or the Isle of Man, the rights are excluded property.

In the following discussion:
(1) "**Qualifying certificates**" are investments within (a) to (e).
(2) "**Islanders**" are persons domiciled in the Channel Islands or the Isle of Man.
The deemed domicile rule does not apply for the purposes of this section: see s.267(2) IHTA.

The IHT Manual para 27270 correctly states:

> Other points to note are:
> [1] the exclusion applies not only to securities etc owned by a domiciled Islander absolutely but also to any settled securities in which he has a beneficial interest in possession[25]
> [2] the exclusion does not extend to settled securities in which there is no interest in possession, i.e. which are held on discretionary trusts
> [3] the relevant domicile is that of the transferor (and not the transferee) of the securities, at the time of the transfer

Points [2] and [3] are obvious but point [1] is important.

The exemption could be particularly useful for an individual who is:
(1) domiciled in the Channel Islands or the Isle of Man, and
(2) deemed UK domiciled (so in principle within the scope of IHT), and
(3) ordinarily resident in the UK (so the FOTRA securities exemption is not available).
The exemption is also useful for a trust with such a person as life tenant.

The exemption dates back to 1931[26] and was presumably an attempt to market the certificates to Islanders, who would otherwise not find them an attractive choice. It seems surprising that the exemption is limited to Islanders; no doubt there were reasons.

25 [Author's note] From 2006 this will now only apply to an estate IP.
26 Section 41 FA 1931. The exemption for FOTRA securities was revived in the same year.

## 53.8 Trusts: foreign situate property

Section 48(3) IHTA provides:

> Where property comprised in a settlement is situated outside the UK—
> (a) the property (but not a reversionary interest in the property) is excluded property unless the settlor was domiciled in the UK at the time the settlement was made ...

This is the main category of settled excluded property, roughly corresponding to the main category of non-settled excluded property. Three important consequences arise from the definition.

First, the resident and domicile status of the beneficiaries is irrelevant for this purpose. The residence of the trustees is similarly irrelevant.

Secondly, excluded property status depends on the domicile of the settlor at the time the settlement was made. The domicile at the time of the transfer or chargeable event is ignored.[27] Contrast the IT and CGT position. The identity of the settlor is therefore crucial: see 69.3.4 (IHT definition of settlor).

Thirdly, the location of the assets comprised in the settlement matters only at the moment a charge arises; provided the assets are then situated abroad, it is irrelevant that they may previously have been situated in the UK. So trustees could transfer the settled property out of the UK the moment before the death of a life tenant, or the occasion of a ten-year charge, and obtain the full benefit of excluded property status: see *Kwok Chi Leung Karl v Commissioner of Estate Duty* [1988] STC 728.

HMRC accept this. IHT Manual provides:

> **4274. Identifying settled property** [September 2008]
> The expression 'property comprised in a settlement' in Section 48(3) IHTA 1984 means the items of property (IHTM04030) held in the settlement (IHTM16000) at the time of the chargeable event that you are considering. In determining the locality (IHTM27071) of any particular property, therefore, you should consider the property in its current form and not its previous history.
> *Example*

27 See 53.12 (Initial interest of settlor or spouse) for an exception where the settlor or their spouse has an initial interest in possession in the settled property.

S, when domiciled in Germany, settles some German realty[28] and some securities then situated in the UK on X for life with remainder to Y. On X's death the life interest comes to an end and the settled fund consists of

a. a villa in Spain, or
b. land in the UK, or
c. a house in Spain and some English securities.

With a., the villa is excluded property even though it partly represents the proceeds of what was previously UK property (the securities). The land in b. is not excluded property although it is partly derived from the German realty. In c., the house is excluded property but the securities are not.

## 53.9 Trusts: authorised unit trusts and OEICs

Section 48(3A) IHTA provides:

> Where property comprised in a settlement is a holding in an authorised unit trust or a share in an open-ended investment company—
> (a) the property (but not a reversionary interest in the property) is excluded property unless the settlor was domiciled in the UK at the time the settlement was made, and
> (b) section 6(1A) above applies to a reversionary interest in the property but does not otherwise apply in relation to the property;[29]
> but this subsection is subject to subsection (3B) below.[30]

### 53.9.1 *Exit charge on purchase of UK funds?*

Suppose a discretionary trust with a foreign domiciled settlor uses UK situate property to purchase UK funds. This section considers whether this gives rise to an IHT exit charge. Section s.65(1) IHTA provides:

> There shall be a charge to tax under this section-
> (a) where the property comprised in a settlement or any part of that property ceases to be relevant property (whether because it ceases to

28 [Author's footnote] The question whether this is possible as a matter of German law is ignored for the purposes of the example.

29 For a discussion of s.48(3A)(b), see 53.11.2 (Foreign situate property and UK funds in estate IP trust).

30 For the subsection 3B exception, see 53.16.3 (Purchased equitable interests).

> be comprised in the settlement or otherwise)...

The question is whether trust property has "ceased to be relevant property" within the meaning of s.65(1). It is helpful to approach this question historically. The position before the 2003 reforms was straightforward. Section 58 IHTA provides (so far as relevant):

> (1) In this Chapter "relevant property" means settled property in which no qualifying interest in possession subsists, other than ...
> (f) excluded property.

The trust property is "settled property in which no qualifying interest in possession subsists" and so is relevant property unless it is excluded property. If UK trust property becomes non UK situate, it ceases to be relevant property. However in that event, s.65(7) IHTA provides relief:

> 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.

Press Release 16 October 2002 (OEICs and AUTs) para 6 explained the reason for the 2003 reforms:

> Overseas investors are in theory liable to inheritance tax on their OEIC and AUT holdings, because they are regarded as being situated in the UK for tax purposes on the investors' death. Competing centres do not charge tax in parallel circumstances. Removing the potential inheritance tax charge will help UK managers compete on an equal footing with overseas fund providers.[31]

Accordingly, s.186 FA 2003 provides:

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31 Similarly, EN FB 2003 provides:
"8. This clause is one of two measures to boost the competitiveness of UK authorised funds announced by Treasury press notice (105/02) dated 16 October 2002. From that date, holdings by non-UK domiciled investors or their trusts in authorised unit trusts and open-ended investment companies will not be chargeable to IHT."

> (1) The Inheritance Tax Act 1984 (c. 51) is amended as follows....
> (3) [This inserts s.48(3A) IHTA] ...
> (8) This section has effect in relation to transfers of value or other events occurring on or after 16th October 2002.

Thus on 10 July 2003 (when the FA 2003 came into force), and with effect in relation to transfers of value or other events occurring on or after 16th October 2002, UK funds became excluded property. If a discretionary trust with a foreign domiciled settlor held UK funds on 10 July, the assets ceased to be relevant property and became excluded property.

The drafter of the 2003 provisions copied the wording of s.48(3). Unfortunately the drafter did not copy the words of s.65(7). If one construes the words of the section literally, then there are three consequences:

(1) A foreign trust holding UK funds on 10 July 2003 became subject to an exit charge under s.65 IHTA.
(2) A foreign trust became retrospectively subject to an exit charge if it had acquired AUTs or OEICs out of UK situate property between 16th October 2002 and 10 July 2003.
(3) A foreign trust became prospectively subject to an exit charge if it acquired AUTs or OEICs out of UK situate property after 10 July 2003.

I think it is safe to say that HMRC did not seek to collect tax under category 1 or 2 in 2003, and would not do so now. It would be inconsistent to seek IHT in a category 3 case. The point is the same in each of the three cases. Is section 65 to be construed literally? The issue raises in a very pure form the question of how the courts construe taxing statutes. The reader will, I think, hardly need to be told that the House of Lords/Supreme Court have vehemently rejected the literal approach.[32]

There can be no doubt about the purpose of the legislation. If there were a charge on the coming into force of the FA 2003, or on the acquisition of UK funds out of UK situate property, then that would directly obstruct the purpose.

For this reason the occasion of a trustee purchasing UK funds is not an occasion that Parliament intended, following the 2003 reforms, to be included in the reference to property "ceasing to be relevant property."

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32 See the House of Lords in *Barclays Mercantile Business Finance v Mawson* 76 TC 446 at [28] - [32]. The passage is too well known to need to be set out here.

Such was the intention of Parliament. The concept of the “intention of Parliament” is a construct. It is to be deduced from the words of the legislation; in most cases one cannot say what would be the intention(s) in the many hundreds of minds involved in both Houses, and it would be idle to speculate. However if a proverbial "officious bystander" had asked any member of Parliament in 2003 whether they intended an IHT charge to arise in these circumstances, the response would be: of course not!

It is not, I think, ever suggested that purposive construction is a one way street which can be used if it favours HMRC. That is clear on principle, but if authority is needed, there is *Bibby v Prudential Assurance* 73 TC 235:

> 69. ... The warning [in *Ramsay*] against a literal construction that would permit the use of a taxing provision for a purpose never intended or contemplated by Parliament was directed at taxpayers, or their tax advisers, but must, in my judgment, be heeded also by the Revenue. The assessments in the present case have represented, in my view, an attempt to use s 95 for a purpose never intended or contemplated by Parliament. Such an attempt is no more acceptable from the Revenue than it would be from a taxpayer.

At least some within HMRC would agree. Chris Tailby former director of the HMRC anti-avoidance group has written:

> The point applies equally to the government (I use the term to include HM Treasury and HMRC) which should not stretch tax law to attempt to collect tax which Parliament did not intend to collect.[33]

The IHT Manual was amended in September 2010 and now provides:

> **4262 Holdings in Open End Investment Companies (OEICs) and Authorised Unit Trusts (AUTs)**
> ... However, this exclusion does not always apply to relevant property trusts as IHTA84/S48(3A) is excluded from IHTA84/S65(7). Any case where the transfer concerns property held in a (relevant property trust where:

33 Tailby, “Some reflections on Tax Avoidance” [2011] PCB 41 at 44.

- the trust was created by a settlor domiciled outside the UK, and
- the trust disposes of UK situs (IHTM27071) assets and also acquires AUTs / OEICs

must be referred to Technical Group.

It appears that HMRC are at present taking the point, but it is considered that the better view is that there is no exit charge; and the sooner that is officially acknowledged, the better for the UK investment management industry.

## 53.10 Trusts: FOTRA securities

FOTRA securities 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.

For the interaction with s.44(2) IHTA, see 55.4.1 (When separate settlements fiction does not apply).

### 53.10.1 *Estate IP trust*

Section 48(4) IHTA provides:

> Where securities issued by the Treasury subject to a condition of the kind mentioned in subsection (2) of section 6 above are comprised in a settlement, that subsection shall not apply to them; but the securities are excluded property if—
>
> (a) a person of a description specified in the condition in question is entitled to a qualifying interest in possession in them.

Qualifying IP is defined in s.59(1) IHTA:

> (1) In this Chapter "qualifying interest in possession" means—
> (a) an interest in possession—
> (i) to which an individual is beneficially entitled, and
> (ii) which, if the individual became beneficially entitled to the interest in possession on or after 22nd March 2006, is an immediate post-death interest, a disabled person's interest or a transitional serial interest, or
> (b) an interest in possession to which, where subsection (2) below

> applies, a company is beneficially entitled.[34]

That is, a qualifying IP is what this book describes as an estate IP. The 2006 reforms have (inadvertently?) greatly restricted the scope of the exemption for FOTRA securities in settlements.

### 53.10.2 *Other 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—
> ...
> (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:

> **27248 - Unknown persons** [June 2006]
> The legislation refers to "known persons". Accordingly, when considering the question of domicile and ordinary residence you should disregard the possibility that some (currently) unknown person (e.g. an unborn child or future spouse/civil partner of an existing beneficiary) might become a beneficiary in the future.
> **27249 - UK charities**
> In the case of *Von Ernst and Cie S.A. v IRC* [1980] 1 WLR 468 the Court ruled **that any payment or potential payment** from the settled property to an incorporated UK charity – to be used by the charity for its charitable purposes – would not be an application for the "benefit" of the charity. Accordingly you should not deny the exclusion for exempt securities merely because a UK charity (whether incorporated or not)

34 The position for companies entitled to IPs is not considered here.

has received or might receive any of the settled property or income from it.

### 53.10.3 *Exit charge on acquisition of FOTRA securities*

Section 65(1) IHTA provides:

> There shall be a charge to tax under this section—
> (a) where the property comprised in a settlement or any part of that property ceases to be relevant property...

The acquisition of FOTRA securities would give rise to a charge but s.65(8) IHTA provides relief:

> If the settlor of a settlement was not domiciled in the UK when the settlement was made, tax shall not be charged under this section by reason only that property comprised in the settlement is invested in securities issued by the Treasury subject to a condition of the kind mentioned in section 6(2) above and thereby becomes excluded property by virtue of section 48(4)(b) above.

If the settlor is UK domiciled, there is still an exit charge.

## 53.11 Estate IP trust

### 53.11.1 *The question*

As we have seen, there are two sets of definitions of excluded property:
(1) Section 6 IHTA defines categories of excluded property for non-settled property to which a person is beneficially entitled.
(2) Section 48 IHTA defines corresponding categories of excluded property for trust property.
Property is either settled or not, so at first sight the definitions appear to be mutually exclusive. However, a settlement under which a beneficiary has an estate interest in possession raises a doubt. Property held in a settlement with an estate IP is certainly settled property (so *prima facie* the s.48 rules apply). However, s.49(1) IHTA provides (for an estate IP):

> A person beneficially entitled to an interest in possession in settled property shall be treated for the purposes of this Act as beneficially

entitled to the property in which the interest subsists.

Since the person is treated as beneficially entitled, should the s.6 IHTA rules apply to settled property?

### 53.11.2 *Foreign situate property and UK funds in estate IP trust*

The answer is provided by s.48(3)(b) IHTA:

> Where property comprised in a settlement is situated outside the UK...
> (b) section 6(1) above applies to a reversionary interest in the property *but does not otherwise apply in relation to the property*;

Thus for settled foreign-situate property the s.48 definition applies and the s.6(1) definition is disapplied. The operation of these rules can be illustrated by two examples:

(1) Suppose a foreign domiciled beneficiary has an estate IP in a settlement made by a UK domiciled settlor. The trust property is situated outside the UK.

The trust property is not excluded property as it does not meet the requirements of s.45(3)(a). It would meet the requirements of s.6(1) but s.48(3)(b) disapplies s.6(1).

(2) Suppose the reverse situation – a UK domiciled beneficiary has an estate IP in 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 qualify as excluded property under s.6(1) but it does qualify under s.48(3)(a). Section 48(3)(b) disapplies s.6(1) but that is irrelevant: the trust property is excluded property.

For UK funds, the same answer is provided by s.48(3A)(b) IHTA:

> Where property comprised in a settlement is a holding in an authorised unit trust or a share in an open-ended investment company ...
> (b) section 6(1A) above applies to a reversionary interest in the property *but does not otherwise apply in relation to the property;*

Thus for settled AUTs and OEICs, the s.48 definition applies and the s.6(3A) definition is disapplied.

### 53.11.3 *FOTRA securities in estate IP trust*

Section 48(4) IHTA provides:

> Where securities issued by the Treasury subject to a condition of the kind mentioned in subsection (2) of section 6 above are comprised in a settlement, that subsection shall not apply to them; ...

Again, the s.48(4) definition of excluded property applies and the s.6(2) definition is disapplied. This is not actually necessary because s.6(2) and s.48(4)(a) lead to the same result, but it does no harm.

### 53.11.4 *Qualifying certificates in estate IP trust*

Qualifying certificates of an individual domiciled in the Channel Islands or the Isle of Man ("**an Islander**") are excluded property.[35] If an Islander is entitled to an estate IP in qualifying certificates, the certificates are not excluded property under s.48(3) or s.48(4). But it is considered that the property does qualify as excluded property under s.6(3) since the individual is to be treated as if they were beneficially entitled. In this case there is no express provision that s.48 overrides s.6. Section 48 and s.6 do not contradict each other; rather they offer two alternative routes to attain excluded property status. Such settled property is therefore excluded property. HMRC agree.

## 53.12 Initial interest of settlor or spouse

### 53.12.1 *The s.80 fictions*

Special rules apply where the settlor or spouse have an estate interest in possession in a trust when it is made ("**an initial IP**"). The basic rule is set out in s.80(1) IHTA:

> Where a settlor or his spouse or civil partner is beneficially entitled to an interest in possession in property immediately after it becomes comprised in the settlement,

35 See 53.7 (Individual domiciled in Channel Islands or Isle of Man).

[a] the property shall for the purposes of this Chapter[36] be treated as not having become comprised in the settlement on that occasion;

[b] but when the property or any part of it becomes held on trusts under which neither of those persons is beneficially entitled to an interest in possession, the property or part shall for those purposes be treated as

[i] becoming comprised in a separate settlement

[ii] made by that one of them who ceased (or last ceased) to be beneficially entitled to an interest in possession in it.

Thus where the settlor or spouse has an initial IP, s.80 imposes three fictions ("**the s.80 fictions**"):

(1) Property which is actually in one settlement ("the actual settlement") will be treated as being comprised in a separate settlement ("the notional settlement").

(2) The person who is treated as the settlor of the notional settlement may be the spouse, ie different from the real settlor of the actual settlement.

(3) The time at which trust property is treated as becoming comprised in the notional settlement is when the settlor/spouse IP ceases, which is different from the time that property actually became comprised in the actual settlement.[37]

### 53.12.2 *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 actual settlement, ie 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

36 "This Chapter" is Chapter 3 Part 3 IHTA which deals with relevant property trusts.

37 This fiction does not apply for the purposes of the ten-year anniversary date, which is fixed by the date of the actual settlement: see s.61(2) IHTA 1984. I cannot see the reason for that rule.

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).

### 53.12.3 *Spouse with initial IP: excluded property rule*

Suppose:
(1) In Year 1, H creates a trust under which W has an initial IP.
(2) In Year 2, W dies (so her IP comes to an end). H does not become entitled to an IP at the time that W dies.
In this example H is the settlor of the actual trust and Year 1 is the date of commencement of the actual trust. However, applying the s.80 fictions, the property is treated as comprised in a notional trust, which is treated as made in Year 2 and W is treated as the settlor.

If that were all, it would follow that the trust property could be treated as excluded property if W was foreign domiciled at the time of her death in Year 2. The domicile of H would be irrelevant. This would benefit the taxpayer if (for instance) H was UK domiciled and W was not, and could sometimes be used for tax avoidance.

Therefore where s.80 applies, s.82 IHTA imposes a further condition relating to excluded property.[38] This provides:

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38 With an economy of drafting, s.82 is also used to for the purposes of the same settlement fiction but although there is some overlap, it is easiest to discuss that aspect separately. See 55.9.1 (Section 81 excluded property rule).

> (1) For the purposes of this Chapter[39] ... property to which section 80 ... applies shall not be taken to be excluded property by virtue of section 48(3)(a) above unless the condition in subsection (3) below is satisfied (in addition to the conditions in section 48(3) that the property is situated outside the UK and that the settlor was not domiciled there when the settlement was made).
>
> ...
>
> (3) The condition referred to in subsection (1) ... is—
>
> (a) in the case of property to which section 80 above applies, that the person who is the settlor in relation to the settlement first mentioned in that section ...
>
> was not domiciled in the UK when that settlement was made.

The "settlement first mentioned" in s.80 is the actual settlement made by H. (The notional settlement treated as made by W is the second settlement mentioned in s.80.)

In relation to foreign situate trust property, s.82 prevents the s.80 fiction from benefiting the taxpayer. The fiction may however benefit HMRC. Suppose:

(1) H is the settlor.
(2) W has an initial IP.
(3) Subsequently the settled property is held on trusts where neither H nor W has an interest in possession.[40]

It is necessary to look at the domicile of H at the time when the actual settlement was actually made *and* at the domicile of W at the time her interest in possession came to an end in order to determine whether foreign situate trust property (in the notional settlement) is excluded property. Both must be domiciled out of the UK (at the right time) in order for foreign situate property to qualify securely for excluded property status.

### 53.12.4 *Settlor with initial IP: excluded property rule*

In practice in lifetime trusts it is rare for the settlor's spouse to have an initial IP but it is common for the settlor to have an initial IP. Suppose first that:

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39 "This Chapter" is Chapter 3 Part 3 IHTA which deals with relevant property trusts.

40 Whether an estate IP or not. This is anomalous, but the drafter of the 2006 rules did not think through the consequences for s.80.

(1) Year 1: H has an initial IP; and
(2) Year 2: that IP comes to an end (without W becoming entitled to an IP).

In this example H is the settlor of the actual trust and Year 1 is the date of commencement of the actual trust. However, applying the s.80 fictions, the property is treated as comprised in a notional trust, which is treated as made in Year 2 though H is still treated as the settlor.

If that were all, it would follow that the trust property could be treated as excluded property if H was foreign domiciled in Year 2. The domicile of H at the time the trust was made would be irrelevant. This could not be used for tax avoidance, but s.82 IHTA nonetheless imposes its further condition relating to excluded property. It is necessary to look at the domicile of H at the time when the actual settlement was actually made *and* at the time their interest in possession came to an end in order to determine whether foreign situate trust property (in the notional settlement) is excluded property. H must be domiciled out of the UK at both times in order for foreign situate property to qualify securely for excluded property status.

Suppose:
(1) In Year 1, H creates a trust under which H has an estate IP.
(2) In Year 2, H dies and W becomes entitled to an IP.
(3) In year 3, W's interest comes to an end (H not at that time becoming entitled to an IP).

In this example H is the settlor of the actual trust and Year 1 is the date of commencement of the actual trust. However, applying the s.80 fictions, the property is treated as comprised in a notional trust, which is treated as made in Year 3 and W is treated as the settlor.

If that were all, it would follow that the trust property could be treated as excluded property if W was foreign domiciled at the time of her death in Year 3. The domicile of H would be irrelevant. Once again, s.82 IHTA imposes a further condition relating to excluded property. In relation to foreign situate trust property, s.82 prevents the s.80 fictions from benefiting the taxpayer. It may however benefit HMRC. It is necessary to look at the domicile of H at the time when the actual settlement was actually made *and* at the domicile of W at the time her interest in possession came to an end in order to determine whether foreign situate trust property (in the notional settlement) is excluded property. Both must be domiciled out of the UK (at the right time) in order for foreign situate property to qualify for excluded property status.

### 53.12.5 *Planning for partly excluded property trust*

I use the term **"partly excluded property trust"** to refer to a trust where:

(1) the trust property in the actual settlement is excluded property on ordinary principles; but

(2) it is not excluded property in the notional settlement under s.80/82 rules.

The s.80/82 rules apply only for the purposes of "this chapter": the relevant property trust regime. They have no wider application. So foreign property of a partly excluded property trust:

(1) is not excluded property for the purposes of the relevant property trust taxation; but

(2) is excluded property for all other IHT purposes (eg GWR and the estate IP trust regime).

Before 2006, s.80 did not much matter as a partly excluded property trust could remain IP in form throughout its life. So in practice it qualified as excluded property. Now it cannot do so. So the tax position of these trusts has been seriously affected as an accidental result of the 2006 reforms.

### 53.12.6 *Avoiding s.80/82 problems: trusts made on or after 22 March 2006*

No difficulty arises for lifetime trusts from 22 March 2006, unless the trust confers a disabled person's interest (which will be rare).

Section 80 still poses a trap for will trusts, where the testator is not UK domiciled and the spouse is UK domiciled. One needs to avoid an IPDI.

A simple solution is to arrange that the will trust is discretionary at the outset, ie the widow does not have an initial interest in possession. A two-year discretionary period will in principle be needed to avoid s.144 IHTA. This is easy if the property given to the trust is not UK situate.

### 53.12.7 *Avoiding s.80/82 problems: trusts made before 22 March 2006*

In cases where an existing trust conferred an initial IP on the settlor/spouse, it would be desirable to revoke the IP before the settlor becomes deemed UK domiciled. It does not matter that the settlor/spouse may have an initial IP provided that when it comes to an end[41] the life tenant is not UK domiciled or deemed domiciled.

53.12.8 *Avoiding s.80/82 problems by FOTRA securities or UK funds*

Section 80 provides that property shall not be taken to be excluded property *by virtue of s. 48(3)* IHTA.[42] So it prevents foreign situate property from being excluded property. It does not apply to FOTRA securities and AUTs.

53.12.9 *Commentary*

What is the purpose of the three s.80 fictions? The standard IHT trust regime would not work well where the settlor or their spouse has the first interest in possession under a settlement commencing after 26 March 1974. Dymond explains:

> 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 CTT or IHT at that time. If an exit charge arose nearly 10 years later, it might be difficult to ascertain the value at the commencement of the settlement, as required by s.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 s.68(4)(b) IHTA. The same difficulty with the settlor's cumulative total might occur at the time of the 10 yearly charge, because of s.66(5)(a).[43]

Section 80 solves this valuation problem but the reader may agree with the author that even before 2006 the cure was worse than the disease. (This does explain why the s.80 fictions only apply for the purposes of the standard IHT trust regime.)

Since 2006 the operation of the rules is bizarre, but (as is generally the case with bizarre law) careful planning can mitigate much of the unfairness.

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41 Not being followed by another IP for the settlor/spouse.

42 I am grateful to Chris Jarman for pointing this out.

43 *Dymond's Capital Taxes*, para 19.700.

## 53.13 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[44] adds funds to the trust later when UK domiciled.
Can the added property be excluded property? The IHT Manual para 4272 provides:

> **4272. When the settlement was made** [October 2007]
> The legislation refers to the settlor's (IHTM16000) domicile (IHTM13000) 'at the time the settlement was made'. You should proceed on the basis that, for any given item of property (IHTM04030) held in a settlement, the settlement was made when that property was put in the settlement. Refer any case where this view is challenged to TG.
> *Example*
> S, when domiciled abroad, creates a settlement of Spanish realty. Later he acquires an UK domicile and then adds some Australian property to the settlement.
> The Spanish property is excluded property because of S's overseas domicile when he settled that property. However, the Australian property is not excluded property as S had a UK domicile when he added that property to the settlement.[45]

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 a separate settlement is deemed to be made where a person adds property to

44 This section considers the position where the *settlor* adds to a trust. For the position where others add to a trust, see 55.5 (B adds property to A's trust).

45 This view is repeated in RI 166.

an existing settlement made by them.[46] But since adding property does not in fact create a new and separate settlement, two separate settlements do not exist;[47] one needs something express or implied in the legislation to deem what is in fact one settlement to be treated as two. When new property is added to an existing settlement, the new property *becomes comprised* in the settlement at that time, but that is not the same as saying the settlement (or a new settlement) was made at that time. The HMRC view leads to a more sensible result. But the legislation is so clearly inconsistent with the HMRC view that even a purposive construction cannot assist.[48]

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,

---

46 This fiction is applied when there are two settlors, see 55.4 (The separate settlements fiction). The same fiction could in principle apply when the settlor adds property to an existing settlement.

47 This is self-evident but if authority is needed see *Truesdale v FCT* (1970) 120 CLR 353 at p.362 accessible *http://law.ato.gov.au*.

> "The words created a trust in s.102 are not, I think, apt to describe the payment of money to a trustee to hold under a trust already constituted. There is an obvious difference between creating a trust in respect of property, on the one hand, and, on the other, transferring property to a trustee to hold upon the terms of an established trust. To read the section as if it applied to such a transfer would be, in the absence of a context, to expand it. Such a reading would be tantamount to saying that the transfer to the trustee of property to be held as part of the assets of an already constituted trust would be to create a second trust, whereas, from the point of view of both the trustee and of the beneficiary, there would be but one trust and the property transferred would be nothing more than an addition to the property subject to the trust."

Contrast Civil Procedure Rules 64.4(2) which distinguishes the person who created a trust from one who provided property for the purpose of the trust.

48 "It may be perfectly proper to adopt even a strained construction to enable the object and purpose of legislation to be fulfilled. But it cannot be taken to the length of applying unnatural meanings to familiar words or of so stretching the language that its former shape is transformed into something which is not only significantly different but has a name of its own. This must particularly be so where the language has no evident ambiguity or uncertainty about it." *Clarke v Kato* [1998] 1 WLR 1647 at p.1655.

> whether effected by instrument, by parol or by operation of law, or partly in one way and partly in another, whereby the property is for the time being—
>
> (a) held in trust for persons in succession or for any person subject to a contingency, or
>
> (b) held by trustees on trust to accumulate the whole or part of any income of the property ... or
>
> (c) charged ... with the payment of any annuity ...
>
> (Emphasis added)

Perhaps the HMRC argument is that because a "settlement" means any disposition of property, each disposition constitutes a new and separate settlement. However, the words "any disposition or dispositions of property" indicate that more than one disposition can create a single settlement. One example would be where an original trust has been modified by a disposition by beneficiaries;[49] another would be where the settlor has made separate dispositions to the same trust. So these words do not help the HMRC argument.[50] 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[51] 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

---

49 See 69.10.1 (The trust law background).

50 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.

51 See 55.4 (The separate settlements fiction).

(2) "the time when [added] property was settled".
It did so in the context of excluded property. That section is now repealed but the fact that the drafter took this view in 1977 remains relevant.

On the other hand, the transitional relief for the deemed domicile rule appears to assume the HMRC view, that excluded property status depends on domicile of the settlor at the time the property was added.[52] But overall this factor is outweighed by the others.

It might take litigation before HMRC amend their published stance on this issue but I think they would be advised not to fight. Until the point is clear, trustees should follow this advice in RI 166:

> **Trust records**
> ... the trustees of a settlement should keep adequate records to enable any necessary attribution of the settled property to be made if ...the settlor has added further assets to the settlement after it was made...

Suppose a settlor creates a trust when UK domiciled and adds property to it when foreign domiciled. On my view, none of the property is excluded property. However, HMRC must abide by their statement (at least until 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 should not be in this situation, but it does arise from time to time by accident.

### 53.13.1 *Contract to transfer to trust*

It may be possible to avoid this problem if a foreign domiciled person contracts to assign property to a trust; provided that the contract is made while non-UK domiciled, domicile at the time of the transfer may not matter.

### 53.13.2 *Same settlor adds property to company held by trust after acquisition of UK domicile*

Suppose:
(1) A settlor creates a trust while domiciled outside the UK;

52 See 52.6 (Pre-1974 transitional rules).

(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.

## 53.14 Occasions where excluded property is relevant for IHT

RI 166 states:

> However, an "excluded" asset is not always completely irrelevant for the purposes of IHT. So—
> [1] an "excluded" asset in a person's estate may still affect the valuation of another asset in the estate, for example, an "excluded" holding of shares in an unquoted company may affect the value of a similar holding in the estate which is not "excluded";
> [2] the value of an "excluded" asset at the time the asset becomes comprised in a settlement may be relevant in determining the rate of any tax charge arising in respect of the settlement under the IHT rules concerning trusts without [estate] interests in possession—ss 68(5), 66(4) and 69(3).

This is correct, but point [1] does not arise in practice and point [2] will only rarely be significant.

## 53.15 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[53] makes a transfer of value, tax shall be charged as if each individual to whom an amount is apportioned under this section

53 Section 102(1) IHTA provides a referential definition of "close company":
"In this Part of this Act—
'close company' means a company within the meaning of the Corporation Tax Acts which is (or would be if resident in the UK) a close company for the purposes of those Acts."

> had made a transfer of value of such amount as after deduction of tax (if any) would be equal to the amount so apportioned, less the amount (if any) by which the value of his estate is more than it would be but for the company's transfer ...

Section 94(2) IHTA explains how the apportionment is made. It contains an exemption for foreign domiciliaries:

> if any amount which would otherwise be apportioned to an individual who is domiciled outside the UK is attributable to the value of any property outside the UK, that amount shall not be apportioned.

This exemption does not apply to FOTRA securities because they are UK situate. This was presumably an oversight and the IHT Manual extends the exemption to cover this:

> **14854. Foreign aspects** [October 2007]
> [The Manual summarises the statutory exemption and continues:]
> [1] A transfer of value by
> - a company incorporated abroad (hence domiciled abroad - *Gasque v IRC* [1940] 2 KB 80) of
> - property situate abroad
>
> is **not** excluded property since s.6(1) IHTA only applies to individuals.
> [2] Nevertheless, if such a company
> - is resident abroad and
> - makes a transfer of exempt Government securities within s.6(2) IHTA,
>
> they **do** qualify as excluded property.[54]

There is no exemption for UK situate AUTs or OEICs but an HMRC concession would be sensibly consistent with the practice on FOTRA securities.

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54 Sentence [1] is not technically accurate. It would be strictly correct to say that *property* of a company incorporated abroad and situate abroad is not excluded property, because the definition of excluded property in s.6(1) only applies to property of individuals; however that is beside the point because (as the Manual has just noted) s.94(2) confers an equivalent exemption. But the important point here is that (however clumsily worded) sentence [2] extends the exemption to FOTRA securities.

## 53.16 Interests in trust property

An interest in trust property (an equitable interest) is itself an item of property which may be subject to IHT. That would lead to double taxation, eg in a trust for A for life, remainder to B, there might be

(1) tax on the death of A (if A has an estate IP) or 10 year charges; and
(2) tax on the death of B (if the reversionary interest is an asset of B's estate).

### 53.16.1 *Reversionary interest*

Section 48(1) IHTA deals with this problem by providing that a reversionary interest is generally excluded property:

> (1) A reversionary interest is excluded property unless—
> (a) it has at any time been acquired (whether by the person entitled to it or by a person previously entitled to it) for a consideration in money or money's worth, or
> (b) it is one to which either the settlor or his spouse [or civil partner] is or has been beneficially entitled, or
> (c) it is the interest expectant on the determination of a lease treated as a settlement by virtue of section 43(3) above.

What about a reversionary interest within (a) to (c)? 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

The words in italics make it clear that the non-settled property rules apply. An equitable interest which is a reversionary interest may be excluded property if it meets the conditions of s.48(1) or if it is not UK situate and owned by a foreign domiciliary.

### 53.16.2 *Interest in possession*

An equitable interest which is an estate IP is excluded properly only if it is owned by a foreign domiciliary and is not UK situate. However, the disposal of the interest is not a transfer of value; s.51 IHTA. Tax is charged under s.52 only if the settled property is not excluded property.

### 53.16.3 *Purchased equitable interests*

Section 48(3) and (3A) IHTA both provide:

> but this subsection is subject to subsection (3B) below. ...

Section 48(3B) IHTA is an anti-avoidance provision which applies to two categories of settled excluded property: foreign situate property and UK funds. It provides:

> Property is not excluded property by virtue of subsection (3) or (3A) above if—
> (a) a person is, or has been, beneficially entitled to an interest in possession in the property at any time,
> (b) the person is, or was, at that time an individual domiciled in the UK, and
> (c) the entitlement arose directly or indirectly as a result of a disposition made on or after 5th December 2005 for a consideration in money or money's worth.

EN FB 2006 explains:

> 8. ... By purchasing interests in existing trusts originally settled by a person domiciled outside the UK, UK-domiciled individuals have increasingly exploited this exemption to convert their wealth into IHT-free form.
> 9. This clause is aimed at blocking such avoidance by providing that property is not excluded property by virtue of section 48(3) or section 48(3A) IHTA if, at any time, a person domiciled in the UK has had an interest in possession in it, and their interest arose from a disposition for a consideration in money or money's worth. This applies whoever paid the money, and if the interest was acquired indirectly (for example, under a will or by intestacy) or has been passed on to someone else.

Section 48(3C) IHTA expands on this:

> For the purposes of subsection (3B) above—
> (a) it is immaterial whether the consideration was given by the person or by anyone else, and
> (b) the cases in which an entitlement arose indirectly as a result of a disposition include any case where the entitlement arose under a will or the law relating to intestacy.

Section 48(3C)(a) confirms (what would have been clear) that the provision can apply if an interest is purchased by A and then given by A to B. I am unable to see the point of s.48(3C)(b).

### 53.16.4 *F(No.1) A 2010 rules*

Sections 52, 53 F(No.1)A 2010 also require consideration, but will require many pages to discuss. They are some way from the themes of this book but I hope to address them in a future edition.

## 53.17 Non-residents foreign currency bank accounts

### 53.17.1 *Individual's account*

Section 157(1)(a) IHTA provides a limited relief for non-residents foreign currency bank accounts:

> (1) In determining for the purposes of this Act the value of the estate immediately before his death of a person to whom this section applies there shall be left out of account the balance on—
> (a) any qualifying foreign currency account of his ...
>
> (5) In this section "qualifying foreign currency account" means a foreign currency account with a bank[55]; and for this purpose—
> (a) "foreign currency account" means any account other than one denominated in sterling.

Section 157(2) IHTA explains who qualifies for the relief:

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55 Section 157(6) IHTA provides: "In this section 'bank' has the meaning given by section 991 of the Income Tax Act 2007."

> This section applies to a person who is not domiciled in the UK immediately before his death, and is neither resident nor ordinarily resident[56] there at that time.

### 53.17.2 *Trustees bank account*

Section 157(1)(b) IHTA provides a similar restricted relief for trustees foreign currency bank accounts:

> (1) In determining for the purposes of this Act the value of the estate immediately before his death of a person to whom this section applies there shall be left out of account the balance on ...
> (b) subject to subsection (3) below, any qualifying foreign currency account of the trustees of settled property in which he is beneficially entitled to an interest in possession.
>
> (3) Subsection (1)(b) above does not apply in relation to settled property
> [a] if the settlor was domiciled in the UK when he made the settlement, or
> [b] if the trustees are domiciled, resident or ordinarily resident in the UK immediately before the beneficiary's death.

For the definition of trust residence see 4.14 (Trust residence for IHT). Domicile presumably depends on the domicile of the trustees in their personal capacity (the rule that trustee domicile should be relevant is difficult to understand).

### 53.17.3 *Overdrawn account*

The IHT Manual provides at para 4380:

> Where the conditions are met, the balance on the account, whether in credit or in debit should be left out of account. You should refer any case of difficulty, especially if you are seeking to disallow a debit

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56 Section 157(4) IHTA incorporates the income tax definitions of residence and ordinary residence:
"For the purposes of this section—
(a) the question whether a person is resident or ordinarily resident in the UK shall, subject to para (b) below, be determined as for the purposes of income tax;"
(Para (b) deals with trustee residence, discussed below).

balance, to TG.

The second sentence suggests, perhaps, that HMRC are not entirely confident in this interpretation. It seems literally correct on a first reading, and provides a certain symmetry of treatment with accounts with a positive balance; on the other hand it is a daft rule, a petty trap easily avoided by the well advised, and inconsistent with the general approach of deduction for debts.[57] I do not think it could have been the intention of Parliament.

### 53.17.4 *Commentary*

This is a limited relief. The bank account is *not* excluded property for IHT purposes. It is only disregarded on the death of the owner or life tenant, so it is taken into account for lifetime gifts of individuals, and ten-year anniversary charges on trusts. The conditions for the relief are also stricter than for excluded property. It would in almost all cases be better to use a foreign bank account (which will be excluded property) rather than to rely on this exemption.

If the purpose of the relief is to encourage foreign domiciliaries to deposit funds with UK banks, these restrictions make no sense. It is suggested that foreign currency accounts (indeed all accounts) ought simply to qualify as excluded property in the same way as non-UK accounts. That change would also ensure the deductibility of overdrawn accounts. Otherwise the relief is just clutter in the system and if (as I expect) it is not much used it would be better to repeal it.

## 53.18 Works of art

The IHTA provides a pragmatic relief for works of art. Section 5(1) IHTA provides relief on death:

> For the purposes of this Act a person's estate is the aggregate of all the property to which he is beneficially entitled, except that ...
> (b) the estate of a person immediately before his death does not include ... a foreign-owned work of art which is situated in the UK for one or more of the purposes of public display, cleaning and restoration

57 See 56.5 (Deduction for debt of foreign domiciled individual).

(and for no other purpose).

Section 64(2) IHTA provides relief from ten year charges:

> For the purposes of subsection (1) above, a foreign-owned work of art which is situated in the UK for one or more of the purposes of public display, cleaning and restoration (and for no other purpose) is not to be regarded as relevant property.

Section 272 IHTA defines these terms:

> "foreign-owned", in relation to property, means property in the case of which the person beneficially entitled to it is domiciled outside the UK or, if the property is comprised in a settlement, in the case of which the settlor was domiciled outside the UK when the property became comprised in the settlement;
> "public display" means display to which the public are admitted, on payment or not, but does not include display with a view to sale;

The reason is self-evident. Dawn Primarolo (then Financial Secretary to the Treasury) explained :

> the public interest would not be served if foreign owners of works of art were unwilling to send them to the UK for [purposes of public display, cleaning or restoration] for fear of a potential inheritance tax charge.[58]

This relief falls short of a complete exemption but in practice it is sufficient, and the gaps are not sufficiently important to discuss further here. See too 10.31 (Public access rule).

## 53.19 Overseas Pensions

A full discussion of the IHT treatment of pensions needs a book to itself. This section focusses on the issues closest to the themes of this book. See too 53.19 (Situs of pension and death benefits).

The IHT Manual provides:

58 Ministerial Statement 25 February 2003 [2003] STI 303.

**17140. Overseas pensions** [October 2007]

Under Section 153 IHTA 1984 certain overseas pensions are left out of account in determining the value of a person's estate (IHTM04029) immediately before their death. See the part of the table at IHTM17132 (IHTM17132) dealing with overseas service for further details.

Where a UK domiciliary (IHTM13000) is a member of an overseas pension scheme although the scheme cannot be 'approved' (IHTM17121) for Section 151 IHTA 1984 purposes it may well still qualify as a sponsored (IHTM17122) superannuation scheme. On the death therefore the relieving provisions of Section 151 IHTA 1984 will still apply to any pension rights terminating and in respect of the pension scheme discretionary trusts itself.

Where the member dies in service and a death benefit (IHTM17030) is paid the IHT treatment is along the normal lines (IHTM17052) and depends on the terms of the pension scheme in question and, in particular, the rules governing payment of the lump sum death benefit. If the death benefit is held by the trustees of the pension scheme on discretionary trusts as regards payment then no claim will arise and Section 151 IHTA 1984 may apply (see IHTM17121 (IHTM17121)). If however the payment is due to the estate as of right (IHTM17052) or if the member has a general power (IHTM17081) of appointment over the funds or if they have assigned rights (IHTM17071) into trust whilst in ill health or where they can withdraw the funds at any time then a charge to IHT may arise.

The concept of a trust is alien in many overseas countries (although the type of pension foundation found in Switzerland and the Netherlands is sometimes considered to be somewhat akin to a UK trust arrangement). It follows that there is not usually a degree of discretion in those arrangements which would mirror a UK trust and they are therefore generally vulnerable to an IHT claim.

Details of lump sums payable under overseas pensions should be included in the form D6 (IHTM10033) at question 2 and will be considered by the Pension Specialist in TG at IHT Edinburgh.

As overseas pension schemes are not approved they are not covered by SP10/86 (IHTM17073). The funds in a pension scheme are regarded (IHTM17125) as provided by the employee whether contributed by the employee or the employer and accordingly the employee would be regarded as the settlor of any trust affecting these funds. If the employee were a beneficiary or possible beneficiary under these trusts the question of a reservation of benefit (IHTM14025) pursuant to Section 102 FA 1986 would be relevant.

Claims under this head will normally be identified by TG on examination of the Trust Deed or Scheme Rules.

Section 153 IHTA provides a narrow relief:

> (1) In determining for the purposes of this Act the value of a person's estate immediately before his death there shall be left out of account any pension payable under the regulations or rules relating to
> [a] any fund vested in Commissioners under section 273 of the Government of India Act 1935 or
> [b] to any fund administered under a scheme made under section 2 of the Overseas Pensions Act 1973 which is certified by the Secretary of State for the purpose of this section to correspond to an Order in Council under subsection (1) of the said section 273....
> (3) Subsection (1) above shall be construed as if contained in section 273 of the Government of India Act 1935 ...
> (4) If, by reason of Her Majesty's Government in the UK having assumed responsibility for a pension, allowance or gratuity within the meaning of section 1 of the Overseas Pensions Act 1973 payments in respect of it are made under that section, this section shall apply in relation to the pension, allowance or gratuity, exclusive of so much (if any) of it as is paid by virtue of the application to it of any provisions of the Pensions (Increase) Act 1971 or any enactment repealed by that Act, as if it continued to be paid by the Government or other body or fund which had responsibility for it before that responsibility was assumed by Her Majesty's Government in the UK.

## 53.20 IHT planning for individual

A foreign domiciliary should endeavour to secure, as far as possible, that their 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 agricultural or business property reliefs. The same applies to trustees of a settlement made by a foreign domiciliary. The question is: how is the individual's property to be transferred abroad?

The transfer abroad of £ Sterling from a UK bank account poses no problem. The transfer of bearer instruments abroad raises no problem. The transfer abroad of foreign currency in a UK bank account abroad needs consideration as to CGT. Chattels could be physically moved abroad but that may not be practical.

It is possible to turn UK situate shares and securities into non-UK situate assets for IHT: see 70.7 (Bearer documents).

Any UK asset could be sold and the proceeds remitted abroad. This is simple and satisfactory for inheritance tax; however, a sale may be ruled out by CGT or commercial reasons.

If the foreign domiciliary does not wish assets to be sold, they might give them to a company owned wholly by them. The shares in the company should not be UK situate.[59] 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*[60] 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.[61]

If the individual is in good health, there is a lot to be said for doing nothing and ignoring IHT planning. The only inheritance tax risk in this strategy is that the individual might die so suddenly that no steps to save tax can be taken. This risk is reduced (but not eliminated) if the spouse exemption is available. It might be possible to take out insurance. In principle it is clearly undesirable to allow a beneficiary in poor health to retain an interest in possession in non-excluded property.

## 53.21 IHT planning for non-estate IP trusts

A discretionary trust (and a non-estate IP trust) is subject to IHT on its ten-year anniversaries. If the settlor is not UK domiciled when they made the

59 See 70.4 (Situs of registered shares) and 70.7 (Bearer documents).

60 2 ITELR 794.

61 A gift to the company by way of *donatio mortis causa* solves the CGT problem: s.62(5) TCGA. But such a gift is not effective for inheritance tax purposes. The donor retains the right of revocation which would not be excluded property on their death.

trust, all that matters for IHT is the situs of the trust fund on that date.[62] 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.

In practice such a course might be subject to *Ramsay* but it depends on how it is done. Ideally the trustees should look for a different strategy such as holding the UK assets in a foreign registered company.

## 53.22 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.

### 53.22.1 *Beneficiaries not ordinarily resident*

If the life tenant is not ordinarily resident in the UK, the trustees might invest in FOTRA securities. The trust property would then be excluded property. See 53.10 (Trusts: FOTRA securities).

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.

### 53.22.2 *UK settlor: foreign domiciled beneficiary*

The best option – if circumstances allow – may be to bring the present

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62 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 54.12 (GWR death charge: excluded property rules for settled property) and following.

settlement to an end by appointment to the foreign domiciled beneficiary absolutely. CGT needs consideration if the trust is UK resident and s.87 TCGA needs consideration if it is not. 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.

An alternative course may be to confer a general testamentary power on the foreign domiciled beneficiary. The beneficiary may on their death create a new trust with excluded property.

### 53.22.3 *Life tenant domiciled in Channel Islands or Isle of Man but deemed UK domiciled*

For this case, see 53.7 (Individual domiciled in Channel Islands or Isle of Man).

CHAPTER FIFTY FOUR

# RESERVATION OF BENEFIT

## 54.1 GWR – Introduction

Here is a rendezvous of questions and question marks! A full discussion needs a book to itself. I focus on matters closest to the themes of this book. The IHT Manual contains much fascinating material which cannot be set out here for reasons of space.

Section 102(1) FA 1986 provides:

> ... this section applies where, on or after 18 March 1986, an individual disposes of any property by way of gift and either—
> (a) possession and enjoyment of the property is not bona fide assumed by the donee at or before the beginning of the relevant period;[1] or
> (b) at any time in the relevant period the property is not enjoyed to the entire exclusion, or virtually to the entire exclusion, of the donor and of any benefit to him by contract or otherwise ...

There are two sets of conditions:

(1) An individual (in this chapter "**the donor**") makes a disposal of property by way of gift. There are three separate elements here: a *disposal*, of *property*, which must be *by way of gift.*

(2) Condition (a) or (b) above must be satisfied (a reservation of benefit).

## 54.2 Terminology

Section 102(2) FA 1986 provides one defined term:

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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."

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 (ie the gift is to a settlement).
(3) "**Non-settled GWR property**" is GWR property which does not become settled property by the gift (ie 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.

## 54.3 Disposal before 18 March 1986

The GWR rules only apply to disposals on or after 18 March 1986. The IHT Manual states correctly:

> **14311 Initial requirements** [November 2009]
> A pre-18 March 1986 settlement which would have been caught by the GWR provisions had it been made after 17 March 1986 will therefore escape the GWR charge unless further gifts into settlement are made after that date. The GWR provisions will apply to the property settled by those further gifts. ...
> *Example*
> On 1 January 1985 the donor settled £100,000 on discretionary trusts under which he was a potential beneficiary. On 1 January 1989 he added a further £50,000 to the settlement. The donor dies 1 April 1992 having remained a potential beneficiary throughout.
> The GWR provisions apply to the 1989 addition but not to the property originally settled. The GWR claim extends to the assets in the settled fund at 1 April 1992 representing that £50,000. The Double Charges Regulations (IHTM 14711) will be in point.

But GWR will apply to pre-1986 settlements on the termination of an estate IP.[2]

## 54.4 When is there a "disposal by way of gift"?

There are some general issues on the meaning of a "disposal by way of gift". Is the surrender of a lease or life interest a "disposal"? Or the giving of consent to an exercise of a power of advancement or appointment? Is a sale at an undervalue "by way of gift"? Or a transfer to a settlement in which the settlor has an estate interest in possession? These questions 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".

## 54.5 When is there a reservation of benefit?

The words used in the statute are remarkably obscure. While in most cases the matter will be clear enough there are significant areas of uncertainty. Some doubtful areas have been resolved for practical purposes by HMRC statements.

### 54.5.1 *Gift to discretionary trust, settlor a beneficiary*

IHT Manual provides:

> **14393 Settlement on discretionary trusts** [November 2009]
> If a donor makes a settlement and is one of the members of the discretionary class of beneficiaries, this is a GWR.
> - The donor's position as a member of the discretionary class of beneficiaries is not an equitable interest retained by them (and so not included in the gift) and
> - as the donor is a member of the class, they have not been excluded (IHTM14333), or virtually excluded, from enjoyment. The fact that they do not receive any tangible benefit during the relevant period is immaterial.

2 See 54.15 (GWR on termination of interest in possession).

This is correct.[3] It is considered that the same applies where an individual makes a gift to a discretionary trust under which:

(1) the settlor is not included in the class of beneficiaries; but
(2) the trustees have an unrestricted power to add the settlor to the class of beneficiaries.[4]

### 54.5.2 *Gift from A to B followed by gift to trust by B*

The position is different where:

(1) A makes a gift to B.
(2) Later, by an independent transaction, B creates a discretionary trust under which A is a beneficiary (or where A can be added as a beneficiary).

In these circumstances A is *not* the settlor. It is considered that there is no reservation of benefit merely because A is a discretionary beneficiary. There will be a reservation of benefit if A actually receives a benefit.

## 54.6 IHT on the disposal by way of gift

A gift which is a chargeable transfer will give rise to a charge to IHT (assuming it exceeds the nil rate threshold) whether or not it is a gift with a reservation.[5] The reservation of benefit does not affect this charge; just

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3 *IRC v Eversden (Greenstock's Executors)* 75 TC 340. (The Court of Appeal did not consider this point.)

4 The HMRC view is, however, equivocal. The IHT Manual provides:

> "**14393 Settlement on discretionary trusts** [November 2009]
> *Example 2*
> ... 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".

5 The IHT Manual makes this somewhat elementary mistake:

> "**14316 Sales for less than full consideration** [November 2009]
> *Example 1*
> In 1989 the donor sold a house, then worth £100,000, to his son for £25,000. This is a disposition partly by way of sale and partly by way of gift. The donor dies in 1993.
> - If the donor has been excluded from enjoyment of the property throughout the period, the gift is a PET chargeable on his death. The loss to his estate is the value of the entirety of the property less the consideration received (£100,000 less

on the death of the donor there may be a further charge to tax. The Inheritance Tax (Double Charges Relief) Regulations 1987 mitigate a double charge. This chapter does not consider the IHT which might arise on a gift; it considers only the GWR aspects.

## 54.7 Gift of excluded property

Section 102 FA 1986 applies when an individual disposes of any property by way of gift. A foreign domiciliary is certainly "an individual". A gift of UK situate property by a foreign domiciliary is clearly within the GWR rule.

What is the position where a foreign domiciliary disposes of excluded property by way of gift? There is nothing which expressly takes the gift out of the scope of the GWR rules. However, it is considered that s.3(2) IHTA does so obliquely. Section 3 IHTA provides:

> **Transfers of value**
> (1) Subject to the following provisions of this Part of this Act, a transfer of value is a disposition made by a person (the transferor) as a result of which the value of his estate immediately after the disposition is less than it would be but for the disposition; and the amount by which it is less is the value transferred by the transfer.
> (2) For the purposes of subsection (1) above no account shall be taken of the value of excluded property which ceases to form part of a person's estate as a result of a disposition.

On a literal approach to construction this makes no difference. The fact that no account is taken of the value of excluded property for the purposes of s.3(1) does not mean that the disposition is not a "disposal by way of gift". However, a purposive construction suggests otherwise. It is absurd that there should be a charge to tax in circumstances where:

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£25,000 = £75,000).

- If the donor was not excluded from enjoyment of the property, for instance because he resided at the property following the disposition, the disposal by way of gift is a GWR. The value of the property disposed of by way of gift is 75% of the value of the whole property. Thus, if the property is still subject to a reservation immediately before the donor's death, 75% of its death value is treated as property to which the donor was beneficially entitled."

(1) a foreign domiciliary with no UK connection makes a gift of excluded property to another person with no UK connection, and enjoys some benefit; and
(2) the foreign domiciliary dies many years later at a time when property representing the property given is situate in the UK.

Nobody would expect the foreign domiciled donor or their executors to comply or to be able to comply with an obligation to pay IHT in such circumstances. The purpose of s.3(2) IHTA is to take excluded property out of the scope of inheritance tax and a disposal of excluded property is by implication ignored. Since it is ignored it is not a disposal "by way of gift". This conclusion is also supported by the use of the term "excluded property" – the property is regarded as excluded from IHT.

HMRC do not appear to accept this view.

## 54.8 GWR spouse exemption

This section considers the GWR position on inter-spouse gifts. For other IHT spouse exemption issues see 54.17 (IHT spouse exemption defence to GWR death charge), 58.1 (IHT spouse exemption on death of a foreign domiciliary); 64.2 (Restriction on IHT spouse exemption for foreign domiciled spouse).

Section 102(5) FA 1986 provides a relief which I call the "**GWR spouse exemption**":

> This section does not apply if or, as the case may be, to the extent that the disposal of property by way of gift is an exempt transfer by virtue of any of the following provisions of Part II of the [IHTA],—
> (a) section 18 (transfers between spouses or civil partners) ... ;

In short, the GWR rules do not apply on gifts between spouses if the IHT spouse exemption applies.[6]

Where a UK domiciled individual makes a gift to a foreign domiciled spouse, the IHT spouse exemption is restricted to £55,000 and a gift over that limit will be within the scope of GWR, unless some other exemption

6 I use the term "**IHT spouse exemption**" to refer to the exemption on inter-spouse transfers in s.18 IHTA. See 54.17 (IHT spouse exemption defence to GWR death charge).

is in point.[7] One solution to this problem is to sell assets at market value, so there is no disposal by way of gift. Watch the SDRT/SDLT implications.

One common situation is where one spouse gives an interest in the family home to the other spouse, but as long as the property is jointly occupied, there is in principle no GWR: see s.102B FA 1986.

### 54.8.1 *Inter-spouse gift of excluded property*

What is the position when a foreign domiciled individual makes a gift of excluded property to their spouse? On a literal construction, the gift will fall within the GWR rules. A gift of excluded property is not a transfer of value, so outside the scope of the IHT spouse exemption, so it is outside the scope of the GWR spouse exemption! But that is absurd and cannot be the correct construction, even if words must be strained to reach this result. This consideration supports the view taken here that gifts of excluded property, and gifts within s.11 IHTA, are deemed not to be by way of gift.[8]

Such property is nevertheless "subject to a reservation" and so qualifies for the GWR exemption to the pre-owned asset rules.

## 54.9 GWR death charge

Section 102(3) FA 1986 provides:

> If, immediately before the death of the donor, there is any property which, in relation to him, is property subject to a reservation then ... that property shall be treated for the purposes of the [IHTA] as property to which he was beneficially entitled immediately before his death.

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

7 Such as the family maintenance exemption: see 64.4 (Disposition for maintenance of spouse and other exemptions).

8 If my view were wrong the further anomaly would arise that gifts of qualifying investments to charity would fall within the scope of GWR because such gifts fall within s.12 IHTA and not s.102(5)(d) FA 1986; but it is not necessary to pursue that here.

subject to the reservation but the property is treated as if they 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 their 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 their estate.

## 54.10 GWR over debt owed by the deceased

Suppose:
(1) S creates a discretionary settlement under which S is a beneficiary;
(2) the trustees lend to S;
(3) S dies.

The debt ("the GWR debt") is treated as being in the estate of S. However a person cannot owe a debt to himself. If the GWR debt is treated as property beneficially owned by the debtor, it must be treated as if it ceased to exist. For this reason there is no IHT charge on the debt under the

GWR rules, on the death of S, even if the GWR debt is UK situate.[9]

## 54.11 GWR death charge: non-settled property excluded property rules

Suppose:
(1) A gives property to B, an individual, outright.
(2) There is a reservation of benefit: A enjoys benefits at the time of A's death.
(3) The property is not UK situate at the time of A's death.
A is treated as if A were beneficially entitled to the property at the time of A's death. It forms part of their estate unless it is excluded property at that time. How do the excluded property rules work in these circumstances?

Here we are concerned with non-settled property. The relevant rule is that:

> Property situated outside the UK is excluded property if the person beneficially entitled to it is an individual domiciled outside the UK.[10]

In the example above, B is *in fact* beneficially entitled to the property. A is *treated* as beneficially entitled. Who is "beneficially entitled" for the purpose of applying the excluded property rule; is it A or is it B? This does not matter if A and B are both foreign domiciled, but it does if one is and the other is not. One common case is in a gift from a UK domiciled donor to their foreign domiciled spouse.[11]

### 54.11.1 *Construction of deeming provisions*

The answer is to be found by applying the general rule of construction which applies to deeming provisions:

> If you are bidden to treat an imaginary state of affairs as real, you must surely, unless prohibited from doing so, also imagine as real the consequences and incidents which, if the putative state of affairs had in

9 If the debt is non-UK situate it may also be outside the scope of IHT because of the excluded property rules. On the question of a deduction for the GWR debt, see 56.7.3 (Debt owed by settlor to settlor-interested discretionary trust).
10 Section 6(1) IHTA.
11 See 54.8 (GWR spouse exemption).

> fact existed, must inevitably have flowed from or accompanied it.[12]
> ... [B]ecause one must treat as real that which is only deemed to be so, one must treat as real the consequences and incidents inevitably flowing from or accompanying that deemed state of affairs[13]...

But context can show that the general rule should not be applied. It is merely a general canon of construction from which "only limited assistance can be derived in choosing between alternative interpretations of the Act".[14] Experience shows that Parliament has often failed to foresee all the consequences of its deeming and nowadays the courts apply deeming provisions in a context sensitive manner.[15]

### 54.11.2 *Conclusion*

Applying this principle it follows that the domicile of the donor A is what matters for excluded property status. Thus if A has a foreign domicile, the property (if not UK situated) is excluded property. The domicile of the donee B is irrelevant. This conclusion is confirmed by the context. It would be absurd if the taxation of A depended on the domicile of B. The taxation of A should depend on A's own domicile position.

For the purposes of the excluded property rule, therefore:

(1) The domicile of the donor at the time of gift is irrelevant (contrast the position where the gift is made in trust).[16]

(2) The situs of the property at the time of the gift is irrelevant to the operation of the excluded property rules on the death of the donor.

HMRC agree. The IHT Manual provides:

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12 Lord Asquith, *East End Dwellings Co Ltd v Finsbury Borough Council* [1952] AC 109 at p.132.

13 *Marshall v Kerr* 67 TC 56 at p.79A.

14 *Russell v IRC* [1988] STC 195 at p.205.

15 In *Murphy v Ingram* [1973] Ch 363 at p.446 Megarry J said:

> "A research student in search of a suitable topic for a thesis might do worse than to choose as his subject 'the Dangers of Deeming'."

But the modern approach reduces these dangers and *Murphy* itself would be decided differently today. For an example, see *De Rothschild v Lawrenson* 67 TC 300 at p.316.

16 See 54.12 (GWR death charge: excluded property rules for settled property) below.

> **14318 The gift: exempt transfers which cannot be GWRs** [2010]
> ...
> *Excluded property*
> Under the charging provisions (IHTM04072), excluded property (IHTM04251) cannot be the subject of a GWR...
> *Example*[17]
> Example 3 (George)
> G is originally domiciled in the UK, but moves to New Zealand and acquires a domicile of choice there. He gives some New Zealand shares to his son, R, but continues to enjoy the dividends until his death ten years later. He dies domiciled in New Zealand.
> The property is subject to a reservation and is therefore deemed to be part of G's estate on death. However, the property is situated 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 IHTA84/S6 (1) and escapes the GWR charge.

This is correct; the Manual continues:

> However, if G had returned to the UK and his domicile of origin had revived, there will be a GWR claim on his death, or if the reservation had ceased in his lifetime and within 7 years of his death, the ending of the reservation will be treated as a deemed PET. This is because at the time the GWR charge arises, G is domiciled in the UK so IHTA84/S61) does not apply...

While it is correct that s.6(1) does not apply on the facts of this version of the example, it is arguable that there is no GWR.[18]

The same applies to gifts to companies, including companies held by trusts.

## 54.12 GWR death charge: excluded property rules for settled property

Suppose:

(1) S (not UK domiciled) gives property to a discretionary settlement.
(2) There is a reservation of benefit, eg S is a beneficiary.

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17 This example was reworded and improved in 2010, probably in response to criticisms of the former wording in the 2010/11 edition of this book.

18 See 54.7 (Gift of excluded property).

(3) The property is not UK situate[19] at the time of the death of S.
S is treated as if S were beneficially entitled to the property at the time of S's death. It forms part of S's estate unless it is excluded property at that time. How do the excluded property rules work in these circumstances?

### 54.12.1 *The rival solutions*

There are two sets of excluded property rules, relating to settled and non-settled property. Which does one apply?

(1) *The Settled Property Solution*
The property subject to a reservation is in fact settled property, so on this view one applies the settled property rules set out in s.48(3) IHTA:

> Where property comprised in a settlement is situated outside the UK—
> (a) The property ... is excluded property unless the settlor was domiciled in the UK at the time the settlement was made. ...

So on this view, where an individual makes a gift to a settlement with reservation of benefit, and dies, the property is excluded property for the GWR rules if:
(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 their death. (The domicile of the donor at the time the settlement was made is

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19 The position is the same if the property consists of UK AUTs or OEICs, but for convenience I refer to non-UK situate property only.

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**".

54.12.2 *The correct solution*

The Non-settled Property Solution has supporters.[20] Nevertheless it is generally regarded as wrong. What about the deeming provision that the property is to be treated as if the donor were beneficially entitled to it? The answer is that the property must still be regarded as "settled property" for the application of the excluded property rules. One does not carry the implications of the deeming provisions as far as the Non-settled Property Solution suggests. One way to reach this conclusion is to note that the deeming provision does not deem the donor to be beneficially and *absolutely* entitled to the settled property. One can be beneficially entitled to property which is settled property. (Bear in mind that "settlement" has a wide definition for IHT. It includes property held subject to a contingency, property charged with the payment of an annuity, and a lease for life. A person entitled to such property may nevertheless be said to be "beneficially" entitled.)

This view is strongly supported by s.49(1) IHTA which provides:

> A person beneficially entitled to an interest in possession in settled property shall be treated for the purposes of this Act as *beneficially entitled* to the property in which the interest subsists.
> [Emphasis added]

No-one suggests that property to which s.49(1) applies is to be treated as non-settled property for the purposes of the GWR rules. The wording of the deeming provision in s.102(3) is materially the same.

Under the Non-settled Property Solution, the property is simultaneously excluded property (for general IHT purposes) and non-excluded property (for GWR purposes). While that is not impossible, it would be remarkable, even in as convoluted an area as this, and for this reason too the Settled Property Solution is to be preferred.

20 Robert Venables QC, "Excluded Property Trusts and GROBs" [2003] OITR Vol 11 p.75. Barrie Akin agrees: *GITC Review*, Vol 1 Issue 2, p.1, accessible *www.taxbar.com*.

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 they had not made the gift. This is the general purpose in the case of gifts by UK domiciliaries. However, arguments on purposive construction only run when one knows the general purpose and is confident that the general purpose applies in the particular circumstances of the case. This argument *assumes* that that purpose necessarily extends to the foreign domiciliary – which begs the question. Perhaps Parliament intended there to be a difference between the two cases. One cannot apply a purposive construction unless the purpose is clear.[21]

Trustees should bear in mind that, even in adopting the Settled Property Solution, there will arguably[22] be a charge to IHT on the death of a settlor who enjoys a benefit over trust property if at the time of their death:

(1) trust property is UK situated (and not UK AUTs or OEICs); and
(2) the property was given to the trust on or after 18 March 1986.

If the settlor is a beneficiary it is safer not to invest directly in UK situate property during their 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 their death. However that won't often happen.

### 54.12.3 *HMRC view*

After a decade of dithering,[23] HMRC now agree with the Settled Property Solution. The IHT Manual provides:

> **14396 Settled property: Settlement created when the settlor is domiciled outside the UK** [January 2011]
> Where the settlor was domiciled outside the UK at the time a settlement

21 In the battle of the anomalies HMRC might instance the case where a foreign domiciliary made a settlement shortly before becoming UK domiciled, and say that it is absurd that a settlement made in such circumstances should avoid IHT on the death of the settlor. But (1) this is certainly the case where the foreign domiciliary enjoys no benefit from the settlement; and (2) this was the case under estate duty; and (3) this was the case under HMRC practice in the first 15 years or so of IHT; in the circumstances it is wrong (if not absurd) to describe that result as absurd.

22 See 54.7 (Gift of excluded property).

23 See the 2010/11 edition of this work para 51.12.3.

was made, any foreign property in the settlement is excluded property and is not brought into charge for Inheritance Tax (IHT) purposes (IHTM27220). This rule applies where property is subject to a reservation of benefit even though the settlor may have acquired a domicile of choice in the UK, or be deemed to be domiciled in the UK, at the time the GWR charge arises (IHTM04071).

*Reservation ceasing on death*

At the material date FA86/S102(3) deems the donor to be beneficially entitled to property that is, at that time, settled property. As the property in which the reservation subsisted is 'property comprised in a settlement', it is the provisions of IHTA84/S48(3) that are in point. It is the domicile of the settlor at the time the settlement was made that is relevant in deciding whether foreign property in which the reservation subsisted is excluded property.

*Example* (Henry)

H, who is domiciled in New Zealand, puts foreign property into a discretionary trust under which he is a potential beneficiary (IHTM14393). He dies five years later having acquired a domicile of choice in the UK and without having released the reservation. The property is subject to a reservation on death but it remains excluded property and is outside the IHT charge.

The Manual continues by noting three exceptions:

*Exceptions to the rule*

There are, however, circumstances where this rule does not apply:

[1] If the trustees had sold the foreign assets so that at the date of death the settled property was invested in UK assets, the exclusion would not apply as the property comprised in the settlement was not situated outside the UK, so IHTA84/S48(3) cannot apply.

[2] If the donor has acquired a domicile of choice (or is deemed domiciled) in the UK and adds other property to the settlement (irrespective of the situs (IHTM27071) of the property), we regard the donor as creating a separate settlement (IHTM04272). All the trust assets will be property subject to a reservation, but the foreign assets settled when the donor was domiciled outside the UK will be excluded property, whereas the assets settled when the donor was domiciled in the UK will be subject to IHT

[3] And in the reverse situation, if a donor who is domiciled (or deemed domiciled) in the UK creates a settlement with foreign assets and the settled property remains subject to a reservation at death, the trust assets will be subject to IHT under FA86/S102(3) even if the settlor dies

domiciled outside the UK as IHTA84/S48(3) does not apply - as well as being subject to relevant property trust charges (IHTM42000).

Point [1] is correct that s.48(3) does not apply but it is arguable that there is no GWR for other reasons[24]. Point [2] is very doubtful: see 53.13 (Settlor adds property to trust after change of domicile). Point [3] is correct, assuming the settled property solution is correct. The unfairness of the double charge (which does not seem to trouble HMRC) may be avoidable by winding up the trust.

## 54.13 Gift to foreign domiciled donee who creates a settlement

Suppose:
(1) A makes an outright gift to B.
(2) B makes a gift of that property to a settlement.
(3) A is a beneficiary of that settlement and enjoys benefits so that there is a reservation of a benefit in relation to A's gift.
(4) B (and not A) is the settlor of the settlement; see 69.4 (Gift from A to B followed by gift to trust by B).

Now which set of excluded property rules is applied? It is suggested that one must apply the rules applicable to settled property for the reasons given in 54.12 (GWR death charge: excluded property rules for settled property). FA 1986 Sch. 20 para 5 needs to be considered but, properly understood, nothing there deems A to be the settlor of the settlement. If that is right, there is no reservation of benefit problem if:
(a) B (the settlor) was not domiciled in the UK when the settlement is made; and
(b) the property is not situated in the UK at the time of the death of A.

Conversely, on this view, there is a GWR problem if B (the settlor) is UK domiciled (regardless of the domicile of A).

## 54.14 GWR PET charge

So far we have considered the position where the benefit continues until the death of the donor. Section 102(4) FA 1986 provides:

24 See 54.7 (Gift of excluded property).

> If, at a time before the end of the relevant period, any property ceases to be property subject to a reservation, the donor shall be treated for the purposes of the 1984 Act as having at that time made a disposition of the property by a disposition which is a potentially exempt transfer.

I refer to this as "**the GWR PET charge**". Section 102(4) is a deeming provision; it is a different deeming from s.102(3), the GWR death charge. In s.102(3) the donor is deemed to be beneficially entitled. Here, the donor is deemed to have made a PET. To understand the significance of this, it is necessary to set out the definition of a PET. A PET is a particular kind of transfer of value (s.3A IHTA) and s.3 IHTA provides:

> (1) [a]... a transfer of value is a disposition made by a person (the transferor) as a result of which the value of his estate immediately after the disposition is less than it would be but for the disposition; [b] and the amount by which it is less is the value transferred by the transfer.
> (2) For the purposes of subsection (1) above no account shall be taken of the value of excluded property which ceases to form part of a person's estate as a result of a disposition.

Note that s.3(1) contains two definitions: s.3(1)[a] defines "transfer of value" and s.3(1)[b] defines "value transferred". For both purposes s.3(2) states that excluded property is (in short) disregarded.

### 54.14.1 *Non-settled GWR PET charge*

Suppose:
(1) a non-UK domiciliary makes a non-settled GWR of non-UK situate property; and
(2) the property ceases to be subject to a reservation (while the donor is still non-UK domiciled).

No-one could sensibly suggest that there is a possible IHT charge. The reason is in s.3(2): the donor is deemed to have made a disposition of excluded property. While one can (just) call that a PET, the value transferred is ignored and no charge to IHT can arise. Nothing in the deeming provision requires one to ignore the application of s.3(2) to s.3(1)[b]. What matters is the domicile of the donor (and the situs of the GWR property) at the time the reservation ceases. There would be a deemed PET if:

(1) F (a foreign domiciliary) makes a GWR.
(2) F becomes UK domiciled.
(3) The GWR is released.[25]

### 54.14.2 *Settled GWR PET charge*

Suppose settled property ceases to be subject to a reservation; eg a donor ceases to be a beneficiary of a trust they have created, and becomes excluded from all benefit. 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 concluded above) the Settled Property Solution is correct on death then there is also no charge on a lifetime cessation of GWR. HMRC agree, and (having eventually come down in favour of the Settled Property Solution) accept the view that there is no charge. The IHT Manual provides:

> **14396 - Settled property: Settlement created when the settlor is domiciled outside the UK** [January 2011]
> ... *Reservation ceasing during lifetime*
> Where the reservation is released during the donor's lifetime, FA86/S102(4) treats the donor as making a disposition of the property by a disposition which is a potentially exempt transfer (PET) (IHTM04072). This is different to the basis of the charge arising on death, but as property in which the reservation ceases is 'property comprised in a settlement' the provisions of IHTA84/S48(3) are again in point to decide whether any foreign property is excluded property.
> As FA86/S102(4) treats the donor as making a disposition, it is the treatment of excluded property when disposition is made that is relevant. IHTA84/S3(2) states that 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 disposition.
> So as the donor is treated as making a disposition, property is treated as ceasing to form part of their estate. Provided that property is excluded property, IHTA84/S3(2) applies to exclude the assets in which the

25 There is a hint of this in IHTM 14318, but the point is not addressed clearly.

reservation ceased from charge.

This vindicates the view taken in the pre 2011 editions of this work. ("The taxpayer should conduct their affairs on the basis of the Settled Property Solution. ... One should not be deterred by the ghost of an argument rattling its chains in the IHT Manual.")

The Manual continues with three exceptions:

> The same exceptions to the above will apply as regards
> [1] foreign property which is replaced by UK situs property (IHTM27071),
> [2] property added to the settlement when the donor is domiciled in the UK, and
> [3] in the reverse situation outlined above, a charge will arise under FA86/S102(4) if the reservation ceases before the donor's death.

For these exceptions, see 54.12.3 (HMRC view).

## 54.15 GWR on termination of interest in possession

Before 22 March 2006, GWR did not in principle apply on the termination of an interest in possession, because the termination did not usually involve a disposal by way of gift. Now s.102ZA FA 1986 provides:

> (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, or falls within section 5(1B) of the 1984 Act 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[26] 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 54.12 (GWR death charge: excluded property rules for settled property).

If the life tenant does not enjoy any GWR, no problem arises.

If the former life tenant does enjoy a benefit the position is thought to be as follows:

(1) The GWR rules do not apply if the GWR property is excluded property.
(2) The GWR property is excluded if:
    (a) the settlor was not UK domiciled when the settlement was made; and
    (b) the trust property is not UK situate (or UK funds excluded property) at the time of the GWR charge (the death of the former life tenant or the time of cessation of benefit).

## 54.16 GWR property subject to debt

Debts are in principle deductible in computing a GWR charge. HMRC accept this. IHT Manual provides:

> **14401. The property comprised in the gift** [November 2009]
> ... *Example*
> In 1990 the donor settles £1 on discretionary trusts of which he is, and remains until his death in 2000, an object. Shortly after the creation of the settlement he advances £50,000 to the trustees by way of loan, interest free and repayable on demand.
> At the time of his death, the settled property comprises £1 cash (representing the original £1 gift into settlement) and the proceeds of an insurance policy (purchased with the borrowed monies) on the donor's life amounting to £250,000.

26 "The no-longer-possessed property" is defined in s.102ZA(3):

> "In subsection (2) above 'the no-longer-possessed property' means the property in which the interest in possession subsisted immediately before it came to an end, other than any of it to which the individual becomes absolutely and beneficially entitled in possession on the coming to an end of the interest in possession."

> 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)

## 54.17 IHT spouse exemption defence to GWR death charge

This section considers whether the IHT spouse exemption can apply on the death of the donor so as to override the GWR death charge.[27]

Suppose:

(1) H makes a gift to S which is a GWR so the gifted property is GWR property.
(2) H dies and leaves H's entire estate to his spouse W (and the IHT spouse exemption applies to H's estate).

On the death of H the position for the GWR property is governed by s.102(3) FA 1986:

> ...that property shall be treated for the purposes of the [IHTA] as property to which [H] was beneficially entitled immediately before his death.

The GWR property is not excluded property (even if S is foreign domiciled).[28] So H will in principle be subject to inheritance tax on the GWR property on H's death.

The spouse exemption is not available on the death of H to avoid this 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

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27 For other IHT issues see 54.8 (GWR spouse exemption); 64.1 (UK domiciliary married to foreign domiciliary) and 58.1 (IHT spouse exemption on death of a foreign domiciliary).

28 See 54.11 (GWR death charge: non-settled property excluded property rules).

that estate is increased.

This exemption does not apply to the GWR property since it does not become comprised in the estate of W. HMRC agree. The IHT Manual provides:

> **14303 Devolution of GWR property** [June 2006]
> It is important to keep in mind that that the GWR rules are fictitious treatments created only for the purposes of preventing IHT avoidance. They do not affect the **actual** devolution of the property in real life, so the gifted property does not actually pass on death under the will or intestacy, neither was any gift actually made at the time the reservation ceased.
> The gifted property passed to the actual donee at the time it was actually made. Thus, any reliefs or exemptions (IHTM11001) that may be available on death, or that apply to PET's, such as spouse or civil partner relief (IHTM11032), charity relief or annual exemptions, will **not** apply to the transfer deemed to be made on death, or deemed to be made when the reservation ceases.

Suppose:
(1) H (UK domiciled) makes a gift to W (foreign domiciled at the time of the gift).[29]
(2) The gift does not qualify for the IHT spouse (or any other) exemption and H continues to enjoy benefits from the property until H's death so the gifted property is GWR property.
(3) W still owns the GWR property at the time of the death of H.
(4) W has become UK domiciled (or deemed domiciled) at the time of the death of H.

At first glance it might seem that the IHT spouse exemption does not apply. On the facts of this example the conditions of the relief are not in reality satisfied. The GWR property does not "become" comprised in the estate of the spouse; and on the occasion of the death of H, the estate of the spouse has not "increased". However, one must remember that s.102(3) FA 1986 is a deeming provision. It is the old question of how far one carries the deeming.[30] If one deems, as s.102(3) requires, the GWR

29 The gift is a PET (but assume H survives seven years so no tax charge arises on the PET).
30 See 54.11.1 (Construction of deeming provisions).

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 they had not made the gift. If H had not made H's gift then (on the facts of the above example) H would qualify for the spouse exemption.

The IHT spouse exemption would also apply to defeat a GWR death charge if H made a gift to a trust under which H's spouse acquired an estate interest in possession on H's 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 A's death.

### 54.17.1 *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 64.11.2 (Gift to foreign domiciled spouse, followed by settlement by spouse).

CHAPTER FIFTY FIVE

# IHT CONSEQUENCES OF TRANSFERS BETWEEN TRUSTS

## 55.1 Transfers between trusts – Introduction

This chapter considers the IHT consequences[1] of transfers between trusts and adding property to trusts. There are three main tiers of rules:

(1) General principles of trust law and tax law which apply in the absence of specific IHT provisions.
(2) A specific IHT provision which applies generally for IHT trust taxation: s.44(2) IHTA. I refer to this as **"general IHT law"**.
(3) Specific IHT provisions which apply only to the taxation of relevant property[2] which I call **"relevant property taxation"**: ss.81–82 IHTA.

The main significance of these rules relates to excluded property status, especially if there has been a change of domicile of the settlor. The rules can affect other matters such as the date and computation of a ten-year charge.

For completeness, a fourth tier of rules applies to employee trusts[3] and pension trusts.

## 55.2 Trust law background

There are several ways by which property can move between settlements

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1 For CGT, see 45.19 (Transfer between trusts). Section 731 ITA may need consideration. Another issue (not discussed in this book) is that the transfer may be a transfer of value or may give rise to an exit charge under s.65 IHTA.

2 That is, trust property which is relevant property as defined by s.58 IHTA. Before 2006 this meant discretionary trusts, but (from March 2006) it includes non-estate IP trusts.

3 See s.86(4)(5) IHTA (not discussed here).

(without a person becoming beneficially entitled to the property in the meantime). For the purposes of this chapter the two important ways are as follows:

(1) Trustees may exercise a power to transfer trust property to another trust.[4]

(2) (a) A beneficiary who is entitled to a contingent or reversionary interest in the capital of the trust fund of trust A may assign that interest to trust B; and

(b) the trustees of trust B in due course become absolutely entitled to the trust fund of trust A.

## 55.3 General tax principles

The position is in short as follows:[5]

(1) If trustees exercise a power to transfer property from trust A to trust B, then, at least to the extent of the transferred property, the settlor of trust A is a settlor of trust B.[6]

(2) If a beneficiary with an equitable interest under trust A transfers this interest to trust B, then, at least to the extent of the interest transferred, the beneficiary is a settlor of trust B.

## 55.4 The separate settlements fiction

Section 44(2) IHTA provides:

> Where more than one person is a settlor in relation to a settlement and

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4 A transfer to a separate settlement 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* para 16.230.
Trust law questions also arise: whether trustees have a power to transfer to another trust and restrictions on accumulation and perpetuity periods. These issues are not discussed here.

5 See 69.7 (Transfer from trust A to trust B by exercise of trustees' power).

6 That is:
(1) If all the property of trust B is derived from A, directly or indirectly, then A is the only settlor of trust B.
(2) If some of the property of trust B is derived from A and some from B, then A and B become joint settlors.

> 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 inheritance taxation of trusts depends on:

(1) the domicile of the settlor

(2) the transfers made by the settlor in the 7 years before commencement of the trust (which affect the trust's nil-rate band for RP taxation).

The rules are drafted on the basis that every settlement has one settlor and only properly work on that basis; instead of making provision for a trust with multiple settlors, the scheme is to regard such trusts as multiple trusts.

IHT Manual provides:

> **42253. More than one settlor** [June 2007]
> ... This separation has 3 main effects
> [1] Where more than one trust exists each will have its own nil-rate band for rate purposes.
> [2] 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.
> [3] 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 settlor domicile aspects of the rule.

When the separate settlements fiction applies, the settled property is treated as being in separate settlements (which I call "**notional trusts**"). It is important to note that these are fictional or notional trusts. They do not exist in the sense that the trust with several settlors exists. Each notional trust must (for IHT purposes) be regarded as possessing three features: (1) notional trust property (2) a notional settlor and (3) a notional date on which it was made. These features are as notional or fictional as the notional trust itself. The statute does not expressly tell us what they are: context and common sense must fill that gap.

### 55.4.1 *When separate settlements fiction does not apply*

The separate settlements fiction is expressed to apply for the purposes of Part 3 IHTA (not generally), but all the important provisions which govern trust tax are in Part 3.[7]

There are two cases where the separate settlements fiction does not apply.

Firstly, the fiction does not apply unless "the circumstances so require". Normally the circumstances do so require, but the drafter was aware that the separate settlements fiction might not always be appropriate. Most likely the drafter could identify any cases where the fiction should not be applied but thought there might be some such cases; another possibility is that the drafter identified some cases but thought they were too difficult or insufficiently important to set out in the statute. So that has been left to the courts to sort out.

Secondly, the fiction does not apply for the purposes of s.48(4) to (6), ie for the purposes of the exemption for FOTRA securities. The reason was that FOTRA exemption does not depend on the identity of the settlor, it depends on the identity of the beneficiaries.[8] It was therefore unnecessary to apply the separate settlements fiction. As far as I can see the fiction would not have done any harm, but it would not have had any effect: presumably the drafter thought it safer or simpler not to have to bother with the separate settlements fiction.

## 55.5 B adds property to A's trust

Suppose:
(1) an individual ("A") creates a trust ("the real trust"), and
(2) another[9] individual ("B") adds property to it.[10]

The real trust has two settlors, A and B. The separate settlements fiction applies, and one must imagine that the trust fund of the real trust is

7 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).

8 See 53.10 (Trusts: FOTRA securities).

9 For the position where the settlor adds to their *own* trust, see 53.13 (Settlor adds property to trust after change of domicile).

10 The same analysis applies if A and B together transfer funds to a new jointly made trust.

comprised in two notional trusts, "notional trust A" and "notional trust B". Common sense suggests:

(1) Notional trust A is regarded as if:
   (a) It holds the property given by A.
   (b) A is its sole settlor.
   (c) It was made at the time A made the real trust.
(2) Notional trust B is regarded as if:
   (a) It holds the property given by B.
   (b) B is its sole settlor.
   (c) It was made at the time B added property to the real trust.

### 55.5.1 *More than one addition to a trust*

Suppose:

(1) An individual ("A") creates a trust ("the real trust").
(2) Another individual ("B") adds property to it ("the first addition").
(3) B later adds more property to the trust ("the second addition").

It is considered that there are still two notional trusts. Notional Trust A is as before. Notional trust B is regarded as if:

   (a) It holds the property given by B.
   (b) B is its sole settlor.
   (c) It was made at the time of the first addition
   (d) B added property to the notional trust at the time of the second addition.

It follows that trust property added by the second addition may be excluded property if B was not UK domiciled at the time of the first addition.[11]

### 55.5.2 *Adding value indirectly*

It is suggested that the same applies if B adds value indirectly to the real trust (eg by a gift to a company held by the real trust). The real trust has two settlors, A and B.[12] 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

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11 See 53.13 (Settlor adds property to trust after change of domicile).

12 See 69.14 (Provision of property for company held by trust).

value given by B is still possible. It may not be easy but it is no harder than many apportionments required for tax.[13]

## 55.6 Direct settlor and indirect settlor

Suppose there is an arrangement under which:
(1) A gives property to B, and
(2) B gives the property to a trust ("the real trust").
It appears at first sight that there are then two settlors: an indirect settlor (A) and a direct settlor (B).[14] Both have provided the *same* property.

What is the IHT analysis? On one view the separate settlements fiction applies so that the settled property in the real trust is treated as being comprised in separate trusts (which I call "notional trust A" and "notional trust B"). On this view the consequence is said to be that:
(1) Notional trust A:
    (a) holds *all* the trust property of the real trust;
    (b) A is its sole settlor;
    (c) I do not know when proponents of this view would say that notional trust A was made. It would either be at the time A gave the property to B or the time that B settled it, and this poses perhaps another difficulty with this view.
(2) Notional trust B:
    (a) also holds *all* the trust property of the real trust;
    (b) B is its sole settlor;
    (c) was made at the time B created the real trust.

The difficulty with this view is that it leads to double taxation[15] 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.

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13 For instance, apportionment of gains of non-resident companies to participators.

14 See 69.4 (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 69.33 (Planning to create trust with foreign domiciled settlor).

15 This view is supported by comments in *Hatton v IRC* [1992] STC 140 at pp.160–161. But (1) the comments are obiter (2) the judge did not have the benefit of counsel's arguments on the issue (3) the judge did not appreciate the double taxation difficulties which arise on their view; in the circumstances it is considered that these comments do not represent the law.

We have therefore one real settlement with two settlors. What is the position for excluded property if A is foreign domiciled and B is not? It will be recalled that settled property is (in short) excluded property "unless *the settlor* was domiciled in the UK at the time the settlement was made". There are two possible solutions:

(1) One cannot say that "the settlor" was domiciled in the UK unless both settlors were domiciled here. In that case the trust property may be excluded property if either A or B are foreign domiciled.
(2) To read the word "the settlor" in this context as meaning "the settlor or one of the settlors".[16] In that case the trust property is only excluded property if A and B are both foreign domiciled.

Both solutions have anomalous results, though in one case the anomaly favours the taxpayer and in the other it favours HMRC.

The best solution to this conundrum is that one should identify A as the "real" settlor and infer that B should not be regarded as a settlor.[17] Then the anomalies do not arise.

### 55.6.1 *The HMRC view*

RI 166 provides:

> **Several persons contribute to a single settlement** [February 1997]
> ...
> [Section 44(2)] is similar in terms to FA 1975 Sch 5 para 1(8), which was considered by Chadwick J in *Hatton v IRC* [1992] STC 140. In the light of the decision in that case [HMRC] take the view
> [1] that the determination of the extent to which overseas assets in a settlement are excluded property by reason of the settlor's domicile is a relevant "required circumstance"; and that
> [2] where a clear, or reasonably sensible, attribution of settled property between the contributions made by several settlors is possible, there will be a separate settlement, with its own attributed assets, for each contributor for IHT purposes;
> [3] if such an attribution is not feasible, each separate settlement will

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16 Applying (perhaps extending) the rule of construction that the singular includes the plural.

17 See 69.4.2 (If A is indirect settlor, is B also the settlor?).

> comprise all the assets of the single, actual settlement.[18]
>
> **Trust records**
>
> It follows from the comments above that the trustees of a settlement should keep adequate records to enable any necessary attribution of the settled property to be made if ... two or more persons have contributed funds for the purposes of the settlement.

Point [2] is correct. Point [3] is difficult to apply and doubtful. It is difficult to apply because how does one know whether attribution is "feasible"? I suggest it should always be feasible where two or more persons have contributed funds.[19] Point [3] is doubtful because it rests on a shaky obiter comment, discussed above, which was actually considering the different situation of *reciprocal* settlors. I do not wish to consider reciprocal settlors here because they are hardly ever found in practice, but if the Judge's comments are right at all, they should be restricted to the case of reciprocal settlors, where it might more plausibly be said that attribution between settlors is not feasible. RI 166[3] suggests that penal taxation may arise as a result of inadequate record keeping, but that cannot be right.

In practice it is perhaps better to avoid joint settlors (or for one person to add property to a settlement made by another). This avoids the complication of the separate settlements fiction. But in a straightforward case there should not be any difficulty as long as:

(1) all settlors are foreign domiciled or all are UK domiciled; or
(2) the settlors include both UK and foreign domiciliaries, but trust record keeping is adequate. (Ordinary trust accounts should suffice.)

It is likewise best to avoid indirect additions to a trust fund (eg a beneficiary using their own funds to improve trust property), where the

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18 In similar vein, IHT Manual provides:

> "**42253. More than one settlor** [June 2007]
>
> ... 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.

19 This is assumed in s.471 ITA; see 69.7.3 (IT and CGT rule).

original settlor is foreign domiciled and another person adding property is UK domiciled. If the settlor adds property to a trust of which they are the settlor, this problem does not arise.[20]

## 55.7 Transfer from trust made by A to trust made by B

This paragraph considers the general IHT position though if (as is usually the case) the trust property is relevant property, s.81 also needs consideration.[21]

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.[22]

Real trust B has two settlors, A and B. The separate settlements fiction applies and one imagines that the settled property is comprised in two notional trusts ("notional trust A" and "notional trust B").

Notional trust A is regarded as if:

(1) it holds the property provided by A;
(2) A is its sole settlor;
(3) The important question is: at what time is notional trust A regarded as being made? The choice is:
    (a) at the time that real trust A was made;
    (b) at the time of the transfer to real trust B.

The latter view cannot be right, for various anomalies would then arise.

(1) Suppose A died before the transfer to real trust B. One cannot then apply the rule that the excluded property status of the trust depends on the domicile of the settlor "at the time the settlement was made".[23]

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20 See 53.13 (Settlor adds property to trust after change of domicile).

21 See 55.9 (The same settlement fiction: s.81).

22 The same analysis applies if the trustees of real trusts A and B each transfer their trust funds to a third real trust C.

23 It has been argued that if A is UK domiciled when A made real trust A and dead at the time of the transfer to real trust B, A's fund can be excluded property after the transfer. The argument is:
(1) Notional trust A is regarded as made at the time of the transfer to real trust B.
(2) A is regarded as not "domiciled in the UK" at that time (because a dead person has no domicile).
The view that notional trust A is regarded as made at the time real trust A was made avoids obvious anomalies and is to be preferred.

(2) Suppose a transfer from trust A to trust B and A changes domicile after the date of trust A but before the transfer:
   (a) If A is UK domiciled when A made real trust A and foreign domiciled at the time of the transfer to real trust B, A's fund would become excluded property after the transfer. One would not expect HMRC to agree with that.
   (b) Conversely, if A is foreign domiciled when A made real trust A and UK domiciled at the time of the transfer to real trust B, the trust fund would cease to be excluded property.

   These are not equivalent or self cancelling anomalies, for in case (a) no transfers would usually take place, whereas in case (b) transfers would take place every time.

Under my analysis, there is in principle no IHT advantage or disadvantage from a transfer to another trust, regardless of changes in the settlor's domicile, or the settlor's death, which is logical and sensible. I see no difficulty in a rule that the notional trust is regarded as made before the transfer, for once one accepts that the notional trust is fictional, it can logically be regarded as being made on any date.

This view is also consistent with the principle in *Muir v Muir* [1943] AC 468.

## 55.8 Transfer from trust made by A to another trust made by A

This section considers the general IHT position though if (as is usually the case) the trust property is relevant property, s.81 also needs consideration.[24]

Suppose:

(1) A creates two separate trusts, trust A1 and A2.
(2) The trustees of trust A1 transfer property ("the transferred property") to trust A2.

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If (contrary to my view) notional trust A is regarded as made at the time of the transfer to real trust B, after the death of A, one might regard A as having at that time the domicile A had:
(1) at the time of A's death; or
(2) at the time A made real trust A.
Another view is that s.44(2) only applies if the circumstances so require, and they do not so require. However adopting my approach, s.44(2) gives a sensible result.

24 See 55.9 (The same settlement fiction: s.81).

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 A made trust A1 but not when A made trust A2.* It is suggested that the transferred property in trust A2 may in principle 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 A made trust A1 and UK domiciled when A made trust A2.* The result is reversed. The transferred property in trust A2 is not excluded property. Trust A2 does not satisfy the condition that the settlor was foreign domiciled when this settlement was made.

Thus there is a distinction between:
(1) transfer from trust made by A to a trust made by B (change of A's domicile irrelevant); and
(2) transfer from trust made by A to another trust made by A (change of A's domicile significant).

This is anomalous but the anomaly naturally follows from the fact that the separate settlements fiction applies in case (1) and not in case (2).

### 55.8.1 *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 which provides:

> In this Chapter references to the commencement of a settlement are references to the time when property first becomes comprised in it.

It is considered that the transferred property may in principle be excluded property if A is living and foreign domiciled at the time of the transfer, even though A was UK domiciled when A 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 A's 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 A made trust A1 and at the time of A's death. A court is likely to regard A as retaining after A's death the domicile A had during A's 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 A death.

## 55.9 The same settlement fiction: section 81

Section 81(1) IHTA provides:

> 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[25] 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 IHT avoidance based on moving property between settlements. Suppose a trust ("the old trust") is approaching its 10-year anniversary (on which a 10-year charge would arise). Simple examples of tax avoidance by transfer to a new trust (in the absence of s.81) are as follows:

(1) The trustees might transfer the trust property to a new trust (made by the same settlor), whose 10-year anniversary is 10 or nearly 10 years ahead.

(2 (a) The trustees might appoint a reversionary interest to a beneficiary.
 (b) The beneficiary transfers that interest to a new trust.
 (c) The new trust becomes entitled to the trust property before the ten year anniversary of the old trust.

25 "This Chapter" is Chapter 3 Part 3 IHTA which deals with relevant property trusts.

These schemes would avoid the 10-year charge on the old trust.[26] Section 81 effectively counteracts both these schemes by deeming the trust property to remain in the old trust. This explains why the same settlement fiction applies only for the purpose of relevant property taxation.

IHT regards trust property as a continuing fund,[27] so s.81 does not apply on a sale between trusts at full value, for no property moves between settlements.

Section 81 does not apply to a loan from trust 1 to trust 2 on commercial terms. It does not apply to an interest free loan repayable on demand, because the promise to repay is full consideration.

The section only applies on a transfer of trust capital: if trustees of a discretionary trust distribute trust income to another trust, it is considered that s.81 does not apply, because the income is not "settled property".

What if property is transferred from trust A to trust B and the terms of the trusts are different? Although the property transferred from is deemed to be held in trust B, it is considered that it is not deemed to be held on the terms of trust A: it is regarded as held on the terms set out in trust B as if they had been incorporated in trust A. For instance, a transfer from a discretionary trust to an estate IP trust gives rise to an exit charge: the property is deemed to remain held in the first trust but the trust property ceases to be relevant property.

### 55.9.1 *Section 81 excluded property rule*

Where s.81 applies, s.82 IHTA imposes an additional requirement for trust property to qualify as excluded property.[28] This provides:

> (1) For the purposes of this Chapter[29] ... property to which section ... 81 above applies shall not be taken to be excluded property by virtue of

26 For completeness: these schemes might also be advantageous if the settlor had made chargeable transfers in the 7 years before the creation of the old trust, as the second trust might have a better nil-rate band in the computation of its ten years charges.

27 Contrast SP E9 "Property is regarded, for the purposes of s.48(3) IHTA, as becoming comprised in a settlement when it, *or other property which it represents,* is introduced by the settlor."

28 With an economy of drafting, s.82 is also used to for the purposes of the s.80 fictions, but although there is some overlap, it is easiest to discuss that aspect separately. See 53.12 (Initial interest of settlor or spouse).

29 "This Chapter" is Chapter 3 Part 3 IHTA which deals with relevant property trusts.

section 48(3)(a) above unless the condition in subsection (3) below is satisfied (in addition to the conditions in section 48(3) that the property is situated outside the UK and that the settlor was not domiciled there when the settlement was made).

(2) [Transitional rules: see 55.9.7 (Section 81 transitional rules).]

(3) The condition referred to in subsection (1) ... above is ...

(b) in the case of property to which subsection (1) or (2) of section 81 above applies, that the person who is the settlor in relation to the second of the settlements mentioned in the subsection concerned,

was not domiciled in the UK when that settlement was made.

I refer to the rule in s.82 (as it applies in a s.81 case) as **"the s.81 excluded property rule"**.

This rule only applies in determining whether foreign situate property is excluded property, so it does not apply for AUTs and OEICs.[30]

This rule only applies for the purposes of relevant property taxation, so one must distinguish:

(1) excluded property for the purposes of relevant property taxation (**"RP excluded property"**); and
(2) excluded property for other IHT purposes (but the scope of this has been greatly reduced by the 2006 reforms.)

The consequences of this rule depend on the circumstances of the inter-trust transfer.

### 55.9.2 *Transfer from trust made by A to another trust made by A*

Suppose:

(1) A creates two separate trusts, trust A1 and trust A2.
(2) The trustees of trust A1 transfer property ("the transferred property") to trust A2.

The possibilities are as follows:

*A is not UK domiciled when A made trust A1 but UK domiciled when A made trust A2.* The transferred property in trust A2 is not excluded property under general IHT principles.[31]

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30 See 53.9 (Trusts: authorised unit trusts and OEICs).

31 See 55.9.5 (B transfers equitable interest to another settlement).

*A is UK domiciled when A made trust A1 but not UK domiciled when A made trust A2.* The transferred property may be excluded property under general IHT principles. However, s.82 prevents foreign situate transferred property in trust A2 from qualifying as RP excluded property. (This is probably an accidental consequence of the wording, because if the drafter had had the point in mind they would have made s.82 IHTA apply for all IHT purposes and not only for the purposes of relevant property taxation.)

In short, for foreign situate transferred property to qualify as RP excluded property, A must be domiciled outside the UK at the time A made trust A1 and trust A2.

### 55.9.3 *Transfer on to third trust or back to first trust*

Suppose:

(1) A creates three separate trusts, A1, A2 and A3.

(2) The trustees of trust A1 transfer property ("the transferred property") to trust A2.

(3) The trustees of trust A2 transfer the transferred property to trust A3.

The transferred property is treated as remaining in trust A1. It is only excluded property if A was not UK domiciled when A made "the second of the settlements mentioned" in s.81(1), but that refers (it is considered) to trust 3. The domicile of A at the time A made trust A2 is not relevant.

Thus if trustees of an excluded property trust transfer property to a non-excluded property trust made by the same settlor, they have fallen into a trap: foreign situate transferred property ceases to be excluded property.[32] But they can extricate themselves from the trap if the trustees of trust A2 transfer the property back to trust A1; or if they transfer it on to trust A3 (if A3 is a trust made when the settlor is not UK domiciled).

### 55.9.4 *Transfer from trust made by A to trust made by B*

Suppose:

(1) A gives property ("A's fund") to a settlement ("real trust A").

(2) B gives property ("B's fund") to a separate settlement ("trust B").

(3) The trustees of real trust A transfer A's fund to trust B.

32 If this was unforeseen, the transfer might well be invalid under the rule in *Hastings-Bass*.

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. 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) foreign situate property in A's fund can only be excluded property if:
    (a) A is foreign domiciled at the time real trust A was made; and
    (b) B is foreign domiciled at the time trust B was made

    (applying the s.81 excluded property 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 A 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 trustees of trust A transfer A's fund to a company held by trust B.

### 55.9.5 *B transfers equitable interest to another settlement*

The position is different if:

(1) A gives property ("A's fund") to a settlement ("trust A").
(2) B has an equitable interest under trust A (perhaps a reversionary or contingent right to trust capital).
(3) B assigns B's 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.

### 55.9.6 *Purpose of section s.81 excluded property rule*

What is the purpose of the s.81 excluded property rule? It often happens that an artificial deeming rule which closes up one avoidance scheme can be exploited for another. The same settlement fiction is an example. Dymond explains what might be done in the absence of the s.81 excluded property rule. Suppose:

(1) A, who is domiciled outside the UK, settles foreign property on discretionary trusts for a short period with remainder to A absolutely.
(2) B, who is UK domiciled, buys A's reversion and settles it on discretionary trusts.[33]

Under general IHT law, B would in principle be the settlor of trust B, which would be within the scope of IHT in the ususal way. However applying the same settlement fiction, A would be the settlor and (because of A's domicile) B's trust would be an excluded property trust!

Section 82 counteracts this scheme. If my analysis is right,[34] then s.82 works, though it does not produce the fair result in every case. Suppose the facts were reversed:

(1) A, who is domiciled in the UK, settles foreign property on discretionary trusts for a short period with remainder to A absolutely.
(2) B, who is foreign domiciled, buys A's reversion and settles it on discretionary trusts.

There is no obvious fairness here in the rule that B's trust should be within the scope of IHT but the example is somewhat contrived and perhaps it does not much matter.

An incidental result is to restrict or prevent tax advantages on a transfer from trust A1 to A2 where A was UK domiciled when A made trust A1 but foreign domiciled at the time A made trust A2.[35]

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33 *Dymond's Capital Taxes*, 19.810. These are the facts considered in 55.9.5 (B transfers equitable interest to another settlement).

34 See 55.9.4 (Transfer from trust made by A to trust made by B).

35 See 55.9.2 (Transfer from trust made by A to another trust made by A).

### 55.9.7 *Section 81 transitional rules*

Section 81(2)(3) IHTA sets out three transitional rules:

> (2) Subsection (1) above shall not apply where the property ceased to be comprised in the first settlement before 10 December 1981; but where property ceased to be comprised in one settlement before 10 December 1981 and after 26 March 1974 and, by the same disposition, became comprised in another settlement, it shall for the purposes of this Chapter be treated as remaining comprised in the first settlement.
> (3) Subsection (1) above shall not apply where a reversionary interest in the property expectant on the termination of a qualifying interest in possession subsisting under the first settlement was settled on the trusts of the other settlement before 10 December 1981.

## 55.10 Pension benefits

Lastly, for completeness, there is a special rule for pension benefits. Section 151(5) IHTA provides:

> Where
> [a] a benefit has become payable under
>   [i] a registered pension scheme
>   [ii] a qualifying non-UK pension scheme or
>   [iii] a section 615(3) scheme, and
> [b] 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 FIFTY SIX

# IHT DEDUCTION FOR DEBTS

## 56.1 IHT deduction for debts – Introduction

This chapter is concerned with IHT deductions for debts.[1] One could write a short book on this important and misunderstood topic. This chapter sets out basic principles and their application to foreign domiciliaries. There is some fascinating material in the IHT Manual which is not discussed here.

## 56.2 Liability of individual

Section 5(3) IHTA provides the authority for deducting an individual's liabilities (or so one might think):

> In determining the value of a person's estate at any time his liabilities at that time shall be taken into account, except as otherwise provided by this Act.

In *Green v IRC* the judge regarded s.5(3) IHTA as merely confirming a

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1 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 70.1 (Concepts of situs).
(2) Whether interest on the debt has a UK source, relevant for:
(a) the recipient of the interest who may suffer UK income tax; and
(b) the payor, who may be required to deduct tax.
See 17.1 (Interest).
(3) Effect of the debt on the POA charges, see 66.17 (Excluded liability rule).
Consistent with the patchwork nature of UK tax law, different (though overlapping) considerations apply in these contexts.

deduction, not authorising it,[2] but that does not ultimately matter.[3]

The general rule has seven exceptions. The first is in s.5(5) IHTA which provides:

> Except in the case of a liability imposed by law, a liability incurred by a transferor shall be taken into account only to the extent that it was incurred for a consideration in money or money's worth.

This does not often apply, because liabilities are normally incurred for full consideration.[4] In particular, if an individual borrows money, the liability to repay the lender is in principle outside the scope of s.5(5), because it is a debt incurred for full consideration. By contrast, if an individual gratuitously covenants to pay money to a person, their 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 Kessler & Brown, *Taxation of Charities and Non-Profit Organisations* (8th ed., 2011), para 22.4 (Meaning of 'consideration').

property to which the debtor is treated as entitled as life tenant.[5] The fifth exception applies if the debt is property to which the debtor is treated as entitled under the GWR rules.[6] The sixth (arguable) exception relates to liabilities on non-residents overdrawn foreign currency bank accounts.[7]

A liability is in principle deductible even though it is owed to a connected person. But in this case s.103 FA 1986 will sometimes apply.

## 56.3 Section 103 FA 1986

The last and most important restriction on deducting debts for IHT is the anti-avoidance provision in s.103 FA 1986. This applies (in short) where an individual owes a debt to a person to whom they have 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 specify the extent of the disallowance:

> ... to an extent proportionate to the value of any of the consideration given for the debt or incumbrance which consisted of—

5 See 53.10 (Debt owed by estate IP trust to life tenant.
6 See 56.7.3 (Debt owed by settlor to settlor-interested discretionary trust).
7 See 53.17.3 (Overdrawn account).

(a) property derived from the deceased; or
(b) consideration (not being property derived from the deceased) given by any person who was at any time entitled to, or amongst whose resources there was at any time included, any property derived from the deceased.

Thus s.103(1) works like this:
(1) One needs to identify the consideration given for the liability.
(2) One asks to what extent the consideration consists of the type of consideration described in s.103(1)(a) and (b).
(3) To that extent the liability is in principle disallowed. (There are defences. I will come to those later.)

### 56.3.1 *Section 103(1)(a) disallowance*

One needs first of all to ascertain whether the consideration for the liability was "property derived from the deceased". If so, the liability is disallowed under s.103(1)(a). The liability is wholly disallowed if all the consideration is "property derived from the deceased" or partly disallowed if the consideration is partly "property derived from the deceased".

The expression "property derived from the deceased" is given a commonsense definition in s.103(3):

> In subsections (1) and (2) above "property derived from the deceased" means, subject to subsection (4) below,
> [a] any property which was the subject matter of a disposition made by the deceased, either by himself alone or in concert or by arrangement with any other person or
> [b] which represented any of the subject matter of such a disposition, whether directly or indirectly, and whether by virtue of one or more intermediate dispositions.

The IHT Manual gives this simple example:

> **28365 How Section 103 FA 1986 applies when the consideration is 'property derived from the deceased'?** [March 2009]
> *Example*
> On 19 March 1987 A gives his brother B £25,000.

> On 25 April 1987 A borrows back from B £25,000.[8]
> On 7 April 1994 A dies.
> Without the legislation A's estate contains the original £25,000. But if the money were still owing when A died the debt might be claimed as a deduction against his estate. And the PET in 1987 is exempt as more than seven years have elapsed.
> The legislation disallows the deduction for IHT purposes ...

The IHT Manual explains "property derived from the deceased":

> **28367 Definition of 'property derived from the deceased' for Section 103 FA 1986 purposes** [March 2009]
> ... In practice, income from property given absolutely by the deceased is treated as falling outside the above definition [contained in s.103(3)]. But where the deceased settled the property, the definition includes income payable under the disposition.
> You should treat money raised by the sale or mortgage of property derived from the deceased as though it was property derived from the deceased.

### 56.3.2 *Section 103(1)(b) disallowance*

Assuming one passes unscathed past the s.103(1)(a) disallowance, the journey takes us to s.103(1)(b). One must identify the person who gave the consideration for the liability. One then asks whether this is a person:

> who was at any time entitled to, or amongst whose resources there was at any time included, any property derived from the deceased.

If so, the liability is disallowed under s.103(1)(b). In principle the liability is wholly disallowed.[9] The IHT Manual gives this simple example:

> **28366 How Section 103 FA 1986 applies when there is 'consideration given by any person whose resources at any time included property derived from the deceased'?** [March 2009]

8 [Author's Note] It is assumed that this £25,000 is, or represents, the £25,000 given to B.

9 Unless the consideration for the debt is given by more than one person (very unusual); but see below on defences to the s.103(1)(b) disallowance.

*... Example*
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-income producing.[10]
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.[11] But this arrangement is caught by s.103(1)(b) FA 1986 and the liability is not an allowable deduction for IHT purposes.

### 56.3.3 *Section 103(2) defences to section 103(1)(b)*

Section 103(2) offers defences to the s.103(1)(b) disallowance.[12] 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.

10 But whether the land is income producing is not directly relevant.
11 [Author's Note] It is assumed that the £25,000 which B lends to A does not represent the land.
12 Section 103(2) does not override the s.103(1)(a) disallowance.

### 56.3.4 *Section 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], ie ignoring s.103(2)[c]. The IHT Manual gives a simple example:

> **28369 - Allowing part of a debt under s.103(2) FA 1986** [March 2009]
> 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][13] 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 allows a deduction (overriding the s.103(1)(b) disallowance) to the extent that the debt exceeds the value of the property derived from the deceased. That is obviously fair.

### 56.3.5 *Section 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 [March 2009]:

> **28369 Allowing part of a debt under Section 103(2) FA 1986** [March 2009]
> ... *Example*
> 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.

13 The IHT Manual erroneously reads: "deceased".

> B lends A £12,000 entirely from his own resources.
> A dies owing B £19,500 [ie 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, though it uses a sloppy paraphrase of the statutory language:

> The debt of £7,500 is clearly referable to the earlier gift of shares – and falls within s.103(1)(a) FA 1986. This liability is not deductible.

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[14] this amount is the excess consideration.

### 56.3.6 *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.

### 56.3.7 *Section 103(4) defence*

Section 103(4) provides an important defence to the s.103(1)(a) and (b)

14 The Manual wrongly refers to s.103(2)(a) IHTA 1984.

disallowances:

> If
> [a] the disposition first-mentioned in subsection (3) above[15] was not a transfer of value and
> [b] it is shown that the disposition was not part of associated operations which included—
> (a) a disposition by the deceased, either alone or in concert or by arrangement with any other person, otherwise than for full consideration in money or money's worth paid to the deceased for his own use or benefit; or
> (b) a disposition by any other person operating to reduce the value of the property of the deceased,
>
> that first-mentioned disposition shall be left out of account for the purposes of subsections (1) to (3) above.

Suppose:
(1) S (not UK domiciled) transfers excluded property (ie 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 usually disallowed under s.103. The same applies if the gift is to a trust where the settlor has a estate IP (eg 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 deduction for the debt is disallowed. The s.103(4) defence does not apply. Condition [a] is satisfied but condition [b] is not, because

15 That is, the disposition made by the deceased. See 56.3.1 (Section 103(1)(a) disallowance).

the gift to the trust is an associated operation.

### 56.3.8 *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 they repay 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.[16]

### 56.3.9 *Assignment of debts*

Suppose:
(1) A borrows from a bank.
(2) B purchases the debt from the commercial lender for its market value.
It is suggested that the purchase price paid by B to the bank is "consideration given for the debt". So A's liability is disallowed if the purchase price which B pays to the bank is property derived from A. Otherwise the section is easy to avoid.

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16 See 54.14 (GWR PET charge).

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.

### 56.3.10 *Pre-1986 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 …

This cannot often apply now.

## 56.4 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.

## 56.5 Deduction for debt of foreign domiciled individual

A UK domiciled individual will not usually mind whether a deduction for their 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.

### 56.5.1 *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.

### 56.5.2 *Debt not an incumbrance*

Section 162(5) IHTA provides:

> Where a liability taken into account is a liability to a person resident outside the UK which neither—
> (a) falls to be discharged in the UK, nor
> (b) is an incumbrance on property in the UK,
> it shall, so far as possible, be taken to reduce the value of property outside the UK.

This identifies three connecting factors. Where a debt is not an incumbrance on any property, there are two connecting factors and four possibilities:

| **Case No.** | **1** | **2** | **3** | **4** |
|---|---|---|---|---|
| Liability to UK resident | No | No | Yes | Yes |
| Discharge out of the UK | No | Yes | No | Yes |

Section 162(5) tells us the answer to Case 1: the debt is set against non-UK property. There is nothing about Cases 2 to 4. However, the implication is that in Cases 2 to 4 the debt reduces the value of the property in the UK.

What is the priority between s.162(4) and (5)? It is considered that (4) is applied first. A liability which is an incumbrance on any property is so far as possible to be taken to reduce the value of that property. Only if it is not an incumbrance on any property, or if the amount of the liability exceeds the value of the property, does one apply the rules in s.162(5). The IHT Manual shows that HMRC accept this:

> **28395 Deducting liabilities where there is excluded property**
> You will see cases where there is excluded property in the estate and deductions may be properly payable out of both excluded and other property. In this situation, provided the debts are to UK creditors, you may allow a deduction in full against the non-excluded property.
> But, in view of s.162(4) IHTA 1984 this does not apply to debts that are charged on excluded property.

### 56.5.3 *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.[17] The IHT Manual shows that HMRC broadly accept this:

> **28396 Deducting UK debts when there is both UK and foreign property in the estate**
> If the deceased's estate includes both UK and foreign assets you should first deduct any UK debts against the UK assets and the deficiency, if

17 See *Chitty on Contracts*, (30th ed, 2010) para 21-054 (Place of payment). Further consideration is needed for a contract not governed by English law.

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 FOTRA securities.

### 56.5.4 *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.

## 56.6 Individual[18] borrows and acquires excluded property

Suppose F is not UK domiciled and owns UK situate property worth £1m. F faces an IHT charge on that amount on F's death.

F borrows £1m charged on the UK property and deposits that sum outside the UK ("the offshore deposit").

The value of their UK situate property is reduced by £1m and the value of their excluded property is increased by £1m. No IHT liability arises on the death of F.[19]

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

18 See also 56.11 (Trustees borrow and acquire excluded property).

19 Except so far as property prices rise.

apply? The risk varies depending on exactly how the arrangement is set up.

## 56.7 Debt owed by individual to trust

### 56.7.1 *Debt owed by non-settlor life tenant to trust*

Suppose the life tenant (not the settlor) owes a debt to trustees of an estate IP trust (as happens when a pre-2006 IP trust lends money to the life tenant). At first sight, the position seems to be:

(1) The life tenant can claim a deduction for the burden of the debt on their death.

(2) The benefit of the debt is an asset of the trust fund, and therefore 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.

There is however one exceptional case. Where the benefit of the debt is excluded property (ie foreign domiciled settlor at the time the settlement was made and the debt not UK situate) then at first sight the result is a mismatch which benefits the taxpayer:

(1) a deduction for the burden of the debt in the estate of the life tenant; and

(2) no IHT on the benefit of the debt, being excluded property.

Robert Venables QC disagrees. He cites s.49(1) IHTA and Lord Asquith's familiar dictum in *East End Dwellings v Finsbury Borough Council* [1952] AC 109[20] and continues:

> If one applies Lord Asquith's dictum, what is deemed to happen when the settlor[21] 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

20 These are set out in 53.11 (Estate IP trust) and 54.11.1 (Construction of deeming provisions) respectively.

21 Venables is considering the position of a settlor life tenant, but the same applies to a non-settlor life tenant.

> 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.[22]

I respectfully agree. The effect of s.49(1) is therefore to disallow the deduction for 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.

### 56.7.2 *Debt owed by life tenant settlor to estate IP trust*

Suppose the life tenant settlor owes a debt to trustees of an estate IP trust (as happens when a pre-2006 IP trust lends money to the life tenant settlor). At first sight, the general position seems to be:

(1) The settlor can claim a deduction for the burden of the debt on their death.

(2) The benefit of the debt is an asset of the trust fund, and therefore 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. There are however two special cases.

If the benefit of the debt is excluded property, at first glance the result is a mismatch which could benefit the settlor (deduction for the burden of the debt, no charge on the benefit of the debt).[23]

If the deduction for the debt is disallowed under s.103[24] the result is a mismatch which would favour HMRC (no deduction for the burden of the debt, but a charge on the benefit of the debt, unless it is excluded property).

However on the view set out in para 56.7.1 (Debt owed by non-settlor life tenant to trust), the burden of the debt and the asset of the trust cancel each other out and both are ignored for IHT purposes. This is a sensible

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22 Robert Venables QC, "An IHT Trap for Settlors of Non-UK Resident Trusts", OTPR, vol 4, issue 3, p.165.

23 This might happen if the settlor was not UK domiciled, but needed the deduction for the debt as their property was UK situate.

24 But this would not often apply to excluded property trusts or to trusts where the settlor has an initial estate IP: see 56.3.7 (Section 103(4) defence).

result, which fits the purpose of the legislation. In practice HMRC appear to accept this.

### 56.7.3 *Debt owed by settlor to settlor-interested discretionary trust*

Suppose the settlor ("S") owes a debt to trustees of a discretionary trust (as happens when a discretionary trust lends money to the settlor).
At first sight, the position seems to be:
(1) The settlor can claim a deduction for the burden of the debt on their death.
(2) The benefit of the debt is an asset of the trust fund, and therefore part of the estate of the settlor under the GWR rules.
These two factors, the deduction and the asset, normally cancel each other out and the position ends up at neutral.

There is however one exceptional case. Where the benefit of the debt is excluded property (ie 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 settlor;[25] and
(2) no IHT on the benefit of the debt, being excluded property.
It is considered that the debt is disallowed under s.102(3) FA 1986. Under this section the benefit of the debt is treated as property to which the settlor was beneficially entitled on their death. The analysis is therefore 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.[26]

## 56.8 Debts to and from trusts

Do not confuse two situations:
(1) The situation where an individual owes a debt to trustees (eg 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 their estate;
  (b) the trustees have an asset, the benefit of the debt (which may or may not be excluded property).

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25 Since s.103 does not usually apply: see (Section 103(4) defence).

26 As to whether the GWR debt is subject to IHT under the GWR rules, see 54.10 (GWR over debt owed by the deceased).

(2) The reverse situation where trustees owe a debt to another person (eg an individual has lent to the trustees). Here:
   (a) the individual owns an asset in their 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.

## 56.9 Deduction for debts of trustees

It is clear that trust liabilities are in principle 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 estate 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 their interest subsists"? In my view it is not the settled property; it is the property subject to the trustees' lien.[27] 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.

For the same reason, trustees debts are deductible when an estate IP terminates on the death of the life tenant and in computing ten-year and

27 Where a trustee has incurred a liability as trustee, they 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.

exit charges.[28]

This is the correct reason why trustee liabilities are allowable.[29]

Section 103(1) FA 1986 provides:

> ... if, in determining the value of a person's estate immediately before his death, account would be taken, apart from this subsection, of a liability consisting of a debt *incurred by him* or an incumbrance created by a disposition *made by him*, that liability shall be subject to abatement.

This does not apply to debts of trustees as we are not concerned with a debt or disposition made by the individual.

56.9.1 *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 (eg where a trust with a foreign domiciled settlor has UK and excluded property) the principles are as follows:

(1) If the liability is an incumbrance on specific trust property, the deduction is set against that property: s.162(4) IHTA.[30]
(2) If the liability is not an incumbrance on specific trust property, it is under general trust law principles an incumbrance on the trust fund as a whole and deducted from the trust assets *pro rata*. The place of

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28 Section 65(5) IHTA assumes liabilities are deductible, though it is not necessary to rely on this.

29 In *Green v IRC* [2005] STC 288 at [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).

30 If under the terms of the trust a liability is payable out of certain property it is for this purpose a incumbrance on that property.

payment and residence of creditor are not relevant, and s.162(5) IHTA does not apply.

## 56.10 Debt owed by estate IP trust to life tenant

Suppose trustees of an estate IP trust owe a debt to the life tenant (as happens when a life tenant lends to a pre-2006 IP trust). At first sight, the position seems to be:

(1) The trust can claim a deduction for the burden of the debt on the death.

(2) The benefit of the debt is 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.

There is however one exceptional case. Where the benefit of the debt is excluded property (ie foreign domiciled life tenant 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 trust;[31] and

(2) no IHT on the benefit of the debt, being excluded property.

It is considered that s.49 IHTA does not disallow the debt.

## 56.11 Trustees[32] borrow and acquire excluded property

### 56.11.1 *Foreign domiciled settlor; trust owns non-excluded property*

Suppose L is the life tenant under an estate IP trust made by a foreign domiciled settlor. The trust owns UK situate property. The trust property is not excluded property. The trustees face an IHT charge on the death of L.

The trustees may borrow, charge the borrowing on the UK property, and invest the borrowed funds outside the UK. In principle, the value of the UK situate property is reduced by the borrowing. The value of excluded property is increased. The IHT liability on the death of L is reduced accordingly.[33]

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31 Of course in most cases the trust property is excluded property so there is no need for the deduction, but that is not necessarily the case: the trust may hold UK property.

32 See also 56.6 (Individual borrows and acquires excluded property).

33 Except so far as property prices increase.

Alternatively, the sum borrowed may be advanced to a (foreign domiciled) beneficiary. Schedule 4B TCGA needs consideration.[34]

### 56.11.2 *UK domiciled settlor but foreign domiciled beneficiary*

Suppose L is the life tenant under an estate IP trust made by a UK domiciled settlor. The trust property is not excluded property. L is not UK domiciled.

The trustees could solve this problem by transferring the trust property to L absolutely, but this may be impractical, and may have a substantial CGT cost.

The trustees borrow and advance that sum to L, who invests it in excluded property. Alternatively, if L is not ordinarily resident, the trustees may borrow themselves and invest in FOTRA securities.

In principle, the value of the trust property is reduced by the borrowing. The borrowed funds are excluded property. The IHT liability on the death of L is reduced accordingly.

These examples may be useful "deathbed" planning since IHT is avoided even if L 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.

## 56.12 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.

The IHT Manual provides:

> **10376 Overseas funerals of non-domiciled deceased** [April 2010]
> 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

34 See 46.1 (Borrowing by non-resident trustees).

funeral expenses are not a liability for the purposes of s.5 IHTA 1984 or s.162 IHTA 1984.

## 56.13 Deduction for foreign taxes

Foreign inheritance taxes and similar taxes may be available as a credit to set against IHT: see 63.1 (Foreign IHT credit relief). Such taxes are not deductible for IHT purposes under s.5(3) as they arise on the death and IHT is charged immediately before the death.

Unpaid foreign taxes which accrue during a person's lifetime are in principle deductible. They are liabilities imposed by law.

The IHT Manual provides:

> **28100 Foreign taxes**
> Special rules (IHTM27000) apply to foreign taxes that are similar in nature to inheritance tax (IHT). These may in some cases be set against the IHT liability. For other types of foreign taxes the general rule is that they can normally only be deducted from the value of property in the country that imposes the tax. This is because the taxes are unenforceable in other countries, *Government of India v Taylor* [1955] AC 491.

The proposition that foreign taxes are unenforceable in other countries now needs to be qualified because under international treaties foreign taxes often are enforceable in other countries. So far as foreign taxes are unenforceable and unpaid it seems right in principle that there should be no deduction and a court would be expected to reach that conclusion even though there is no express provision to that effect. But it is difficult to see why the deduction should be against property in the country concerned: it should be against non UK property generally, under s.162(5) IHTA, unless the foreign tax legislation imposes an incumbrance (which does not seem likely).

### 56.13.1 *Irish tax liabilities*

The IHT Manual provides:

> **28101 Deduction for tax debts in the Republic of Ireland**
> If the deceased died owing tax in the Republic of Ireland, you should allow a deduction against the free estate for any tax that has actually been paid to the Irish authorities provided the deceased
> - was domiciled in the United Kingdom, and

> • had no assets in the Republic of Ireland.
>
> Where, in these circumstances, the deceased also has assets in a third country, you should apportion the tax debts.
>
> If a deduction is claimed for any 'Probate Tax' paid in the Republic of Ireland, you must refer the matter to TG (IHTM01081) for advice. This tax, which is paid by the executors or administrators of an estate, is not covered by our Double Taxation Convention with the Republic of Ireland.

### 56.13.2 *Canadian income tax liabilities deducted for IHT*

The IHT Manual explains the Canadian tax background:

> **28102. Canadian income tax**
>
> Under Canadian law, the estate of an individual is deemed to have been disposed of immediately before his death. Income tax is charged on any resulting gains. If, under the (Income Tax) Double Taxation Agreement the deceased was resident in Canada, the charge applies to all property wherever situate. But if the deceased was resident in the UK the charge applies only to Canadian immovable property and to certain business property.

(There was a similar charge to CGT in the UK between 1965 and 1971. The UK abolished the CGT charge on death; Canada abolished its Estate Duty instead, a wiser decision). ESC F18 provides:

> 1. Under IHTA 1984 s 5(3) a person's liabilities at the time of death are taken into account in arriving at the value of their estate for the purposes of IHT. The Board of Inland Revenue will by concession regard this provision as applying to income tax in Canada charged on a deemed disposal immediately before death, even though the liability may not in strictness have arisen until the person had died.
>
> 2. Where there is an IHT charge on a deceased person's world-wide estate, and income tax in Canada is charged on deemed gains which are attributable to assets forming part of that estate, the Canadian tax will rank as a deduction in arriving at the value of the estate for IHT purposes. The Canadian tax will normally be treated as reducing the value of assets outside the UK whether those assets are liable to IHT or not; but if the Canadian tax exceeds the value of those assets, the excess will be set off against the value of the UK assets.

### 56.13.3 *Foreign tax on UK situate shares*

The IHT Manual provides:

> **27201. Procedure for relief by concession on shares**
> Occasionally shares in a company, although situated in some part of the UK by UK law, are also treated as liable to tax in a foreign country on the grounds, for example, that the company carries on business there. In this circumstance, by concession the amount of foreign tax is allowed as a deduction against the value of the shares. This concession operates whether the company is incorporated in the UK or elsewhere.
> The concession applies in the same way where the obligation to pay foreign tax on death falls upon the company and the company has the right to be reimbursed by the personal representatives of the deceased shareholder before it registers a transfer of the shares.
> The concession does not apply to cases covered by the statutory reliefs provided for by Section 158 IHTA 1984 and Section 159 IHTA 1984. Nor does it apply to shares that become liable to the foreign tax by reason of the operation of a Double Taxation Convention to which the UK is not a party.

I would have thought in this situation s.158 or 159 relief would normally apply, and in other cases relief would be available by law and not by concession. I would be interested if any reader can identify the foreign taxes to which this paragraph is applicable.

CHAPTER FIFTY SEVEN

# IHT PLANNING BEFORE AND AFTER A CHANGE OF DOMICILE

## 57.1 IHT planning in anticipation of acquiring UK domicile

The basic strategy for the foreign domiciliary is to transfer their assets to a trust. If the settlor has a foreign domicile when at the time the trust is made, settled property can be excluded property and will retain that status indefinitely, even if the settlor later become domiciled here. This has been common practice since 1975, and HMRC accept it.

### 57.1.1 *Time limit*

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 a permanent home in the UK will acquire a UK domicile as soon as they arrive here. Such an individual must carry out the 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 if and when they later form the intention to live here permanently. They must carry out the tax planning before their mind is made up, ie while their long-term intentions remain unclear.

(3) The individual who arrives and remains residing in the UK without deciding to live here permanently will acquire a deemed UK domicile after 15 to 17 years' residence here: see 52.2 (Deemed UK domicile). This is the long-stop deadline for the IHT planning, although limited planning opportunities remain available for the deemed domiciliary:

see 52.7 (Tax planning for the deemed domiciliary).

### 57.1.2 *Form of trust*

A life interest trust will normally be suitable, ie :

(1) income is to be paid to the settlor for life;

(2) subject thereto the trust fund 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) they may mandate the trustees to retain the income and add it to capital. This may be useful to avoid relevant income: see 27.16 (Is income of life tenant relevant income?).

A simple discretionary settlement is a possible alternative.

## 57.2 IHT planning: trust with foreign domiciled settlor

There are two general points. The first is to avoid UK situate property, at least at the time when it matters: see 53.20 (IHT planning for individual).

Trust property in a settlement created by a true foreign domiciliary can remain effectively free of IHT so long as the trust continues to exist. The trustees should be reluctant to appoint trust capital to a beneficiary who is or may become UK domiciled; that property may cease to be excluded property. On the contrary, 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 their own estate then it may be worth adopting a policy of gradually spending their own assets while allowing their trust fund to accumulate or invest for capital growth. It may be attractive for the beneficiary to purchase an income tax efficient annuity.

## 57.3 Trust with 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 the settlor is not a beneficiary and 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 55.8 (Transfer from trust made by A to another trust made by A).

A third-best solution involves loans: see 56.11 (Trustees borrow and acquire excluded property).

CHAPTER FIFTY EIGHT

# IHT ON DEATH: WILLS AND IOVs

## 58.1 IHT spouse exemption on death of a foreign domiciliary

Section 18 IHTA provides:

> (1) A transfer of value is an exempt transfer to the extent that the value transferred is
> [a] attributable to property which becomes comprised in the estate of the transferor's spouse or civil partner or,
> [b] so far as the value transferred is not so attributable, to the extent that that estate is increased.[1]

I refer to this as "**the IHT spouse exemption**".[2]

Suppose:

(1) H (not UK domiciled) dies leaving an estate which consists of:
  (a) UK property (not excluded property), and
  (b) foreign situate property (which is excluded property).

(2) Part of H's estate passes[3] to H's widow W.

This raises the interesting question of the interaction of the excluded property rules and the IHT spouse exemption. Sections 4 and 5 IHTA provide:

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1 I add for completeness that ss.18(3) and 56 contain anti-avoidance provisions rarely in point and not discussed here. There is a full discussion on the (almost) identical charity provisions in Kessler & Brown, *Taxation of Charities and Non-Profit Organisations*, (8 ed., 2011). For the restriction for foreign domiciled spouses, see 64.2 (Restricted IHT spouse exemption for foreign domiciled spouse).

2 References to spouse, marriage, and widow/ers here include a civil partner, civil partnership and a surviving civil partner. See Appendix 1.2 (Meaning of spouse) and 1.3 (Meaning of "civil partner").

3 By will, by survivorship or by the relevant succession law; this makes no difference.

> **4 Transfers on death**
> (1) On the death of any person tax shall be charged as if, immediately before his death, he had made a transfer of value and the value transferred by it had been equal to the value of his estate immediately before his death. ...
> **5 Meaning of estate**
> (1) For the purposes of this Act a person's estate is the aggregate of all the property to which he is beneficially entitled, except that ...
> (b) the estate of a person immediately before his death does not include excluded property or a foreign-owned work of art which is situated in the United Kingdom for one or more of the purposes of public display, cleaning and restoration (and for no other purpose).

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 H's death did not include H's 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 H's foreign situate (excluded) property passes to H's 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 civil partner or,
> [b] so far as the value transferred is not so attributable, to the extent that that estate is increased.[4]

The deemed transfer of value is not exempt under s.18(1)[a]. There is "property which becomes comprised in the estate of the spouse". However, the value transferred is not attributable to that property. That leaves the exemption in s.18(1)[b]. A transfer of value is an exempt transfer to the extent that the estate of the spouse is increased. The estate

4 In the case considered here the restriction in s.18(2) does not apply since H (the transferor) is not domiciled in the UK.

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 H's 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 advisors.

Now suppose H leaves W a pecuniary legacy. The IHT Manual provides:

> **11013 Quantifying the exemption** [October 2007]
> *... Example ...*
> Where the will of a person domiciled (IHTM13000) abroad disposes of his UK estate and some or all of his world estate, exemption for pecuniary legacies (IHTM12082) should be given against the UK estate in the proportion which that bears to the world estate, and not wholly against the UK estate. Where you have difficulty in obtaining details of the world estate, or where the official practice meets resistance, you should refer the case to TG.

This is correct in relation to charities. The IHT charity exemption is more narrowly worded. But for spouses, it is not consistent with the words of s.18(1)[b]. It is suggested that the spouse exemption applies to the full extent of the pecuniary legacy. It makes no difference whether the pecuniary legacy is subsequently paid out of UK or foreign situate property.

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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 their 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 56.12 (Funeral expenses).

Chapter 3 Part 2 IHTA (Allocation of Exemptions) does not shed much light on the issue. Section 36 IHTA provides that these rules apply where (*inter alia*) s.18 IHTA applies:

> in relation to a transfer of value but the transfer is not wholly exempt …

In the circumstances we are envisaging, the transfer will be "wholly exempt" if the value given to the spouse equals the value of the UK situate property. What happens if the value given to the spouse is less than the value of the UK situate property so the transfer is not wholly exempt? Let us assume that what the spouse receives is a "specific gift" as defined in s.42(1). Section 38(1) IHTA provides that:

> Such part of the value transferred shall be attributable to specific gifts as corresponds to the value of the gifts …

This confirms the view taken above.

## 58.2 Will drafting – General approach

There has always been considerable scope for tax saving through an appropriately drafted will. On disclosure rules on death, see 75.10 (Reporting on death of foreign domiciled individual).

### 58.2.1 *UK domiciled testator: foreign domiciled beneficiaries*

Here the testator should in principle give their estate to beneficiaries absolutely so that the property may qualify as excluded property in their hands. A short-term discretionary will trust within s.144 IHTA is just as good from a tax viewpoint, and allows additional flexibility.

### 58.2.2 *Foreign domiciled testator: UK domiciled beneficiaries*

From an IHT viewpoint, the will should in principle provide that the estate is held on trust for the beneficiaries so that trust property situated outside the UK will remain excluded property.

### 58.2.3 *Gift to spouse by will: foreign domiciled testator and foreign domiciled spouse*

Where a foreign domiciled testator has non-excluded property and excluded property, and the spouse is foreign domiciled so the IHT spouse exemption is fully available, the safe course will be:

(1) to give the non-excluded property to:
  (a) the spouse; or
  (b) a trust where the spouse has an interest in possession (better where the spouse is UK domiciled).

(2) to give excluded property to other persons.

A pecuniary legacy to the spouse should be charged on non-excluded property. Watch the drafting.

This course should avoid a dispute with HMRC. However, it is not necessary.

### 58.2.4 *Gift to spouse by will: UK domiciled testator and foreign domiciled spouse*

Where a UK domiciled testator has a foreign domiciled spouse, the usual IHT spouse/civil partner exemption does not apply (ignoring the small £55k allowance). The choice for the will lies between a discretionary will trust or an absolute gift to the foreign domiciled spouse. Which is better? Either way, there is a charge to IHT on the death of the testator. But if the property is given to the spouse, it is outside the scope of IHT thereafter, so long as it is not UK situate. If the property is given to a will trust, it remains within the scope of IHT, it is not excluded property, as the will trust has a UK domiciled settlor. So at first sight, the absolute gift seems better. Having said that, if property goes into the discretionary will trust and out to the spouse again within two years, the IHT position is just the same as a direct gift: s.144 IHTA 1984. And it may be desired to pass the property to others, perhaps giving it to the next generation (particularly if not UK domiciled). Also when the testator makes the will, one would not usually know the domicile position at the time of the death. If the spouse/civil partner lives long enough, she may become deemed UK domiciled for IHT purposes. All things considered, the discretionary will trust seems the more flexible and safer course for the will, in a routine case. In most cases, the will trust is likely to be wound up within two years. But the only cost is the cost of the deed of appointment.

### 58.2.5 *Charitable gift 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 or EU charities which qualify for UK tax relief[8];

(2) to give excluded property to other persons.

A pecuniary legacy to the charity should be charged on non-excluded property.

## 58.3 Instruments of variation ("IOVs")

The IHT Manual provides:

> **35094 Redirection of excluded property** [June 2006]
> Another scheme (see also IHTM35093) where the taxpayers seek to take advantage of the provisions of s.142 IHTA 1984 without there being a bona fide variation is where the estate contains excluded property (IHTM04251) such as government securities.
> The deceased, domiciled (IHTM13000) outside the UK, may leave property in this country to chargeable beneficiaries and excluded property to the spouse or civil partner (IHTM11032). An IoV may then be used for the spouse's or civil partner's entitlement to be switched from excluded property to the ordinary UK estate without any change in the amount the spouse or civil partner receives.
> You should refer cases of this type immediately above to TG (IHTM01081) without making any preliminary enquiries provided the basic facts are clear.

I do not understand in what sense it could be said that this is not a "bona fide variation".[9] Section 142(5) IHTA expressly envisages an IOV relating to excluded property.

A variation of this kind cannot sensibly be challenged if properly carried out. If the author's view of the spouse exemption is right, however, an

8 See Kessler & Brown, *Taxation of Charities and Non-Profit Organisation* (8th ed., 2011).

9 It would be different if there was an arrangement under which the spouse later swapped the UK property for the excluded property.

IOV would not be necessary. It may nevertheless be desirable as a useful precaution where a will has not been drafted in the manner recommended above.

CHAPTER FIFTY NINE

# Double Inheritance Taxation - Introduction

## 59.1 International estate and inheritance taxes

Many states (though by no means all) impose tax on the transfer of wealth occurring on death. These taxes may be divided into two types:
(1) The taxable person may be the deceased or his/her estate.
(2) The taxable persons may be the beneficiaries of the estate (the heirs).
In international tax terminology, type (1) is called an estate tax and type (2) is called an inheritance tax. Under this terminology IHT is strictly an estate tax and its title "inheritance tax" is a misnomer. However no confusion arises as long as one remembers that and I use the term "inheritance taxes" to include both types.

Jurisdiction to charge inheritance tax (as for income tax) is normally based one of two criteria:

(1) personal nexus to the state: domicile, residence or nationality or the deceased or of the beneficiary;
(2) situs of assets (a source rule).

These wide and differing criteria are the cause of double inheritance taxation:

(1) **Residence-source conflict** when
    (a) State A imposes tax on the deceased (estate tax) or the heir (inheritance tax) because of their personal nexus to the state (residence, domicile or nationality),
    (b) State B imposes tax because the assets are situate in that state.

  A residence-source conflict will result in the double taxation of the assets situate in state B.

(2) **Residence-residence conflict** when more than one state imposes tax on the same person because of their residence, domicile or nationality. A residence- residence conflict will typically result in double taxation on worldwide assets.

(3) **Source-source conflict** where state A regards an asset as situate in state A and state B regards the asset as situate in state B, because they have different rules determining situs. Here the conflict results in double taxation on the dual situate assets.

For a general discussion of the problems, see Study on Inheritance Taxes in EU Member States and Possible Mechanisms to Resolve Problems of Double Inheritance Taxation in the EU.[1]

## 59.2 Incorporation of IHT DTAs into UK law

International treaties (including DTAs) do not automatically become part of UK law, but must be incorporated into UK law by statute. Accordingly, s.158(1) IHTA provides:

> If Her Majesty by Order in Council declares—
> (a) that arrangements specified in the Order have been made with the government of any territory outside the UK with a view to affording relief from double taxation in relation to capital transfer tax payable under the laws of the UK and any tax imposed under the laws of that territory which is of a similar character or is chargeable on or by reference to death or gifts inter vivos, and
> (b) that it is expedient that those arrangements should have effect,
> the arrangements shall, notwithstanding anything in this Act, have effect
> [i] so far as they provide for relief from capital transfer tax, or
> [ii] for determining the place where any property is to be treated as situated for the purposes of the tax.

Under s.158(1)[ii] a DTA could in theory *increase* the scope of IHT, by providing that property which is not UK situate on general principles is to be regarded as UK situate. However in practice DTAs do not do this.

## 59.3 IHT double taxation treaties

In the following three chapters I consider

(1) the pre-CTT IHT DTAs (India, Pakistan, Italy and France. )

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1 Copenhagen Economics commissioned by the European Commission, Directorate-General for Taxation and Customs Union, Aug 2010. *http://ec.europa.eu/taxation_customs/resources/documents/common/consultations/tax/2010/08/inheritance_taxes_report_2010_08_26_en.pdf*

(2) the USA IHT treaty
(3) foreign IHT credit relief
I hope to deal with the other treaties in future editions.

### 59.3.1 *The OECD model*

The OECD approved the Estate and Inheritance Draft Model Convention in 1966. This model was revised in 1982 (Model Double Taxation Convention on Estates and Inheritances and on Gifts). It is therefore somewhat outdated.

## 59.4 EU law aspects

The ECJ have ruled that the EU Treaty does not oblige Member States to eliminate double inheritance taxation which arises from the exercise of fiscal sovereignty by Member States.[2] However the European Commission are looking at this area, and say:

> ... the significant differences in the civil and tax legislation of the Member States in the field of inheritances can potentially result in double, or even multiple, taxation by several Member States in the case of cross-border inheritances. ... it is clear that international double taxation is an obstacle to crossborder activity and investment within the EU.

Accordingly, some major changes can be expected in this area in a few years time.[3]

2 Case C-67/08 *Block*.

3 Possible approaches to tackling cross-border inheritance tax obstacles within the EU, Consultation paper June 2010 accessible *http://ec.europa.eu/taxation_customs/common/consultations/tax/2010_06_inheritance_en.htm*

CHAPTER SIXTY

# IHT DTAs: India, Pakistan, Italy, France

## 60.1 IHT double tax treaties – Introduction

In recent times the UK has had three death/gift taxes:
Estate Duty: 1894 - 1974
Capital Transfer Tax: 1974 - 1986
Inheritance Tax: 1986 -

In this chapter I consider the four IHT double tax treaties which were made before the introduction of CTT. I refer to these as "**the India, Pakistan, Italy and France IHT DTAs**"[1] or together as "**the pre-CTT DTAs**". These treaties are important to those who are deemed domiciled in the UK, but treaty-domiciled in India, Pakistan, Italy or France.

I comment only on the UK aspects of the treaties. Foreign law advice will also be needed in any case where a treaty applies. The provisions

1 For some reason DTAs do not have short titles. The full titles are:
(1) Agreement between the Government of the United Kingdom and the Government of India for the avoidance of double taxation and the prevention of fiscal evasion with respect to duties on the estates of deceased persons [SI 1956 No. 998]
(2) Agreement between the Government of the United Kingdom of Great Britain and Northern Ireland and the Government of Pakistan for the avoidance of double taxation and the prevention of fiscal evasion with respect to duties on the estates of deceased persons [SI 1957 No. 1522]
(3) Convention between the United Kingdom of Great Britain and Northern Ireland and France for the Avoidance of Double Taxation with respect to Duties on the Estates of Deceased Persons [SI 1963 No. 1319]
(4) Convention between the Government of the United Kingdom of Great Britain and Northern Ireland and the Government of the Italian Republic for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with respect to Duties on the Estates of deceased persons [SI 1968 No. 304].

relating to exchange of information are not discussed.

The four pre-CTT DTAs are similar but not identical and the many small differences can be important. This does make a coherent exposition rather difficult. It is surprising that no standard model form was adopted, but there it is. It does make one appreciate the tremendous value of the OECD model IT/CGT convention.

## 60.2 Application of pre-CTT DTAs to IHT

India IHT DTA Art. I provides:

> The duties which are the subject of the present Agreement are
> (a) In India, the estate duty imposed under the Estate Duty Act, 1953, and
> (b) In the UK, the estate duty imposed in Great Britain.

Article II (1) provides commonsense definitions of India, Great Britain, UK, territory, and duty, which need not be set out here.

Although the treaty refers to Great Britain, it also applies in Northern Ireland.[2]

The treaty refers to UK estate duty but it is extended to IHT by s.158(6) IHTA:

> Where arrangements with the government of any territory outside the UK are specified under any Order in Council which—
> (a) was made, or has effect as made, under section 54 of the Finance (No 2) Act 1945 or section 2 of the Finance Act (Northern Ireland) 1946, and
> (b) had effect immediately before the passing of this Act,
> the Order shall, notwithstanding the repeal of that section by the Finance Act 1975 remain in force and have effect as if any provision made by those arrangements in relation to estate duty extended to capital transfer

2 India IHT DTA Art. X provides: "The present Agreement shall apply in relation to the estate duty imposed in Northern Ireland as it applies in relation to the estate duty in Great Britain, but shall be separately terminable in respect of Northern Ireland by the same procedure as is laid down in Article XII." This was because Northern Ireland was from 1921 a separate unit for estate duty purposes.

> tax[3] chargeable by virtue of section 4 above; ...[4]

The Pakistan, Italy and France IHT DTAs are substantially the same: see Arts. I and II of each DTA.

## 60.3 Treaty IHT exemption

Each treaty provides an IHT exemption in slightly different terms.
India IHT DTA Art. III(3) provides:

> [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 IHT DTA Art. V(2) provides:

> Where duty is imposed in the territory of one Contracting Party on the death of a person who at the time of his death was not domiciled in any part of that territory but was domiciled in some part of the territory of the other Contracting Party, no account shall be taken, in determining the amount or rate of such duty, of property situated outside the former territory, provided that this paragraph shall not apply to duty imposed in the territory of a Contracting Party on property passing under a settlement governed by its law.

France IHT DTA Art. V(1) provides:

3 The reference to CTT has effect as a reference to IHT: s.100 FA 1986.

4 The Italy treaty adds:

> "The present Convention shall also apply to any other duties of a substantially similar character to the duties referred to in para (1) above which may be imposed in Great Britain or Italy subsequently to the date of signature of the present Convention."

This is also in the France and Pakistan DTAs. It is missing from the India treaty but it makes no difference as s.158 does the same work.

> 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.

I refer to this as "**treaty IHT exemption**".

The exemption applies to duty imposed on a death.[5] That includes the charge which applies on property in the individual's free estate, property in an estate IP trust, and property within the GWR charge on death.

The Pakistan DTA contains an amusing error. Pakistan DTA Art.V(2) provides:

> (2) 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 Pakistan [*sic*], or
> (b) passes under a disposition or devolution regulated by the law of some part of Great Britain;
> and, in determining the amount or rate of duty payable in Great Britain, property not falling within sub-para (a) or (b) shall be disregarded.

There is clearly a typographical error here and the word "Pakistan" in (a) should read "Great Britain".[6] It is considered that the error can be

5 This is stated expressly in the India, Pakistan and Italy IHT DTAs. In the France IHT DTA it is not stated expressly but is clearly implied.

6 I am grateful to Simon McKie for drawing this point to my attention.
The same mistake is made in Art V(1):

> "Where a person at the time of his death was domiciled in some part of Great Britain and was not domiciled in some part of Pakistan, duty shall not be imposed in Pakistan 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 [*sic*], or
> (b) is settled property of which the deceased was life tenant where the settlor was domiciled in some part of Pakistan at the time that the settlement took effect, or
> (c) passes under a devolution regulated by the law of some part of Pakistan and in determining the amount or rate of duty payable in Pakistan, property falling within (a), (b), or (c) shall be disregarded.

corrected as a matter of construction under the slip rule. HMRC practice is (rightly) not to take this point.[7]

### 60.3.1 *Failed PETs*

What about the charge on a lifetime PET which becomes a chargeable transfer because the transferor dies within 7 years, known as a "**failed PET**"? The treaties must be considered separately, since the wording of each treaty IHT exemption varies.

India and Italy IHT DTAs provide exemption from duty *on the death*. In the case of a failed PET, the IHT charge is on the lifetime transfer of value. Strictly, the charge is not "on the death", even though it is only on the occasion of death that the transfer becomes chargeable. However a purposive construction is appropriate. The relief would have applied to the estate duty charge on lifetime gifts within 7 years of death. In substance the charge on failed PETs is a charge on death. This is a strong argument, for treaties are not interpreted strictly or literally. A relief for a charge "on" the death means a relief for a charge which becomes payable *at the time of* the death.[8]

In France, the IHT exemption does seem to apply to a failed PET since the words "on the death" are not present, and the point does not arise.

In Pakistan the case for IHT exemption seems somewhat weaker since it is a very loose construction to say that the charge on a failed PET is a charge on property which "passes or is deemed to pass" on a death (the terminology is from Estate Duty legislation where it had a somewhat technical meaning). Nevertheless the purposive argument is still arguable.

However there is a serious difficulty. Section 158(6) IHTA provides that the treaties have effect 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 have effect in relation to that charge. It is considered, therefore,

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and, in determining the amount or rate of duty payable in Great Britain, property not falling within sub-para (a) or (b) shall be disregarded."

In some published versions the error has been corrected, but I am not aware of any authority for that. The original is accessible on *www.kessler.co.uk*.

7 Private correspondence.

8 Further support can be found from the area of transferable nil-rate bands. This relief increase the nil-rate band "for the purposes of the charge to tax *on the death* of the survivor"; see s.8A(3) IHTA. HMRC accept that this relief applies to the charge on a failed PET.

that although the terms of the treaties of France (relatively clearly), India and Italy (reasonably clearly) and Pakistan (arguably) do provide relief for a failed PET, this does not help the taxpayer, because UK domestic law (in breach of the treaty obligations) does not do so.

The conclusion is that there is no treaty relief for a failed PET. This is odd, perhaps absurd. But the treaties give rise to many other anomalies. There is no relief on ten-year charges on trusts. There is clearly no relief on a lifetime chargeable transfer which is not a PET, such as a straightforward gift to a trust.[9]

### 60.3.2 *Planning*

This raises tricky planning choices for a person who qualifies for IHT treaty exemption. 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.

## 60.4 Domicile requirement of treaty IHT exemption

### 60.4.1 *Individual not UK domiciled*

A requirement for IHT exemption in the India and Pakistan DTAs 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. The subsequent application of a deemed domicile rule to the treaties

9 It appears from an incoherent passage in the IHTM para 13024 that HMRC agree.

would have raised a number of difficulties.[10] The obvious solution was to keep the treaties free from the deemed domicile rule.

IHT exemption in the Italy IHT DTA 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 IHT DTA (which also has a domicile tie-breaker) does not include the requirement that the individual is not domiciled in the UK. Since the Italy IHT DTA (1968) came well after the France IHT DTA (1963) it is strange that the Italy wording did not copy the France one. But there it is.

### 60.4.2 *Domicile in treaty state*

The requirement for IHT exemption in each treaty is that the individual must be domiciled in the treaty state. But "domicile" here has a non-standard meaning so I refer to it as "**treaty-domicile**".

### 60.4.3 *Treaty-domicile: India and Pakistan*

India IHT DTA Art. II(2) provides:

> For the purposes of the present Agreement, the question whether a deceased person was at the time of his death domiciled in any part of the territory of one of the Contracting Governments shall be determined in accordance with the law in force in that territory.

Pakistan is differently worded but the same in substance. Pakistan DTA Art. II(2) provides:

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10 It is an interesting question whether it would have been a breach of the treaties. Even if not a technical breach, the treaty countries could reasonably have objected. Deemed domiciled individuals would have suffered double taxation. An alternative would have been to renegotiate existing treaties (introducing new rules at least for treaties which lacked a tie-breaker) but presumably that was thought to be impractical or too much trouble.

> 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/Pakistani law. One should not assume that Indian/Pakistani law of domicile is the same as in the UK.[11]

### 60.4.4 *Treaty-domicile: Italy and France*

Italy IHT DTA Art. II(2) repeats the India IHT DTA but goes on to add a tie-breaker clause:

> (a) For the purposes of the present Convention, the question whether a deceased person was domiciled at the time of his death in any part of the territory of one of the Contracting Parties shall be determined in accordance with the law in force in that territory.
> (b) Where by reason of the provisions of the preceding paragraph a deceased person is deemed to be domiciled in the territory of each of the Contracting Parties, then this case shall be solved in accordance with the following rules:
>     (i) he shall be deemed to be domiciled in the territory of the Contracting Party in which he had a permanent home available to him at the time of his death; if he had a permanent home available to him in the territory of each of the Contracting Parties he shall be deemed to be domiciled in the territory of the Contracting Party with which his personal and economic relations were closest (centre of vital interests);

It is not often necessary to look beyond this point but, for completeness, the DTA continues.

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11 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'."

For further references see the Trusts Discussion Forum under the thread *Does India have a concept of 'domicile'?* (May 2011).

(ii) if the Contracting Party in whose territory he had his centre of vital interests cannot be determined, or if he had not a permanent home available to him in the territory of either Contracting Party, he shall be deemed to be domiciled in the territory of the Contracting Party in which he had an habitual abode;

(iii) if he had an habitual abode in the territory of each of the Contracting Parties, or in the territory of neither, he shall be deemed to be domiciled in that of which he was a national;

(iv) if he was a national of both territories or of neither of them, the taxation authorities of the Contracting Parties shall determine the question by mutual agreement.

The tie-breaker wording follows the tie-breaker in the OECD Model Convention definition of residence, Art. 4(2) and reference should be made to the OECD Commentary.[12] France is the same as Italy: France IHT DTA Art. II(3). A key question is what is required for a person to be domiciled in Italy under Italian law.

## 60.5 Treaty-situs

The next requirement of treaty IHT exemption is that the property must not be situate in the UK. For this purpose the DTAs contain situs rules. It is therefore necessary to distinguish between ordinary IHT situs and what I shall call "**treaty-situs**". 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 (later, Lord) 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.

### 60.5.1 *Treaty-situs: India, Pakistan, Italy*

India IHT DTA Art. IV(1) provides:

> Subject to para (2) of this Article, where a person was at the time of his death domiciled in any part of the territory of one of the Contracting Governments, ...

12 See 5.6 (Tie-breaker tests for individuals).

This is the case we are considering.

> ... the situs of any property *which for the purposes of duty passes or is deemed to pass on his death* shall, for the purposes of the imposition of duty and of the credit to be allowed under Art. VI, be determined exclusively in accordance with the rules in Art. V of the present Agreement.

However there is a condition in Art. IV(2):

> Para (1) of this Article shall apply if, and only if, apart from the said Art. V—
> (a) duty would be imposed on the property under the law of each of the Contracting Governments; or
> (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 IHT DTA will never apply.

Pakistan is the same: Pakistan IHT DTA Art. III. Pakistan's estate duty was abolished in 1979. One wonders why the treaties have survived more than three decades after losing their *raison d'être.*

Italy and France are substantially the same.[13] They omit 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.

### 60.5.2 *Treaty-situs: France and Italy*

France retains its duty on successions on death, so the treaty situs rules are

13 Italy IHT DTA Art. III.

relevant. I here set out the rules in the French Treaty Art. 4 highlighting in italic those significantly different from IHT-situs:

The rules referred to in paragraph 1 of Article III are :

(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*[14] *surviving for the benefit of the estate of a deceased person shall be deemed to be situated at the place where the deceased person was domiciled at the time of his death*;

(l) *judgment debts shall be deemed to be situated at the place where the deceased person was domiciled at the time of his death*;

(m) *any other right or interest shall be deemed to be situated at the place determined by the law in force in the territory of the Contracting Party where the deceased person was not domiciled at the date of his death.*

## 60.6 Proper law

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 and Parkinson, "A disposition or devolution regulated by the law of some part of Great Britain: the Proviso to the Limitation of Taxing Rights in the IHT Treateies with France, India and Pakistan" [2011] PCB 126.

Where relief is lost because an English law will applies, the problem could in principle be resolved by an IoV, though the drafting would require some care.

## 60.7 Transferable nil rate bands and IHT DT reliefs

Section 8A IHTA provides

14 ie torts, not contractual rights.

**8A Transfer of unused nil-rate band between spouses and civil partners**
(1) This section applies where—
(a) immediately before the death of a person (a "deceased person"), the deceased person had a spouse or civil partner ("the survivor"), and
(b) the deceased person had unused nil-rate band on death.

Section 8A(2) IHTA defines "unused nil rate band on death":

> A person has unused nil-rate band on death if—
> M > VT
> where—
> M is the maximum amount that could be transferred by a chargeable transfer made (under section 4 above) on the person's death if it were to be wholly chargeable to tax at the rate of nil per cent. (assuming, if necessary, that the value of the person's estate were sufficient but otherwise having regard to the circumstances of the person); and
> VT is the value actually transferred by the chargeable transfer so made (or nil if no chargeable transfer is so made).

The availability of a transferable nil rate band depends on whether there was a chargeable transfer on the death of the first spouse. Assuming there would be a chargeable transfer (but for IHT DTA relief) does the availability of DTA relief alter the position? The IHTM para 43025 provides:

> **Transferable Nil Rate Band: interaction of ability to transfer unused nil rate band with double taxation agreements, double taxation relief and successive charges relief** [August 2009]
> The extent to which an estate is chargeable to tax may be governed by a double taxation agreement [IHTM27161], or a liability to tax may be reduced to nil by double taxation relief [IHTM27181] or successive charges relief [IHTM22041].
> [1] Where, under the terms of a double taxation agreement, an asset is not subject to tax, then if this means that the chargeable estate is below the nil rate band, the amount unused is available for transfer.
> [2] However, where there is a liability to tax that is reduced to nil by either double taxation relief or successive charges relief, the nil rate band remains fully used. We do not repay any "excess" relief and there is no provision to convert "excess" relief into unused nil rate band.

Unilateral IHT credit relief takes the form of a credit against IHT. It falls within [2]. Where that relief applies there is still a chargeable transfer so that transferrable NRB relief does not become available.

The India France and Pakistan IHT DTAs provide that "duty shall not be imposed" on certain property. The USA DTA provides that certain property "shall not be taxable" in the UK. These reliefs fall within [1]. It is not obvious that this prevents there being a chargeable transfer but it might be said to follow from a commonsense reading. Treaties are not to be construed technically. HMRC read the legislation in this way, so that the transferable nil rate band is available to the surviving spouse.

The Italy IHT DTA provides that "No account shall be taken, in determining the amount or rate of duty" on death, in relation to certain property. It is considered that the effect is the same as the other pre-CTT DTAs.

## 60.8 Claims for treaty IHT exemption

A claim is required for foreign IHT credit relief or for a refund of tax.[15] There is no requirement to make a formal claim for treaty IHT exemption. However if an IHT account is in principle required on a death,[16] a treaty saying that tax "shall not be imposed" or property "shall not be taxable" (as most of the pre-CTT DTAs or the US IHT DTAs) does not override this requirement. The same applies to the differently worded exemption in the Italy IHT DTA ("no account shall be taken in determining the amount or rate of duty...").

Similarly, for a deemed domiciled individual, the US treaty does not override the duty to disclose a lifetime chargeable transfer or the making of a non-resident settlement.[17]

So the usual returns should be made with a claim for DTA relief.

## 60.9 Deductions

Article V(1) Italy IHT DTA provides:

> In determining the amount on which duty is to be computed, permitted

15 See 63.9 (Claims for foreign IHT credit relief).
16 See 75.10 (Reporting on death of foreign domiciled individual).
17 See 75.9 (IHT reporting requirement on creation of settlement).

> deductions shall be allowed in accordance with the law in force in the territory in which the duty is imposed.

This seems unnecessary. Perhaps there were Estate Duty reasons for it? I would be grateful to any reader who could explain.

Identical wording is found in the Pakistan Treaty art 5(3) and also in some post-CTT DTAs, eg USA IHT art.8(1). There is no equivalent in other treaties but the omission does not matter.

CHAPTER SIXTY ONE

# IHT DTA: USA

## 61.1 USA IHT treaty – Introduction

This chapter considers the USA IHT Treaty.[1]

For some reason DTAs do not have short titles. I use the expression "**USA IHT DTA**" (or, for short, just DTA) to refer to the DTA dated 19 October 1978 officially called "the Convention between the Government of the USA and the Government of the UK for the avoidance of double taxation and the prevention of fiscal evasion with respect to taxes on estates of deceased persons and on gifts".

I comment only on the UK aspects of the treaty. Separate US advice will be needed in any case where the treaty applies.

### 61.1.1 *Cross references*

Issues and wording which the USA IHT DTA has in common with other treaties are discussed elsewhere. For credit for US tax, see 63.8 (USA DTA: Credit for foreign IHT). For the interaction of the USA IHT DTA and transferable nil rate bands, see 60.7 (Transferable nil rate bands and IHT DT reliefs). For claims and disclosure issues see 60.8 (Claims for treaty IHT exemption) and 63.9 (Claims for foreign IHT credit relief).

## 61.2 Scope

Article 1 USA IHT DTA provides:

> This Convention shall apply to any person who is within the scope of a tax which is the subject of this Convention.

1 The text is accessible on *http://uniset.ca/misc/us-uk_esttax.html*

Thus the DTA applies to trustees as well as to individuals, even if the trustees are not themselves US treaty-domiciled.

## 61.3 Taxes covered

Article 2 USA IHT DTA provides:

> (1) The existing taxes to which this Convention shall apply are:
> (a) in the US: the Federal gift tax and the Federal estate tax, including the tax on generation-skipping transfers; and
> (b) in the UK: the capital transfer tax.
> (2) This Convention shall also apply to any identical or substantially similar taxes which are imposed by a Contracting State after the date of signature of the Convention in addition to, or in place of, the existing taxes. The competent authorities of the Contracting States shall notify each other of any changes which have been made in their respective taxation laws.

The DTA applies to IHT which is "substantially similar" to CTT.

### 61.3.1 *"Tax"*

Article 3(f) USA IHT DTA provides:

> the term "tax" means:
> (i) the Federal gift tax or the Federal estate tax, including the tax on generation-skipping transfers, imposed in the US, or
> (ii) the capital transfer tax imposed in the UK, or
> (iii) any other tax imposed by a Contracting State to which this Convention applies by virtue of the provisions of para (2) of Article 2, as the context requires.

## 61.4 Definitions

The DTA provides commonsense definitions of the following terms, which are not set out here: US; UK; Enterprise; Competent Authority; Contracting State.

### 61.4.1 *"National"*

Article 3(e) USA IHT DTA provides:

> the term "nationals" means:
> (i) in relation to the US, US citizens, and
> (ii) in relation to the UK any citizen of the UK and Colonies, or any British subject not possessing that citizenship or the citizenship of any other Commonwealth country or territory, provided in either case he had the right of abode in the UK at the time of the death or a transfer.

### 61.4.2 *"Decedent"*

The DTA uses the term "decedent" which is an Americanism for "deceased".

### 61.4.3 *Undefined terms*

Article 3(2) USA IHT DTA provides:

> As regards the application of the Convention by a Contracting State, any term not otherwise defined shall, unless the context otherwise requires and subject to the provisions of Article 11 (Mutual Agreement Procedure), have the meaning which it has under the laws of that Contracting State relating to the taxes which are the subject of the Convention.

## 61.5 Treaty-domicile

For present purposes there are three types of domicile:
(1) domicile in the ordinary UK law sense (**"UK law domicile"**);
(2) deemed UK domicile for IHT (**"deemed UK domicile"**);
(3) domicile for the purposes of the treaty (**"treaty-domicile"**).
The definition of treaty-domicile is distinctly non-standard. Article 4(1) USA IHT DTA provides:

> For the purposes of this Convention an individual was domiciled:
> (a) in the US:

> [i] if he was a resident (domiciliary) thereof or
> [ii] if he was a national thereof and had been a resident (domiciliary) thereof at any time during the preceding three years

The definition of resident (domiciliary) is crucial: this is a matter of US law.[2]

Article 4(1) USA IHT DTA provides:

> For the purposes of this Convention an individual was domiciled: ...
> (b) in the UK:
> [i] if he was domiciled in the UK in accordance with the law of the UK [ie if UK law domiciled]
> [ii] or is treated as so domiciled for the purpose of a tax which is the subject of this Convention [i.e. if deemed UK domiciled].

Next come a series of tie-breakers to deal with persons who under (1)(a) and (b) would be treaty-domiciled in both jurisdictions:

> (2) Where by reason of the provisions of para (1) an individual was at any time domiciled in both Contracting States, and
> (a) was a national of the UK but not of the US, and
> (b) had not been resident in the US for Federal income tax purposes in seven or more of the ten taxable years ending with the year in which that time falls,
> he shall be deemed to be domiciled in the UK at that time.
> (3) Where by reason of the provisions of para (1) an individual was at any time domiciled in both Contracting States, and
> (a) was a national of the US but not of the UK, and
> (b) had not been resident in the UK in seven or more of the ten income tax years of assessment ending with the year in which that time falls,
> he shall be deemed to be domiciled in the US at that time.
> For the purposes of this paragraph, the question of whether a person was so resident shall be determined as for income tax purposes but without regard to any dwelling-house available to him in the UK for his use.

2 The term "resident" for estate tax is defined in Treasury Reg: 20.0-1(b). For gift tax see Treasury Reg: 25.2501-1(b).

The last sentence is based on wording formerly in the IHT deemed domicile rule, see 52.2.5 (Meaning of "residence" for 17-year residence rule).

Where these tie-breakers fail to break the tie, we turn to Art. 4(4):

> Where by reason of the provisions of para (1) an individual was domiciled in both Contracting States, then, subject to the provisions of paras (2) and (3), his status shall be determined as follows:
> (a) the individual shall be deemed to be domiciled in the Contracting State in which he had a permanent home available to him. If he had a permanent home available to him in both Contracting States, or in neither Contracting State, he shall be deemed to be domiciled in the Contracting State with which his personal and economic relations were closest (centre of vital interests);
> (b) if the Contracting State in which the individual's centre of vital interests was located cannot be determined, he shall be deemed to be domiciled in the Contracting State in which he had an habitual abode;
> (c) if the individual had an habitual abode in both Contracting States or in neither of them, he shall be deemed to be domiciled in the Contracting State of which he was a national; and
> (d) if the individual was a national of both Contracting States or of neither of them, the competent authorities of the Contracting States shall settle the question by mutual agreement.

This is the standard OECD Model wording: see 5.6 (Tie-breaker tests for individuals).

### 61.5.1 *Resident of possession of the US*

Article 5(5) USA IHT DTA relates to nationality and treaty-domicile:

> An individual who was a resident (domiciliary) of a possession of the US and who became a citizen of the US solely by reason of his
> (a) being a citizen of such possession, or
> (b) birth or residence within such possession,
> shall be considered as neither domiciled in nor a national of the US for the purposes of this Convention.

I understand that the possessions of the US are mainly uninhabited islands[3] so few (if any) individuals are affected by this provision.

## 61.6 IHT exemptions for individuals

Article 5 USA IHT DTA provides two exemptions for individuals. Article 5(1) provides:

> (a) [i] Subject to the provisions of Articles 6 (Immovable Property (Real Property)) and 7 (Business Property of a Permanent Establishment and Assets Pertaining to a Fixed Base Used for the Performance of Independent Personal Services) and the following paragraphs of this Article,
> [ii] if the decedent or transferor was domiciled in one of the Contracting States at the time of the death or transfer, property shall not be taxable in the other State.
> (b) Sub-para (a) shall not apply if at the time of the death or transfer the decedent or transferor was a national of that other State.

This can confer IHT exemption. To qualify for IHT exemption under Art. 5(1) the individual must be:
(1) treaty-domiciled in the USA and
(2) not a UK national.
Article 5(2) USA IHT DTA provides:

> Subject to the provisions of the said Articles 6 and 7, if at the time of the death or transfer the decedent or transferor
> [a] was domiciled in neither Contracting State and
> [b] was a national of one Contracting State (but not of both),
> property which is taxable in the Contracting State of which he was a national shall not be taxable in the other Contracting State.

Can this confer IHT exemption? In order to need and qualify for IHT exemption under art. 5(2):
(1) the individual must be:
 (a) treaty-domiciled in neither state (so in particular not UK domiciled or deemed domiciled) and

3 Howland Island; Baker Island; Jarvis Island; Navassa Island; Johnston Atoll; Midway Islands; Palmyra Atoll; Wake Islands; Guantanamo Bay; Kingman Reef.

(b) a US national and not a UK national

(2) property must be taxable in the UK (or no relief is needed) so it must be UK situate.

(3) the property must be taxable in the USA.

This is just possible. Condition (1) is possible because a US national is not necessarily treaty-domiciled in the USA. If such an individual held UK situate property, it would be exempt from IHT under Art. 5(2) provided it was taxable in the USA. In practice though this will be rare.

These two exemptions applies to charges on death and on lifetime gifts. The exemptions even apply to UK situate property (so long as the property is not land or a permanent establishment).

## 61.7 IHT exemption for trusts

Article 5(4) USA IHT DTA provides:

> [a] Paras (1) and (2) shall not apply in the UK to property comprised in a settlement;
>
> [b] but, subject to the provisions of the said Articles 6 and 7, tax shall not be imposed in the UK on such property if at the time when the settlement was made the settlor was domiciled in the US and was not a national of the UK.

Article 5(4)[b] provides exemption from:

(1) IHT 10 year and exit charges;

(2) the charge on the death of an individual with an estate IP;

(3) GWR lifetime and death charges.

The exemption applies to UK situate property (so long as the property is not land or a permanent establishment).

It is an interesting question whether a common form grantor trust is a settlement for this purpose: it is (I think) a settlement for US purposes but not for IHT purposes.[4] It is also an interesting question whether or to what extent UK rules determining when a settlement is made (and who is the settlor) apply for the purposes of this relief.

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4 See 72.11 (American revocable trusts (grantor trusts)).

## 61.8 Requirement to pay foreign tax

Article 5(5) USA IHT DTA provides:

> If by reason of the preceding paragraphs of this Article
> [a] any property would be taxable only in one Contracting State and
> [b] tax, though chargeable, is not paid (otherwise than as a result of a specific exemption, deduction, exclusion, credit or allowance) in that State,
> tax may be imposed by reference to that property in the other Contracting State notwithstanding those paragraphs.

The IHT Manual provides:

> **27177. Certification of disclosure and tax enforcement procedure with the USA** [October 2007]
> Before we give up our rights to tax property in accordance with Article 5(1) of the DTC with the USA, we require the US authorities to certify that disclosure has been made to them and that payment of any appropriate tax has been made or will be enforced. This is because Article 5(5) of the DTC withdraws this restriction and allows us to tax the property if the USA is unable to enforce its right to tax. Conversely, we also need to certify to the above if the US authorities must give up their right to tax property.
> Cases in which para (1) operates to exclude some UK property from the charge to IHT and which are, or but for that exclusion would be, taxpaying should not be closed until the US authorities have certified on Form 742 that disclosure has been made to them and that payment of any appropriate tax has been made or will be enforced.
> This requirement should be explained to the taxpayer and 2 prints of Form 742 issued to them. Attention should be directed to the appropriate paragraphs of the form, which the taxpayer is required to complete. In particular where by reason of the Convention the UK is giving up its taxing rights, only para 1 is in point, and paras 2 to 7 are not appropriate. On receipt of a correct and duly certified form the case may be closed: any error or difficulty should be referred to TG.
> Where the USA gives up the right to tax property under Article 5(1), US form 706 CE will be forwarded to this Office in duplicate for certification.
> After checking (it is important that the forms themselves should not be marked in any way) they and the file should be sent with a note of any error or omission to TG for the issue of the appropriate certificate.

## 61.9 Dual-situate assets

Article 5(6) USA IHT DTA provides:

> If at the time of the death or transfer
> [a] the decedent or transferor was domiciled in neither Contracting State and
> [b] each State would regard any property as situated in its territory and
> [c] in consequence tax would be imposed in both States,
> the competent authorities of the Contracting States shall determine the situs of the property by mutual agreement.

This is not relevant if IHT exemption or US tax exemption applies. It is a different technique from dealing with the problem of dual-situate assets from that adopted in the pre-CTT treaties, which set out their own treaty-situs rules (as did the previous US estate duty treaty.)

## 61.10 Immovable property

Article 6 USA IHT DTA provides:

> (1) Immovable property (real property) may be taxed in the Contracting State in which such property is situated.
> (2) The term "immovable property" shall be defined in accordance with the law of the Contracting State in which the property in question is situated, provided always that debts secured by mortgage or otherwise shall not be regarded as immovable property. The term shall in any case include property accessory to immovable property, livestock and equipment used in agriculture and forestry, rights to which the provisions of general law respecting landed property apply, usufruct of immovable property and rights to variable or fixed payments as consideration for the working of, or the right to work, mineral deposits, sources and other natural resources; ships, boats, and aircraft shall not be regarded as immovable property.
> (3) The provisions of paras (1) and (2) shall also apply to immovable property of an enterprise and to immovable property used for the performance of independent personal services.

This is what one would expect.

## 61.11 Business property

Article 7(1) USA IHT DTA provides:

> Except for assets referred to in Article 6 (Immovable Property (Real Property)) assets forming part of the business property of a permanent establishment of an enterprise may be taxed in the Contracting State in which the permanent establishment is situated.

I do not set out the lengthy provisions relating to permanent establishment here, since this will rarely arise.

## 61.12 Deductions

On this topic, see 60.9 (deductions).

## 61.13 Extension of IHT spouse exemption

Under domestic IHT law, the usual IHT spouse exemption is restricted when the transferor is UK domiciled and the spouse is foreign domiciled. Article 8 restricts this restriction. There are separate provisions for absolute transfers and for transfers to a trust under which the spouse has an IP. There is no relief for the situation where H has an interest in possession and on H's death W acquires an interest in possession (where the IHT spouse exemption is sometimes available under s.49D IHTA 1984).

Civil partners are not mentioned (of course). One might perhaps construe spouse widely to include "civil partner" but only if US tax law changes to treat civil partners exactly like spouses (which seems unlikely).

### 61.13.1 *Relief for absolute inter-spouse transfers*

Article 8(3) USA IHT DTA provides:

> Property which passes to the spouse from a decedent or transferor who was domiciled in or a national of the US and which may be taxed in the UK shall, where
> (a) the transferor's spouse was not domiciled in the UK but the transfer would have been wholly exempt had the spouse been so domiciled, and
> (b) a greater exemption for transfers between spouses would not have been given under the law of the UK apart from this Convention,
>
> be exempt from tax in the UK to the extent of 50 per cent of the value transferred, calculated as a value on which no tax is payable and after

taking account of all exemptions except those for transfers between spouses.

In order for this to be needed and to apply the following conditions must be satisfied:
The transferor is:
(a) Treaty-domiciled in the US or a US national.
(b) UK law domiciled or deemed UK domiciled (or else the IHT spouse exemption is not restricted under IHT domestic law).
The transferee (spouse) is:
(a) not treaty-domiciled in the UK.-
(b) not UK law domiciled or deemed UK domiciled (or else the IHT spouse exemption is not restricted under IHT domestic law).
This relief applies on death and on lifetime transfers.

61.13.2 *Transfer to settlement under which spouse has IP*

Article 8(4) USA IHT DTA provides:

> (a) Property which on the death of a decedent domiciled in the UK became comprised in a settlement shall, if the personal representatives and the trustees of every settlement in which the decedent had an interest in possession immediately before death so elect and subject to sub-para (b), be exempt from tax in the UK to the extent of 50 per cent of the value transferred (calculated as in para (3)) on the death of the decedent if:
> (i) under the settlement, the spouse of the decedent was entitled to an immediate interest in possession,
> (ii) the spouse was domiciled in or a national of the US,
> (iii) the transfer would have been wholly exempt had the spouse been domiciled in the UK, and
> (iv) a greater exemption for transfers between spouses would not have been given under the law of the UK apart from this Convention.
> (b) Where the spouse of the decedent becomes absolutely and indefeasibly entitled to any of the settled property at any time after the decedent's death, the election shall, as regards that property, be deemed never to have been made and tax shall be payable as if on the death such property had been given to the spouse absolutely and indefeasibly.

In order for this to be needed and to apply the following conditions must be satisfied:

The transferor is:

(a) Treaty-domiciled in the UK.
(b) UK law domiciled or deemed UK domiciled (or else the IHT spouse exemption is not restricted under domestic law).

The transferee (spouse) is:

(a) treaty-domiciled in the US or a national of the US.
(b) not UK law domiciled or deemed UK domiciled (or else the IHT spouse exemption is not restricted under domestic law).

In addition:

(1) An election is required.
(2) The spouse must be entitled to an immediate IP (this probably rules out relying on s.144 IHTA (discretionary will trusts)).
(3) This relief only applies on the death of the transferor.

## 61.14 Non-discrimination

Article 10(1)(a) USA IHT DTA provides:

> Subject to the provisions of sub-para (b), nationals of a Contracting State shall not be subjected in the other State to any taxation or any requirement connected therewith which is other or more burdensome than the taxation and connected requirements to which nationals of that other State in the same circumstances are or may be subjected.

This would extend IHT Agricultural property relief to US agricultural property, which could be relevant to companies holding agricultural land but the point will not often arise.

Article 10 continues:

> (2) The taxation on a permanent establishment which an enterprise of a Contracting State has in the other Contracting State shall not be less favourably levied in that other State than the taxation levied on enterprises of that other State carrying on the same activities.
> (3) Nothing contained in this Article shall be construed as obliging either Contracting State to grant to individuals not domiciled in that Contracting State any personal allowances, reliefs and reductions for taxation purposes which are granted to individuals so domiciled.
> (4) Enterprises of a Contracting State, the capital of which is wholly or

partly owned or controlled, directly or indirectly, by one or more residents of the other Contracting State, shall not be subjected in the first-mentioned Contracting State to any taxation or any requirement connected therewith which is other or more burdensome than the taxation and connected requirements to which other similar enterprises of the first-mentioned State are or may be subjected.
(5) The provisions of this Article shall apply to taxes which are the subject of this Convention.

## 61.15 Other articles

The following articles of the USA IHT DTA are not discussed here:

Article 11: mutual agreement procedure.
Article 12: exchange of information.
Article 13: diplomatic and consular officials.
Article 14: entry into force.
Article 15: termination.

CHAPTER SIXTY TWO

# IHT DTA: SWITZERLAND

## 62.1 Swiss IHT treaty – Introduction

This chapter considers the Swiss IHT Treaty[1] found in S.I. 1994 No 3214.

For some reason DTAs do not have short titles. I use the expression "**Swiss IHT DTA**" (or, for short, just DTA) to refer to the DTA called "the Convention between the United Kingdom of Great Britain and Northern Ireland and the Swiss Federation for the avoidance of double taxation with respect to taxes on estates and inheritances".

I comment only on the UK (IHT) aspects of the treaty. Separate Swiss advice will be needed in any case where the treaty applies.

For the interaction of the DTA and transferable nil rate bands, see 60.7 (Transferable nil rate bands and IHT DT reliefs). For claims and disclosure issues see 60.8 (Claims for treaty IHT exemption) and 63.9 (Claims for foreign IHT credit relief).

## 62.2 Scope

Article 1 Swiss IHT DTA provides:

> This Convention shall apply:
> (a) to estates and inheritances where the deceased was domiciled, at the time of his death, in one or both of the Contracting States; and
> (b) to property comprised in a settlement made by a person who was domiciled, at the time the settlement was made, in one or both of the Contracting States.

---

1 Accessible on *http://www.legislation.gov.uk/uksi/1994/3214/schedule/made*

## 62.3 Taxes covered

Article 2(1) Swiss IHT DTA provides:

> (1) The existing taxes to which this Convention shall apply are:
> (a) in the UK, the inheritance tax, insofar as it applies to the estate of a deceased person (hereinafter referred to as "UK tax");
> (b) in Switzerland, the cantonal and communal taxes imposed on estates and inheritances (hereinafter referred to as "Swiss tax").

Thus there is no relief for IHT on lifetime gifts or for 10 year and exit charges on trusts. There is relief for trusts conferring an estate interest in possession.

## 62.4 Definitions

The DTA provides commonsense definitions of the following terms, which are not set out here: UK; Switzerland; Contracting State; Enterprise; Competent Authority; tax.

### 62.4.1 *"National"*

Article 3(g) Swiss IHT DTA provides:

> (g) the term "national" means:
> (i) in relation to the UK, any British citizen or any British subject not possessing the citizenship of any other Commonwealth country or territory, provided he has the right of abode in the UK and any legal person, partnership, association or other entity deriving its status as such from the law in force in the UK;
> (ii) in relation to Switzerland, any Swiss citizen and any legal person, partnership, association or other entity deriving its status as such from the law in force in Switzerland;

### 62.4.2 *Undefined terms*

Article 3(2) Swiss IHT DTA provides:

> As regards the application of the Convention by a Contracting State, any

term not defined therein shall, unless the context otherwise requires, have the meaning which it has under the law of that State concerning the taxes to which the Convention applies.

## 62.5 Treaty-domicile

The definition of treaty-domicile is non-standard. Article 4(1) Swiss IHT DTA provides:

> For the purposes of this Convention, a deceased person was domiciled:
> (a) in the UK if he was domiciled in the UK in accordance with the law of the UK or is treated as so domiciled for the purposes of a tax which is the subject of the Convention;

That applies to a person who is UK law domiciled and one who is deemed UK domiciled. The treaty continues:

> For the purposes of this Convention, a deceased person was domiciled:
> (b) in Switzerland if he was domiciled or was resident in Switzerland in accordance with the law of Switzerland or if he was a Swiss national and Swiss civil law requires his succession to be ruled in Switzerland.

I assume this means:

> For the purposes of this Convention, a deceased person was domiciled:
> (b) in Switzerland if
> [i] he was domiciled *in Switzerland in accordance with the law of Switzerland* or
> [ii] was resident in Switzerland in accordance with the law of Switzerland or
> [iii] if he was a Swiss national and Swiss civil law requires his succession to be ruled in Switzerland.

That is, the words "and Swiss civil law requires his succession to be ruled in Switzerland" govern only [iii].

The treaty adds:

> However, a deceased person shall be deemed not to be domiciled in one of the States if that State imposes tax only by reference to property situated in that State.

I do not see how this could apply, but it does not matter.

The definition of domiciled/resident in Switzerland in accordance with the law of Switzerland is crucial: this is a matter of Swiss law. The 1993 Protocol clarifies which Swiss law applies.[2]

Next come a series of tie-breakers to deal with persons who under (1) would be domiciled in both jurisdictions:

> (2) Where by reason of the provisions of paragraph (1) of this Article a deceased person was domiciled in both States, then, subject to the provisions of the attached Protocol, his status shall be determined as follows:
> (a) he shall be deemed to have been domiciled in the State in which he had a permanent home available to him; if he had a permanent home available to him in both States, he shall be deemed to have been domiciled in the State with which his personal and economic relations were closer (centre of vital interests);
> (b) if the State in which he had his centre of vital interests cannot be determined, or if he did not have a permanent home available to him in either State, he shall be deemed to have been domiciled in the State in which he had an habitual abode;
> (c) if he had an habitual abode in both States or in neither of them, he shall be deemed to have been domiciled in the State of which he was a national;
> (d) if he was a national of both States or of neither of them, the competent authorities of the Contracting States shall settle the question by mutual agreement.

This is standard OECD Model wording: see 5.6 (Tie-breaker tests for individuals).

The 1993 Protocol provides:

> (1) With reference to Article 4:
> An individual who was a national of one of the Contracting States without being a national of the other Contracting State and who was domiciled in the State of which he was a national immediately before coming to the other State shall not be domiciled in the other State for the purposes of this Convention if:
> (a) he was temporarily present in that other State by reason only of his

2 It provides: "The reference to Swiss civil law concerns chapter 6 of the loi fédérale sur le droit international privé of 18th December 1987."

employment or was a spouse or other dependent of a person temporarily in that other State for such purpose; and
(b) that individual had retained the domicile of the State of which he was a national; and
(c) that individual had no intention of becoming a permanent resident of the other Contracting State.

This could help a Swiss national who is a long term employee in the UK as it could confer better treaty relief even after they become deemed UK domiciled, but that will not often arise. It could similarly hinder a UK national who is an employee in Switzerland as it could prevent them claiming relief.

### 62.5.1 *Types of domicile*

When dealing with treaties it is always necessary to distinguish between three different concepts of domicile:
(1) domicile in the domestic English law sense (**"UK law domicile"**);
(2) deemed UK domicile for IHT ("**deemed UK domicile**");
(3) domicile for the purposes of the treaty ("**treaty-domicile**").
The Swiss IHT DTA is unusual as it distinguishes between persons:
(1) domiciled in UK/Switzerland under paragraph (1) of Article 4 "solely in one of the Contracting States" whom I call **"solely UK/Swiss domiciled"**. Someone who is "solely Swiss domiciled" cannot be UK law domiciled or deemed UK domiciled for IHT purposes.
(2) domiciled in UK/Switzerland under paragraph (2) of Article 4 whom I call **"tiebreaker UK/Swiss domiciled"**. Someone who is tiebreaker Swiss domiciled is UK law domiciled or deemed UK domiciled but treaty-domiciled in Switzerland because of the tiebreaker clause in the treaty.

## 62.6 IHT exemption

There are special rules for immovable property and permanent establishments (articles 5 and 6 discussed below ) and ships and aircraft (article 7 not discussed here.)

Subject to that, Article 8 Swiss IHT DTA provides various exemptions for individuals.

### 62.6.1 *UK situate property of solely Swiss domiciliary*

Article 8(1) provides:

> (1) Subject to the following provisions of this Convention:
> (a) property not dealt with in Articles 5, 6 and 7 which is situated in either Contracting State and forms part of the estate of a person:
> (i) domiciled by virtue of the provisions of paragraph (1) of Article 4 solely in one of the Contracting States shall, subject to paragraph (2) of this Article, be taxable only in that latter Contracting State;

Thus UK situate property of a solely Swiss domiciliary qualifies for treaty exemption on death even though not of course excluded property. To this rule there are four exceptions. Firstly property covered by articles 5, 6, 7 (land, PEs ships and aircraft). Secondly, shares in UK incorporated companies, as article 8(2) provides:

> Shares in a company incorporated in the UK which form part of the estate of a person domiciled by virtue of the provisions of paragraph (1) of Article 4 solely in Switzerland at the time of his death may also be taxed in the UK.

There is not much left for this treaty exemption to apply to, though it could be relevant (eg to UK situate debentures). From a planning point of view it is not generally important since it is usually possible for a solely Swiss domiciliary to avoid IHT by avoiding UK situate property but it could be useful for, say, UK situate chattels.

### 62.6.2 *Swiss situate property of tiebreaker Swiss domiciliary*

Article 8(1) provides:

> (1) Subject to the following provisions of this Convention:
> (a) property not dealt with in Articles 5, 6 and 7 which is situated in either Contracting State and forms part of the estate of a person ...
> (ii) domiciled by virtue of the provisions of paragraph (1) of Article 4 in both Contracting States shall, subject to paragraph (3) of this Article, be taxable only in the Contracting State in which it is situated;

Thus in principle Swiss situate property of a tiebreaker Swiss domiciliary qualifies for treaty IHT exemption on death even though not of course excluded property (because the individual is UK law domiciled or deemed domiciled for IHT purposes). However five wide exceptions greatly restrict the scope of the rule. The first four are the exceptions mentioned above: property covered by articles 5, 6, 7 and 8(2) (UK land, PEs, ships and aircraft, and shares in UK companies.) Lastly, article 8(3) provides:

> Any property which is situated in Switzerland and which would be taxable only in Switzerland under paragraph (1)(a)(ii) of this Article may also be taxed in the UK if the deceased was:
> (a) by virtue of the provisions of paragraph (2) of Article 4 domiciled in the UK at the time of his death; or
> (b) by virtue of those provisions domiciled in Switzerland at the time of his death but:
> (i) had been domiciled [ie treaty-domiciled] in the UK at any time within the five years preceding his death; and
> (ii) was at that time a national of the UK without being a national of Switzerland.

Thus a person who is a UK national[3] cannot take advantage of this treaty IHT exemption until they have been treaty-domiciled in Switzerland for 5 years. A UK national cannot avoid IHT by becoming treaty-domiciled in Switzerland shortly before death. However a non-UK national who is UK law domiciled or deemed domiciled could in principle do so.

### 62.6.3 *Property outside UK and Switzerland*

I refer to property outside the UK and Switzerland as **"third country property."**
Article 8(1)(b) provides

> (1) Subject to the following provisions of this Convention:
> (b) property not dealt with in Articles 5, 6 and 7 which is not situated in either Contracting State and forms part of the estate of a person:
> (i) domiciled by virtue of the provisions of paragraph (1) of Article 4 solely in one of the Contracting States shall be taxable only in that Contracting State;

3 Unless also a Swiss national, ie a dual national.

(ii) domiciled by virtue of the provisions of paragraph (1) of Article 4 in both Contracting States shall, subject to paragraph (4) of this Article, be taxable only in the Contracting State in which, under paragraph (2) of Article 4, the deceased was domiciled at the time of his death.

Art.8(1)(b)(i) is not relevant for IHT since non UK situate property of a solely Swiss domiciliary is excluded property in any event. However art.8(1)(b)(ii) is important.

However in principle third country property of a tiebreaker Swiss domiciliary qualifies for treaty IHT exemption on death even though not of course excluded property (because the individual is UK law domiciled or deemed domiciled for IHT purposes). However five wide exceptions greatly restrict the scope of the rule. The first four are the exceptions mentioned above: property covered by articles 5, 6, 7 and 8(2) (UK land, PEs, ships and aircraft, and shares in UK companies.) Lastly, article 8(4) provides a rule equivalent to article 8(3):

(4) Any property which is not situated in either Contracting State and which would be taxable only in Switzerland under paragraph (1)(b)(ii) of this Article may also be taxed in the UK if the deceased:
(a) had been domiciled in the UK at any time within the five years preceding his death; and
(b) was at that time a national of the UK without being a national of Switzerland.

Thus a person who is a UK national[4] cannot take advantage of this treaty IHT exemption until they have been treaty-domiciled in Switzerland for 5 years. A UK national cannot avoid IHT by becoming treaty-domiciled in Switzerland shortly before death. However a non-UK national who is UK law domiciled or deemed domiciled could in principle do so.

### 62.6.4 *Situs rule*

The 1993 Protocol provides:

(3) With reference to Article 8:

4 Unless also a Swiss national, ie a dual national.

> The situs of any property dealt with in that Article shall be determined by the law of the UK in effect at the date of entry into force of this Convention.

## 62.7 Extension of IHT spouse exemption

Under domestic IHT law, the usual IHT spouse exemption is restricted when the transferor is UK domiciled and the spouse is foreign domiciled. Article 10(2) restricts this restriction:

> (2) Property which passes to the spouse from a deceased person who was domiciled in or a national of Switzerland and which may be taxed in the UK shall, where:
> (a) the spouse was not domiciled in the UK but the transfer would have been wholly exempt had the spouse been so domiciled, and
> (b) a greater exemption for transfers between spouses would not have been given under the law of the UK apart from this Convention,
> be exempt from tax in the UK to the extent of 50 per cent of the value transferred, calculated as a value on which no tax is payable and after taking account of all exemptions except those for transfers between spouses.

Civil partners are not mentioned (as the treaty was made before the introduction of civil partnerships). One might construe spouse widely to include "civil partner" particularly if Swiss tax law treats civil partners like spouses.

## 62.8 Immovable property

Article 5 Swiss IHT DTA provides:

> (1) Immovable property which forms part of the estate of a person domiciled in a Contracting State and which is situated in the other Contracting State may be taxed in that other State.
> (2)The term "immovable property" shall have the meaning which it has under the law of the Contracting State in which the property in question is situated provided always that debts secured by mortgage or otherwise shall not be regarded as immovable property. The term shall in any case include property accessory to immovable property, livestock and equipment used in agriculture and forestry, rights to which the provisions of general law respecting landed property apply, an interest

> in the proceeds of sale of land which is held on trust for sale, usufruct of immovable property and rights to variable or fixed payments as consideration for the working of, or the right to work, mineral deposits, sources and other natural resources; ships and aircraft shall not be regarded as immovable property.
> (3) The provisions of paragraphs (1) and (2) of this Article shall also apply to immovable property of an enterprise and to immovable property used for the performance of professional services or other activities of an independent character.

This is fairly standard form.

## 62.9 Business property

Article 6(1) USA IHT DTA provides:

> (1) Except for assets referred to in Articles 5 and 7 and in paragraph (2) of Article 8, movable property of an enterprise which forms part of the estate of a person domiciled in a Contracting State which is the business property of a permanent establishment situated in the other Contracting State, may be taxed in that other State.

This is standard form. I do not set out the lengthy provisions relating to permanent establishment here, since this will rarely arise.

## 62.10 Other articles

The following articles of the Swiss IHT DTA are standard forms and not discussed here:

Article 11: non-discrimination
Article 12: mutual agreement procedure.
Article 13: exchange of information.
Article 14: diplomatic and consular officials.
Article 15: entry into force.
Article 16: termination.

CHAPTER SIXTY THREE

# FOREIGN IHT CREDIT RELIEF

## 63.1 Foreign IHT credit - Introduction

"**Foreign IHT credit relief**" arises where foreign tax is set against UK IHT. This may be "**DTA IHT credit**" where a DTA confers a credit or "**Unilateral IHT credit**" where UK tax law (not a DTA) confers a credit.

In this chapter I first consider unilateral IHT credit and then five IHT DTAs: the four pre-CTT DTAs and the USA IHT DTA.

For the interaction of unilateral relief and transferable nil rate bands, see 60.7 (Transferable nil rate bands and IHT DT reliefs). For deduction for foreign IHT (as opposed to credit) see 56.13 (Deduction for foreign taxes). For interaction with concession for UK situate property, see 56.13.3 (Foreign tax on UK situate shares).

## 63.2 Unilateral IHT credit

Unilateral IHT credit is important as the UK does not have many IHT DTAs. Section 159(1) IHTA provides:

> Where the Board are satisfied that in any territory outside the UK (an "overseas territory") any amount of tax imposed by reason of any disposition or other event is attributable to the value of any property, then, if—
> (a) that tax is of a character similar to that of capital transfer tax or is chargeable on or by reference to death or gifts inter vivos, and
> (b) any capital transfer tax chargeable by reference to the same disposition or other event is also attributable to the value of that property,
>
> they shall allow a credit in respect of that amount ("the overseas tax") against that capital transfer tax in accordance with the following provisions.

Statute calls this "unilateral relief" but I prefer the term "**unilateral foreign IHT credit**" (or foreign IHT credit relief) which seems clearer. I refer to the foreign tax (which statute calls "the overseas tax" as "**foreign IHT**".

Unilateral relief is based on the international understanding that the state where an asset is located has the primary right of taxation and the state whose claim to tax depends on a personal nexus (residence or, as in the UK, domicile) should provide unilateral relief for double taxation.

The IHT Manual provides:

> **27185 Introduction** [October 2007]
> ... 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.

## 63.3 Requirement to pay foreign IHT

The requirement that the foreign IHT must actually be paid is slipped into the definition of "tax imposed". Section 159(6) IHTA provides:

> In this section references to tax imposed in an overseas territory are references to tax chargeable under the law of that territory and paid by the person liable to pay it.

The IHT Manual provides:

> **27185. Introduction** [October 2007]
> ... 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)

## 63.4 Use of foreign IHT credit

Credit is only set against "that capital transfer tax" ie tax attributable to the value of the same property as is subject to the foreign IHT.

The IHT Manual provides:

> **27185. Introduction** [October 2007]
> ... 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.

## 63.5 Amount of credit

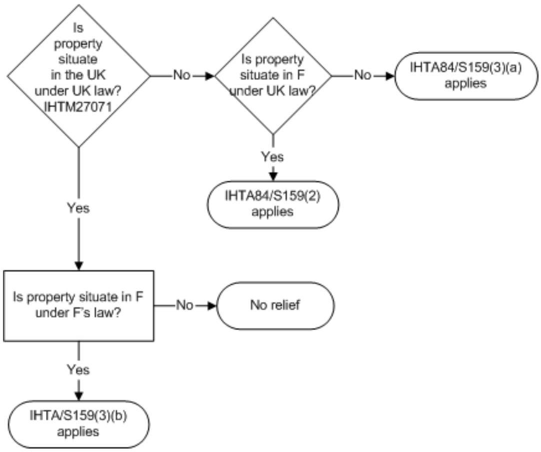
The rules determining the amount of IHT credit differ depending on

(1) situs of property under UK law and

(2) situs of property under the foreign law.

The IHT Manual provides:

> **27185. Introduction** [October 2007]
> ... Because of the terms of Section 159(2), (3) and (4) IHTA 1984 it is necessary to consider the situs (IHTM27071) of property according to UK law and, possibly, according to a foreign law when allowing a credit for foreign tax. You must raise any questions necessary to establish the situs as soon as it seems likely that a Section 159 IHTA 1984 credit will be claimed.
> 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. ... SAV (Foreign) will provide the exchange rate required...
> **27186 Procedure chart**




The reader is invited to consider whether flow charts like these are helpful.

### 63.5.1 *Situs in overseas territory*

Section 159(2) IHTA provides:

> Where the property is situated in the overseas territory and not in the UK, the credit shall be of an amount equal to the overseas tax.

The IHT Manual provides:

> **27187. Relief under Section 159(2) IHTA 1984** [January 2010]
> Where the property concerned is situate (under UK law) in the foreign country, relief is due under Section 159(2) IHTA 1984 and the credit due is equal to the foreign tax paid.
> In practice, the credit cannot exceed the IHT attributable to the property concerned.

More accurately, the *credit* (as defined) can exceed the IHT attributable to the property, but this credit is only set against the IHT attributable to the property, so the amount of the relief is the lesser of the credit and that IHT. The IHT Manual goes on to give an example:

> *Example*
> B died in September 2002, leaving an apartment in Spain valued at £50,000. B's total estate amounts to £300,000 (there were no lifetime gifts), with total IHT payable of £20,000.

> The Spanish authorities charge tax equivalent to Sterling £4,000 on the apartment on B's death.
> The IHT payable on the apartment is:
> £50,000 × (£20,000/£300,000) = £3,333.33
> Accordingly, the double taxation credit due under Section 159(2) IHTA 1984 is restricted to £3,333.33.

The effect of the credit is that the total tax paid is the higher of the UK and the foreign IHT rates.

### 63.5.2 *Situs in third country or dual situate property*

Section 159(3) IHTA provides:

> Where the property—
> (a) is situated neither in the UK nor in the overseas territory, or
> (b) is situated both in the UK and in the overseas territory,
> the credit shall be of an amount calculated in accordance with the following formula—
>
> $$\frac{A}{A+B} \times C$$
>
> where
> A is the amount of the capital transfer tax,
> B is the overseas tax and
> C is whichever of A and B is the smaller.

The IHT Manual provides:

> **27188. Relief under Section 159(3) and Section 159(4) IHTA 1984**
> [Sept 2008]
> Relief is due under Section 159(3) IHTA 1984 where the UK and another foreign country tax the same property and that property is situate:
>
> - neither in the UK nor in the foreign country, or
> - both in the UK and in the foreign country.
>
> Where relief is due under Section 159(3) IHTA 1984, it is given on a split credit basis and will be less than the foreign tax paid. [The Manual sets out the formula in s.159(3) and continues:]
> *Example 1*
> Country X and the UK tax an item of property which is situate neither in Country X or UK.

Country X charges tax of £40
UK charges IHT of £60
The credit is: $60/(60 + 40) \times (40) = £24$

HMRC IHT Customer Guide gives two examples of unilateral relief calculations:[1]

**Example 1**
Ann is domiciled in Ruritania, but is also treated as domiciled in the UK. She makes a gift of property situated in Utopia.

| Item | Amount |
|---|---|
| UK inheritance tax (A) | £3,000 |
| Ruritanian inheritance tax (B) | £1,000 |
| C is the smaller of A and B | £1,000 |

Credit against UK IHT is £3,000 / (£3,000 + £1,000) X £1,000 = £750

| | |
|---|---|
| **Net UK tax** | **£2,250** |

**Example 2**
Tom is domiciled in Utopia but holds shares in a Ruritanian company, which maintains a duplicate share register in the UK. Under UK law we regard the shares as situated in the UK, but Ruritanian law regards them as situated in Ruritania. Tom dies (but his estate is not liable to Utopian tax).

| Item | Amount |
|---|---|
| UK inheritance tax (A) | £1,000 |
| Ruritanian inheritance tax (B) | £4,000 |
| C is the smaller of A and B | £1,000 |

Credit against UK IHT is £1,000 / (£1,000 + £4,000) X £1,000 = £200

| | |
|---|---|
| **Net UK tax** | **£800** |

This may not be fully adequate to eliminate double taxation. Where an IHT DTA applies a more generous form of credit may apply.

### 63.5.3 *Property taxed in more than one overseas territory*

Section 159(4) IHTA provides:

> Where tax is imposed in two or more overseas territories in respect of

1 *www.hmrc.gov.uk/cto/customerguide/page20.htm#15.*

property which—
(a) is situated neither in the UK nor in any of those territories, or
(b) is situated both in the UK and in each of those territories,
subsection (3) above shall apply as if, in the formula there set out, B were the aggregate of the overseas tax imposed in each of those territories and
C were the aggregate of all, except the largest, of A and the overseas tax imposed in each of them. ...

The IHT Manual provides an example:

**27188 Relief under Section 159(3) IHTA 1984 and Section 159(4)**
[September 2008]
*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

### 63.5.4 *Interaction of s.159(2)(3)*

Section 159(5) IHTA deals with the interaction of the two reliefs:

Where credit is allowed under subsection (2) above or section 158 above in respect of overseas tax imposed in one overseas territory, any credit under subsection (3) above in respect of overseas tax imposed in another shall be calculated as if the capital transfer tax were reduced by the credit allowed under subsection (2) or section 158; and where, in the case of any overseas territory mentioned in subsection (3) or (4) above, credit is allowed against the overseas tax for tax charged in a territory in which the property is situated, the overseas tax shall be treated for the purposes of those provisions as reduced by the credit.

The IHT Manual provides:

**27188 Relief under Section 159(3) IHTA 1984 and Section 159(4)**
[September 2008]
... If relief is due under Section 159(3)(a) IHTA 1984 or Section 159(4)(a) IHTA 1984, Section 159(5) IHTA 1984 must be considered

when calculating the foreign tax paid (B in the formulas above). If the foreign country has allowed a credit against its tax for tax paid in another foreign country, please refer to TG.
Where relief is due under Section 159(3)(b) IHTA 1984 or Section 159(4)(b) IHTA 1984, above, the foreign tax at B is simply the gross amount paid – no account need be taken of any credit for tax paid in another country.
**27189. Procedure when both Section 159(2) and Section 159(3) IHTA 1984 apply**
It may happen that relief is due under both Section 159(2) IHTA 1984 – or convention relief under Section 158 IHTA 1984 – and under Section 159(3) IHTA 1984.
If this is the case, Section 159(5) states that the credit allowed under Section 159(3) must be calculated on the basis that A in the formula (the Inheritance Tax paid) is the net amount of Inheritance Tax after allowing the credit under Section 158 or Section 159(2)
…

### 63.5.5 *Interaction of unilateral IHT credit relief and DTA credit relief*

Section 159(7) IHTA provides:

> Where relief can be given both under this section and under section 158 above [double tax treaties], relief shall be given under whichever section provides the greater relief.

The IHT Manual provides:

> **27200. Procedure when both forms of relief apply**
> Unilateral relief and relief under a DTC are **not** mutually exclusive. Where both reliefs are prima facie due with reference to the same item of property, relief is restricted by Section 159(7) IHTA 1984 to whichever is the greater. In practice, where the amount of credit is the same under either basis, the credit should be treated as Convention relief.
> In cases where, either;
> (a) both reliefs are due, but the unilateral relief appears the greater or
> (b) the interaction of the two reliefs gives rise to undue difficulty
> you must refer the case to TG (IHTM01081). In Scotland, your Team Leader should be consulted in cases of difficulty.

> **Unilateral relief may be given for a State tax in addition to unilateral or Convention relief in respect of tax levied by the country of which the State forms part.**
> *Example*
> Deceased, a British citizen, dies domiciled in the UK. His estate includes an apartment in New York, stocks and shares in US Companies and a New York bank account.
> The world-wide estate will be subject to UK tax, but US Federal Estate Tax will (because of the terms of the DTC) be payable only on the immovable property in the USA. The UK will give credit for the US tax under the DTC.
> NY State will also charge State Estate Tax on the movable assets situate there and the UK will give unilateral relief for this tax.
> But the total unilateral and convention credit cannot exceed the amount of UK IHT payable on the property concerned.

63.5.6 *Concession for Canada Estate Duty?*

The IHT Manual provides:

> **27186 Procedure Chart**
> Relief should be given under Section 159(2) IHTA 1984 rather than Section 159(3)(a) where tax is paid, under an agreement between the provinces concerned, in Quebec or Ontario on shares which by UK law are situate in the other province. This applies also to a similar arrangement between Quebec and British Columbia.

Canada abolished estate duty in 1972. This passage is therefore 40 years out of date! For the current Canadian position, see 56.13.2 (Canadian income tax liabilities deducted for IHT). However it illustrates an approach which may perhaps be applied to federal estate duties in other federal jurisdictions, if there are any.

## 63.6 Planning

The rule is in short that the relief is the lesser of (1) foreign IHT and (2) UK IHT attributable to the same property. This requires careful planning to maximise the benefit of the relief.

Suppose T owns land in country X which on T's death will bear IHT in country X. If T makes a chargeable gift of the land (eg a gift by will to T's children) then the foreign IHT credit is available. If T makes an exempt gift (eg to T's spouse or to charity) the foreign IHT credit is lost. Foreign jurisdictions do not normally allow death duty exemption on the grounds that a gift is made to a UK charity. (In some cases EU member states may allow relief.) For instance, suppose T wishes to makes a will giving foreign property to a UK charity. The gift may bear foreign death duties which are set against UK IHT so the effective IHT burden is reduced or eliminated.[2] It would be better:

(1) to give the foreign property to beneficiaries who are chargeable under UK law.
(2) to give other (perhaps UK) property to the UK charity which would otherwise bear inheritance tax at the full rate.

In some cases the matter could be put right by a deed of variation.

## 63.7 DTA IHT credit: pre-CTT DTAs

Article VI of the UK/France IHT DTA provides:

> Where one Contracting Party imposes duty on the death of a person who was domiciled in its territory at the time of his death on any property which, under the present Convention, is situated in the territory of the other Contracting Party, the former Party shall allow against so much of its duty, ascertained in accordance with its law, as is attributable to that property a credit (not exceeding the amount of the duty so attributable) equal to so much of the duty imposed by the other Contracting Party as is attributable to such property.

Similarly, art.VI of the UK/Italy IHT DTA provides:

> (1) Where one Contracting Party imposes duty on any property which is not situated in its territory but is situated in the territory of the other Contracting Party, the former Party shall allow against so much of its duty (as otherwise computed) as is attributable to that property a credit (not exceeding the amount of the duty so attributable) equal to so much of the duty imposed in the territory of the other Contracting Party as is attributable to such property.
> (2) For the purposes of this Article, the amount of the duty of a

2 The position may be complicated further by foreign rules which make the rate of death duty depend on the relationship of the beneficiary to the deceased; forced heirship rules may also need to be considered.

> Contracting Party attributable to any property shall be ascertained after taking into account any credit, allowance or relief, or any remission or reduction of duty other than in respect of duty payable in the territory of the other Contracting Party

This does not add much to the unilateral IHT credit otherwise available under domestic law but it would be relevant for an asset which is UK situate under domestic situs rules but not UK situate under treaty situs rules.

India and Pakistan DTAs have similar articles but since these countries do not impose IHT, the articles have no effect.

## 63.8 USA DTA: Credit for foreign IHT

Article 9 USA IHT DTA provides:

> (2) Where under this Convention the UK may impose tax with respect to any property other than property which the UK is entitled to tax in accordance with the said Article 6 or 7 (that is, where the decedent or transferor was domiciled in or a national of the UK), then, except in the cases to which para (3) applies, double taxation shall be avoided in the following manner:
> (a) Where the US imposes tax with respect to property in accordance with the said Article 6 or 7, the UK shall credit against the tax calculated according to its law with respect to that property an amount equal to the tax paid in the US with respect to that property.
> (b) Where the US imposes tax with respect to property not referred to in sub-para (a) and the decedent or transferor was a national of the UK and was domiciled in the US at the time of the death or transfer, the UK shall credit against the tax calculated according to its law with respect to that property an amount equal to the tax paid in the US with respect to that property.
> (3) Where both Contracting States impose tax on the same event with respect to property which under the law of the US would be regarded as property held in a trust or trust equivalent and under the law of the UK would be regarded as property comprised in a settlement, double taxation shall be avoided in the following manner:
> (a) Where a Contracting State imposes tax with respect to property in accordance with the said Article 6 or 7, the other Contracting State shall credit against the tax calculated according to its law with respect to that property an amount equal to the tax paid in the first- mentioned Contracting State with respect to that property.
> (b) Where the US imposes tax with respect to property which is not taxable in accordance with the said Article 6 or 7 then
> (i) where the event giving rise to a liability to tax was a generation-skipping transfer and the deemed transferor was domiciled in the US

at the time of that event,

(ii) where the event giving rise to a liability to tax was the exercise or lapse of a power of appointment and the holder of the power was domiciled in the US at the time of that event, or

(iii) where (i) or (ii) does not apply and the settlor or grantor was domiciled in the US at the time when the tax is imposed,

the UK shall credit against the tax calculated according to its law with respect to that property an amount equal to the tax paid in the US with respect to that property. ...

(4) The credits allowed by a Contracting State according to the provisions of paras (1), (2) and (3) shall not take into account amounts of such taxes not levied by reason of a credit otherwise allowed by the other Contracting State. No credit shall be finally allowed under those paragraphs until the tax (reduced by any credit allowable with respect thereto) for which the credit is allowable has been paid. Any credit allowed under those paragraphs shall not, however, exceed the part of the tax paid in a Contracting State (as computed before the credit is given but reduced by any credit for other tax) which is attributable to the property with respect to which the credit is given.[3]

## The IHT Manual provides:

**27170. USA** [October 2007]

Where a DT credit is due you may give a provisional allowance but the case must not be closed until the payment has been certified by the US authorities on Form 742.

You must send the taxpayer two prints of form 742 ask them to complete the forms and send them to the US authorities at the address given on the form. One of these copies is certified and returned to this office and the other is retained by the US authorities. The certified form must be checked and the appropriate credit allowed. If you have any difficulty applying the DTC or calculating the tax attributable to the property please seek advice from TG.

- The credit given cannot exceed the amount of tax payable in the UK on the property concerned.

*Certification of IHT paid for the US authorities*

The US form 706 CE is forwarded to this Office in duplicate for certification. After checking (it is important that the forms themselves should not be marked in any way) they and the file must be sent with a note of any error or omission to TG. If the case is closed TG arranges for one copy to be certified and sent with a schedule of any necessary amendments to the US authorities; the other copy is filed. The taxpayer is informed that the certificate has been sent and is provided with a copy of any amending schedule.

Where a certificate of tax paid cannot be issued on application because the amount of tax has not been finalised and paid, an explanation must be given to

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3 Art 9(5) deals with claims; see 63.9 (Claims for foreign IHT credit relief).

the taxpayer together with a reminder that it is open to them to lodge a provisional claim for a credit with the US authorities (there is a time limit – Article 9). When the case is ready for certification the application is referred with the file to TG to issue the certificate.
If there is any adjustment of tax after a certificate has been issued the file must again be referred to TG for the issue of an amending certificate.

## 63.9 Claims for foreign IHT credit relief

There is no domestic law provision requiring a claim for unilateral IHT credit relief or for IHT DTA relief(unlike the position for IT and CGT where a claim is required by statute). However the treaties assume that a claim is to be made for a credit or a refund of tax and so by implication impose a claim requirement in these cases. The wording varies between treaties.
Article VII India IHT DTA provides:

> 1. Any claim for a credit or for a refund of duty founded on the provisions of the present Agreement shall be made within six years from the date of the death of the deceased person in respect of whose estate the claim is made, or, in the case of a reversionary interest where payment of duty is deferred until the date on which the interest falls into possession, within six years from that date.
> 2. Any such refund shall be made without payment of interest on the amount so refunded.

Article VII Pakistan IHT DTA is the same. Article VII France IHT DTA provides:

> 1. Any claim for a credit or for a refund of duty founded on the provisions of the present Convention shall be made within five years from the date of the death of the deceased person in respect of whose estate the claim is made, or, where the event causing duty to be payable occurs at some later date, within five years from that date.
> 2. Any such refund shall be made without payment of interest on the amount so refunded.

Article VII Italy IHT DTA is the same but lacks para 2.
Article 9(5) USA IHT DTA provides:

> Any claim for a credit or for a refund of tax founded on the provisions

of the present Convention shall be made within six years from the date of the event giving rise to a liability to tax or, where later, within one year from the last date on which tax for which credit is given is due. The competent authority may, in appropriate circumstances, extend this time where the final determination of the taxes which are the subject of the claim for credit is delayed.

CHAPTER SIXTY FOUR

# UK DOMICILIARY MARRIED TO FOREIGN DOMICILIARY

## 64.1 UK domiciliary married to foreign domiciliary – Introduction

This chapter considers the position of a UK domiciled individual who is married to a foreign domiciled spouse.[1] It is necessary to consider the various taxes separately.

## 64.2 Restricted IHT spouse exemption for foreign domiciled spouse

Section 18(1) IHTA normally provides complete exemption for transfers between spouses.[2] Section 18(2) imposes an important exception:

> If, immediately before the transfer, the transferor but not the transferor's spouse or civil partner is domiciled in the UK the value in respect of which the transfer is exempt (calculated as a value on which no tax is chargeable) shall not exceed £55,000 less any amount previously taken into account for the purposes of the exemption conferred by this section.

So where:
(1) the transferor is UK domiciled (or deemed UK domiciled), and
(2) the transferee (the spouse of the transferor) is foreign domiciled

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1 References to "spouse", "marriage", and "widow/ers" include a civil partner, civil partnership and a surviving civil partner. See App 1.2 (Meaning of spouse) and App 1.3 (Civil partners).

2 For the interaction of the IHT spouse exemption and excluded property rules, see 58.1 (IHT spouse exemption on death of a foreign domiciliary).

the exemption is restricted to £55,000 only.[3] While it is generally true that a foreign domicile is a passport to tax saving, this is one circumstance in which a foreign domicile is a serious drawback.

This restriction does not apply the other way round, where the foreign domiciled individual makes a transfer to their 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.

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.[4]

Where the foreign domiciled spouse is a citizen of another member state, the discrimination is unlawful in EU law. The government justify the discrimination on the grounds of the "potential avoidance risk".[5] But that is not sufficient to justify discrimination.

### 64.2.1 *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

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3 The IHT Manual states:

"**11033 Spouse/civil partners domiciled outside UK** [October 2007]

The £55,000 limit applies to

- the value before grossing (IHTM26121)
- the cumulative total of all transfers to a spouse, or spouses, or civil partner domiciled outside the UK. So you should take into account the amounts allowed under earlier transfers in which the IHTA84/S18 (2) limitation applied in considering whether the £55,000 is exceeded
- transfers on or after 9 March 1982. For transfers before that date the limit was lower, and you should refer to the Taxes Acts 1982 Edition held in the library

Where the £55,000 limit is exceeded, you should allocate the exemption in the manner which is most favourable to the spouse or civil partner. Factors you should bear in mind include the incidence of tax and the availability of business relief (IHTM24131), agricultural relief (IHTM24001) or other reliefs."

4 See 52.2 (Deemed UK domicile)

5 Public Bill Committee debate on Finance Bill, Hansard 13 May 2008 col.181.

from this section, would be a chargeable transfer".[6] So if one spouse makes a gift to the other, that gift uses up the lifetime £55,000 limit even though the gift is made more than seven years from the death and would otherwise qualify as an exempt transfer, as a PET.

The position is different for a gift of excluded property.[7] Such a gift is not a transfer of value at all and therefore it is not a transfer which qualifies for the spouse exemption and does not use up the £55,000 exemption.

The position is less clear for a transfer (outside s.11) which qualifies for the annual or normal expenditure exemptions. Such a transfer is an exempt transfer under those exemptions: does it also use up the £55,000 limit for inter-spouse gifts? There is no clear answer in the legislation but it is suggested that these transfers do not use up the £55,000 limit. That would seem to better fit the scheme of the legislation.

See 58.1 (IHT spouse exemption on death of a foreign domiciliary); 58.2 (Will drafting - general approach); and 54.8 (GWR spouse exemption).

## 64.3 Spouse or widow of settlor becomes entitled to settled property

The termination of an estate interest in possession (during the life of the life tenant) is a transfer of value under s.52 IHTA. Section 53(4) IHTA provides:

> Tax shall not be chargeable under s.52 above if on the occasion when the interest comes to an end—
> (a) the settlor's spouse or civil partner, or
> (b) where the settlor has died less than two years earlier, the settlor's widow or widower or surviving civil partner,
>
> becomes beneficially entitled to the settled property and is domiciled in the UK.[8]

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

6 Transfers before 22 March 2006 are governed by s.3A(1) IHTA but the wording on this point is the same.

7 Likewise a gift within s.11 IHTA; see 64.4 (Disposition for maintenance of spouse and other exemptions).

8 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 estate interest in possession on the death of the life tenant.

## 64.4 Disposition for maintenance of spouse and other exemptions

Where the IHT spouse exemption does not apply, another exemption may sometimes fill the gap. An inter-spouse gift may qualify for relief under s.11(1) IHTA:

> A disposition is not a transfer of value if it is made by one party to a marriage[9] or civil partnership in favour of the other party ... and is—
> (a) for the maintenance of the other party ...[10]

This should normally[11] apply, in particular, to the common case where an individual gives a half share in the family home to their spouse. The most basic requirement of "maintenance" is to have a secure roof over one's head.[12] In *Phizackerley v IRC*[13] 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.

9 "Marriage" is defined to include a former marriage in certain cases: s.11(6) IHTA.

10 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).

11 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.

12 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).

13 [2007] STC (SCD) 328.

A gift which is within s.11 IHTA (Disposition for family maintenance) 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.)[14]

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.

## 64.5 Transferable nil-rate band

The IHT Manual provides:

> **43042 Domicile of first spouse or civil partner to die** [August 2009]
> Every person, UK domiciled or not, is entitled to the full nil rate band that can be set against their estate that is subject to IHT.
> The availability of TRNB on the estate of the first to die of a non domiciled spouse or civil partner is calculated only by reference to property that is potentially subject to an UK IHT charge. For a non domiciled spouse or civil partner, **VT** [IHTM43020] will be calculated only by reference to their estate in the UK. Assets held outside the UK, by a person not domiciled, or deemed domiciled in the UK, regardless of the devolution of those assets are not taken into account when calculating the available unused nil rate band.
> Thus where the survivor dies in the UK and their spouse or civil partner, who held no UK assets, died abroad leaving all their all overseas assets to their children, none of the nil rate band was used on the first death and the personal representatives of the survivor may claim to transfer 100% of the nil rate band to the estate of the survivor.
> *Example*[15]
> Abdul [died] domiciled abroad. His only asset situated in the UK was a US dollar account containing US$250,000. He left this and the remainder of his

14 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.

15 The HMRC example, as is the current trend, contains several facts which are wholly irrelevant to the tax position and which only serve to make it harder to identify the relevant points. The following footnotes identify these.

estate to his son, Jamil who lives in the UK.[16] After the death, his wife, Soroya, moved to the UK to live with Jamil and died domiciled in the UK.[17]

The assets situated outside the UK are not liable to IHT. The US dollar account is left out of account [IHTM04380] in determining Abdul's estate at death. So although whole estate passed to Jamil, no property was chargeable to IHT, leaving the nil rate available for transfer in full on Soroya's death..

**IHTM43043 - Domicile: calculation where the domicile of the survivor at the first death is outside the UK** [August 2009]

On the death of the first spouse or civil partner, exemption for assets passing to the surviving spouse or civil partner may be limited to £55,000 in accordance with s8(2) IHTA if the surviving spouse or civil partner was not domiciled or deemed domiciled in the UK. [IHTM11033]

If the entire estate passed to the surviving spouse or civil partner, anything over £55,000 is a chargeable legacy. Where the net estate is above the nil rate band plus £55,000 there will be no nil rate band to transfer, as illustrated below.

**Example**

Susan died in 2002/03. She left an estate worth £450,000 all to her husband Lars who is domiciled in Sweden.

**Unused nil rate band calculation**

**M** = £250,000

**VT** = £395,000 (Estate of £450,000 less limited spouse exemption of £55,000)

**M** is not greater than **VT**, so there is nothing to transfer.

Where the net estate is less than the nil rate band plus £55,000, there will still be an amount of nil rate band available to transfer. This example shows how both the amount that the net estate is below the nil rate band, and limited spouse exemption combine to produce the amount of nil rate band available to transfer.

**Example**

Charles died in 2002/03. He left an estate worth £200,000 all to his wife Helga who is domiciled in Sweden.

**Unused nil rate band calculation**

**M** = £250,000

**VT** = £145,000 (Estate of £200,000 less limited spouse exemption of £55,000)

**M** is greater than **VT** by £105,000

**Transferable nil rate band calculation**

**E** =£105,000

**NRBMD** = £250,000 so

(105,000 ÷ 250,000) × 100 = 42.0000%

On Helga's death, the nil rate band on her death would be uprated by 42%. This approach will be appropriate on the death of the survivor when either

- they remain domiciled abroad and their UK assets exceed the single nil rate band, or

16 Where the son lives, and where he is domiciled (which might not be the same) are completely irrelevant to the example.

17 Where the widow lives and where she dies domiciled, are irrelevant to the example.

- between the first death and their own, they became domiciled, or deemed domiciled in the UK.

## 64.6 Inter-spouse gift of 100% BPR or APR property

This section considers a gift of property qualifying for 100% business or agricultural property relief from a UK domiciled individual to their non-UK domiciled spouse. It is necessary to consider IHT on the gift and the gift with reservation rules. For convenience I refer to "business property" but similar rules govern agricultural property.

### 64.6.1 *IHT on the gift*

In the normal case of a gift of property qualifying for 100% BPR, the value transferred by the gift is nil. However, s.113A IHTA provides:

> **Transfers within seven years before death of transferor**
> (1) Where any part of the value transferred by a potentially exempt transfer which proves to be a chargeable transfer would (apart from this section) be reduced in accordance with the preceding provisions of this Chapter, it shall not be so reduced unless the conditions in subsection (3) are satisfied.

The conditions which must be satisfied are set out in subsection (3):

> The conditions referred to in subsections (1) and (2) above are—
> (a) that the original property was owned by the transferee throughout the period beginning with the date of the chargeable transfer and ending with the death of the transferor; and
> (b) except to the extent that the original property consists of shares or securities to which subsection (3A) below applies that, in relation to a notional transfer of value made by the transferee immediately before the death, the original property would (apart from s.106 above) be relevant business property.

In brief, BPR is lost unless the property is retained by the donee for seven years. (There is an exception for replacement property which is not discussed here.)

### 64.6.2 *GWR on the gift if the donor survives seven years*

What about GWR? The position varies according to whether or not the donor survives seven years from the gift.

If the donor does survive seven years then s.113A has no application. By subsection (1) it applies to a PET *which proves to be a chargeable transfer*. If the donor survives seven years then the PET does not "prove to be a chargeable transfer". Accordingly the value transferred by the gift remains at nil. The gift therefore normally qualifies as an exempt transfer under:

(1) s.20 IHTA (small gifts); or
(2) s.18 IHTA (IHT spouse exemption).

The gift therefore falls outside the scope of the GWR rules by virtue of s.102(5) FA 1986.

The principle applies to:

(1) outright gifts of 100% BPR property whether or not to spouses;
(2) gifts to trusts under which the spouse has an interest in possession even if such gifts are not "outright gifts" (but consider s.102(5A)).

It does not matter that the property is sold or disposed of by the donee within the seven years as long as the donor has survived seven years. Section 113A(7A) IHTA provides:

> The provisions of this Chapter for the reduction of value transferred shall be disregarded in any determination for the purposes of this section of whether there is a potentially exempt or chargeable transfer in any case.

This is irrelevant because the disregard is only for the purposes of s.113A, not for the purposes of ss.18, 20 IHTA and s.102 FA 1986.

### 64.6.3 *GWR if donor dies within seven years*

The position is different if the donor dies within seven years. Suppose:

(1) H (UK domiciled) gives 100% BPR property to W (foreign domiciled);
(2) H dies within seven years;
(3) The conditions in s.113A(3) are not satisfied (for instance the property

has been sold[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.

## 64.7 Divorce settlement where IHT spouse exemption not available

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] Secondly, s.10 IHTA provides:

> **Dispositions not intended to confer gratuitous benefit**
> (1) A disposition is not a transfer of value if it is shown that it was not intended, and was not made in a transaction intended, to confer any gratuitous benefit on any person and either—
> (a) that it was made in a transaction at arm's length between persons not connected with each other, or
> (b) that it was such as might be expected to be made in a transaction at arm's length between persons not connected with each other.

H does not normally intend to confer any "gratuitous benefit" on W. (Assume the divorce settlement is negotiated at arm's length.) Accordingly the disposition falls within s.10 IHTA and is not a transfer of value for IHT purposes.

There is a theoretical HMRC argument that the condition in s.10(1)(b) IHTA is not satisfied. The argument would be that a divorce settlement cannot be "such as might be expected to be made in a transaction at arm's

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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*, 5th ed, para 2.35. Relief may also be available under s.11 IHTA; see 64.4 (Disposition for maintenance of spouse and other exemptions).

length between persons not connected with each other" since persons not connected with each other would not be in a divorce situation. In my view this argument is not correct. It is the old question of how far one carries the fiction of a deeming provision. The argument carries it too far because it reaches a conclusion which does not fit in with the scheme of the IHTA. IHT Manual (while not explicit) suggests that HMRC do not take the point.[21]

## 64.8 Joint accounts

### 64.8.1 *Introduction*

This section considers a joint bank or building society account held by two account holders. I refer to money in the account as "account money".

There is an important distinction between:

(1) an account on which either account holder can draw a cheque;

(2) an account on which both account holders must sign a cheque.

This book only considers the first type of account. For remittance aspects see 10.40 (Joint accounts).

### 64.8.2 *The property law background*

First of all one must ascertain the rights of the account holders. It would need a chapter to analyse the relevant case law.[22] In outline, three distinct questions arise, and the possible answers to them are as follows:

(1) *Beneficial ownership of the account money while in the account*. The possibilities are:

 (a) Entitlement in equal shares (the most common case)

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21 IHTM 4165 [September 2008]: "Dispositions made on divorce or dissolution of a civil partnership (IHTM11032) for the benefit of a former spouse or civil partner, whether under a Court Order or as a result of arm's length negotiations, are normally within s.10 IHTA 1984."

22 For a summary see *Dymond's Capital Taxes*, para 10.400 and "Cohabitation: the financial consequences of relationship breakdown" Law Com No 307, July 2007, para A.46, accessible *www.lawcom.gov.uk/docs/lc307.pdf*.
Further consideration is needed for an account not governed by English law (but an English court will assume English law principles apply in the absence of evidence to the contrary). English law principles apply in Ireland: *Lynch v Burke* ITR Vol 5 p.271.

(b) Entitlement in proportion to contributions and withdrawals[23]
(c) One account holder beneficially entitled to the whole.

(2) *Beneficial ownership of money withdrawn from the account* (or assets purchased with that money). The possibilities are:
(a) Individual who withdraws funds becomes beneficial owner (the most common case)[24] or
(b) Same as beneficial ownership of the account money (as to which see above).

(3) *Beneficial ownership of account money on death of an account holder.* The possibilities are:
(a) The survivor is beneficially entitled by survivorship.
(b) The deceased owner's share (as to which see (1) above) passes under their will or intestacy.

The answer to one of these three questions does not determine the answers to the others. For instance, account money may belong beneficially to one of the account holders, eg H and W may hold as nominees for H. Such an account may be held on terms that:

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23 In practice the court will assume this is not the case unless there is evidence, such as appropriate records kept by the account holders. John Avery Jones gives cogent reasons for rejecting this analysis for the parent/child account in *Sillars v IRC* [2004] STC (SCD) 180, at [11].

24 See *Re Bishop* [1965] Ch 450 at p.456:

> "Where a husband and wife open a joint account at a bank on terms that cheques may be drawn on the account by either of them, then, in my judgment, in the absence of facts or circumstances which indicate that the account was intended, or was kept, for some specific or limited purpose, each spouse can draw upon it not only for the benefit of both spouses but for his or her own benefit. Each spouse, in drawing money out of the account, is to be treated as doing so with the authority of the other and, in my judgment, if one of the spouses purchases a chattel for his own benefit or an investment in his or her own name, that chattel or investment belongs to the person in whose name it is purchased or invested: for in such a case there is, in my judgment, no equity in the other spouse to displace the legal ownership of the one in whose name the investment is purchased. What is purchased is not to be regarded as purchased out of a fund belonging to the spouses in the proportions in which they contribute to the account or in equal proportions, but out of a pool or fund of which they were, at law and in equity, joint tenants. It also follows that if one of the spouses draws on the account to make a purchase in the joint names of the spouses, the property purchased, since it is purchased in joint names, is, prima facie, joint property and there is no equity to displace the joint legal ownership. There is, in my judgment, no room for any presumption which would constitute the joint holders as trustees for the parties in equal or some other shares."

(a) on the death of H, the account money passes to W by survivorship;[25] or
(b) the account money may pass under the will of H.

The permutations are almost endless. Note that joint tenancy/tenancy in common is not a comprehensive categorisation since those two terms alone are insufficient to determine the answers to the three questions which may arise.

The property law questions depend on the intention of the account holders. In practice spouses and cohabitees generally operate joint accounts without giving any consideration to the ownership of the money, except a general desire to share assets. A search for intention is unrealistic, and the fallback position is that:

(1) Account money is beneficially owned in equal shares.
(2) Withdrawals belong to the account holder who withdraws the funds.
(3) Beneficial ownership passes by survivorship.

I refer to this as a "**common form account**".

The circumstances in which parent/child joint accounts arise are different so the rights of the account holders tend to be materially different. For instance, the terms of the account may be that:

(a) One account holder ("P") may withdraw up to the whole amount of P's benefit and the others may make no withdrawal at all during P's lifetime.
(b) The balance may pass to the survivor 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. The following analysis applies to a common form account.

### 64.8.3 *Account money in estate of both account holders*

In strict law the *whole* of the account money is in the estate of both account holders, under s.5(2) IHTA which provides:

> A person who has a general power which enables him, or would if he

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25 As in the parent/child joint account *O'Neill v IRC* 1998 STC (SCD) 110; the apparent breach of the Wills Act 1837, and the possibility that this is a settlement for IHT, are tacitly ignored.

26 This was found to be the case on the facts in *Sillars v IRC* [2004] STC (SCD) 180.

> were sui juris enable him, to dispose of any property other than settled property, ... shall be treated as beneficially entitled to the property ... and for this purpose "general power" means a power or authority enabling the person by whom it is exercisable to appoint or dispose of property as he thinks fit.[27]

Beneficial ownership is therefore irrelevant and GWR is irrelevant on death of an account holder.

### 64.8.4 *Payment into joint account by one account holder*

Payment into the joint account by an account holder is not a transfer of value because the estate of the payor is not decreased. HMRC agree. The IHT Manual provides:

> **15043 Lifetime gifts arising out of a transfer of an account into joint names** [October 2007]
> Where A places money in a joint account (IHTM15042) in the names of A and B as joint tenants (IHTM15082) and retains the right to withdraw the whole of it, as a general rule there will not be a lifetime transfer (IHTM15060) at the time the money is paid into the account.

Payment into the joint account by an account holder is not a GWR. HMRC do not accept that[28] but in practice GWR does not often matter.

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27 This was accepted without discussion in the Court of Appeal in *IRC v Melville* 74 TC 372 at [36]:

"... the inheritance tax regime produces instances of double taxation which are not limited to the circumstances specified in s 48. A clear example is one falling within s 5(2) of the Act, the very common case of a joint bank account which permits any holder to draw on that account. The same property, the moneys in the account, is under s 5(2) taxable on the death of each holder. The Revenue in practice do not strictly enforce that provision and treat each holder as beneficially entitled only to the proportion of monies in the account which he has contributed".

28 IHT Manual is garbled; so far as relevant it provides:

"**15061 Gifts with reservation** [September 2009]
An example of a joint ownership arrangements involving a GWR is ... if ... A transfers ... a joint money account into joint beneficial ownership of himself and his son, and then A either

- receives (or has the right to receive) all the ... interest for his own benefit or
- has the right to withdraw all the money in the joint account for his own benefit."

Presumably the manual means to say that there is a GWR if A transfers *his money*

### 64.8.5 *Death of an account holder*

Either account holder is strictly subject to IHT on death on the whole of the account money (subject to exemptions such as the spouse exemption). This rule results in double taxation which is undone by concession. The IHT Manual provides:

> **15042 Joint money accounts** [November 2009]
> 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.5(2) IHTA) on a share of the account greater than that which results from the practice outlined above.*
>
> When raising a claim based on the deceased's contributions you should note that the true legal position is far from clear and, accordingly, it is vital to establish the facts and any relevant documents, e.g. application forms, withdrawal mandates, passbooks, terms and conditions of account

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into a joint account and has the right to withdraw all the money. This view is supported by *Sillars v IRC* [2004] STC (SCD) 180 (where the taxpayer was not represented by counsel). But it is considered that a payment into an account of this kind is not a disposal by way of gift. If it were a GWR, many difficulties arise which the Tribunal did not consider in *Sillars*. On the death of A, however, since the property is in the estate of the individual, it does not matter whether payment into the account was a GWR.

etc. before considering the legal and equitable rules. Where the account holder has a joint account governed by Scots Law see IHTM15051 and IHTM15054.

### 64.8.6 *Spouse exemption on death of account holder.*

There are two possibilities:
(1) The account holders may not qualify for the spouse exemption because
  (a) They are married but one is, and one is not, UK domiciled.[29] (This scenario is relevant to the subject of this book, but one cannot examine it in isolation from the others.)
  (b) They are cohabitees.
  (c) There is some other unmarried relationship, such as parent and child.
(2) The account holders may qualify for the IHT spouse exemption.

In the second case, the IHT spouse exemption may apply to the transfer of value on the death of an account holder. HMRC agree. The Manual passage continues:

> Refer to TG (IHTM01081) any case in which the parties dispute the claim. However, there is no need to refer if the deceased's interest passes to an exempt beneficiary, such as a surviving spouse or civil partner (IHTM11032). You should also avoid questions and arguments on this subject unless the amount of tax at stake is substantial.

This is correct, though it needs a slightly purposive construction to say that property "becomes comprised" in the estate of the surviving spouse when the property is already in that estate.

### 64.8.7 *One account holder pays in and other withdraws*

Suppose:
(1) A transfers A's money into the joint account held by A and B and
(2) B withdraws that money into B's own name,

A's estate is reduced at stage (2). A does not make a transfer of value at stage (2) within the normal definition, as that requires a disposition and A

29 In this section I ignore the limited £55k spouse exemption.

does not make a disposition.

One might think that A makes a transfer of value by omission under s.3(3) IHTA. This provides:

> Where the value of a person's estate is diminished, and the value—
> (a) of another person's estate, or
> (b) of any settled property, other than settled property treated by s.49(1) below as property to which a person is beneficially entitled,
> is increased by the first-mentioned person's omission to exercise a right, he shall be treated for the purposes of this section as having made a disposition at the time (or latest time) when he could have exercised the right, unless it is shown that the omission was not deliberate.

But the value of the estate of the account holder who withdraws the funds is not increased so the conditions of s.3(3) are not satisfied.

However, s.272 IHTA provides a wider definition of "disposition":

> "disposition" includes a disposition effected by associated operations;

It is considered that A makes a disposition (and hence a transfer of value) by associated operations at stage (2). Section 268(3) IHTA provides:

> Where a transfer of value is made by associated operations carried out at different times it shall be treated as made at the time of the last of them; but where any one or more of the earlier operations also constitute a transfer of value made by the same transferor, the value transferred by the earlier operations shall be treated as reducing the value transferred by all the operations taken together, except to the extent that the transfer constituted by the earlier operations but not that made by all the operations taken together is exempt under s.18 above.

"Associated operation" is defined in s.268(1) IHTA. This provides (so far as relevant):

> (1) In this Act "associated operations" means ... any two or more operations of any kind, being—
> (a) operations which affect the same property, or one of which affects some property and the other or others of which affect property which represents, whether directly or indirectly, that property, or income arising from that property, or any property representing accumulations of any such income, or

(b) any two operations of which one is effected with reference to the other, or with a view to enabling the other to be effected or facilitating its being effected, and any further operation having a like relation to any of those two, and so on,

whether those operations are effected by the same person or different persons, and whether or not they are simultaneous; and "operation" includes an omission.

The associated operations are:
(1) A's payment into the account.[30]
(2) B's withdrawal from the account.
HMRC agree. The IHT Manual provides:

> **15043 Lifetime gifts arising out of a transfer of an account into joint names** [October 2007]
> Where A places money in a joint account (IHTM15042) in the names of A and B as joint tenants (IHTM15082) and retains the right to withdraw the whole of it, as a general rule there will not be a lifetime transfer (IHTM15060) at the time the money is paid into the account. *But if any part is subsequently withdrawn for the benefit of B, the other joint owner, there may be a transfer at that time.*
> Refer to TG any case where
> - there is such a withdrawal
> - it is claimed that there was an immediate gift when the money was paid into the joint account
> - there is evidence that an immediate gift was intended, or
> - the position is more complicated, for example where withdrawals need both signatures
>
> **(This text has been withheld because of exemptions in the Freedom of Information Act 2000)**

### 64.8.8 *Spouse exemption on lifetime withdrawal*

The IHT spouse exemption may apply to the transfer of value on the lifetime withdrawal by an account holder. Since HMRC accept the application of the spouse exemption on death, they must also accept its application during the lifetime of the account holders.

30 It might be argued that the associated operation is A's omission to withdraw from the account; it makes no difference if this is the case.

The exemption does not of course apply when one spouse is and the other is not UK domiciled because the IHT spouse exemption is restricted. The transfer of value takes place when the funds are withdrawn from the account so that is the point where the conditions for the spouse exemption need to be satisfied. For instance if:
(1) Year 1: H makes a payment into the joint account
(2) Year 2: W makes a payment from the joint account
The IHT exemption applies if the conditions for the exemption are satisfied in Year 2. It does not matter whether or not they are satisfied in Year 1.

### 64.8.9 *One account holder pays in and same account holder withdraws*

Suppose:
(1) A transfers A's money into the joint account held by A and B and
(2) A withdraws that money into B's own name.
A does not make a transfer of value. What about B? V's estate is reduced at stage (2). But it is considered that B makes no transfer of value. It might be said that B makes a transfer of value by associated operations, the operation being B's omission, but that would not be consistent with the policy of s.3(3) IHTA. This can be rationalised by saying that although B makes an omission, which is an associated operation, B does not make a transfer of value by associated operations.

### 64.8.10 *Third party pays into account*

The discussion above assumes that the account money is provided by one or both account holders.

Suppose:
(1) A third party transfers their money into a joint account held by A and B and
(2) A dies.
In strictness A is taxed on the whole account, but by concession it appears that A is taxed on half. The IHT Manual provides:

> **15042 Joint money accounts** [November 2009]
> You should modify this approach where this is necessary to give effect to the realities of the situation.
> *Example*

> A, B and C share a joint account. They all contribute to it. A dies and his proportion of the account accrues by survivorship to B and C. After A's death, the entitlement of B and C should take into account A's contributions.
> **(This text has been withheld because of exemptions in the Freedom of Information Act 2000)**

Presumably this means that afterA's death, B and C are each regarded as entitled to (1) their own contributions to the account and (2) half of the contribution of A.

Suppose:

(1) A third party transfers their money into a joint account held by A and B and

(2) A withdraws that money into A's own name.

It is suggested that B does not make a transfer of value. It might be said that there is a transfer of value by associated operations, the operation being the omission by the first account holder, but that would only be the case if the two steps formed part of an arrangement; any other view would not be consistent with the policy of s.3(3) IHTA.

### 64.8.11 *Payment out of account by way of gift*

If B draws on the account to make a gift to a third party donee, B has made a transfer of value.

If A had paid the account money into the joint account A has also made a transfer of value by associated operations at the time of B's withdrawal.[31] But that is not the case if B, or a third party, has provided the funds.

### 64.8.12 *Planning implications*

The best way to avoid the difficulties described in this section is that substantial sums should not be put in joint accounts at all (except where the account holders qualify for the full IHT spouse exemption). An

31 It is considered that there is no transfer of value under s.3(3) IHTA because although the estate of the third party donee is increased, it is not increased by any failure to exercise a right. But since there is a transfer of value by associated operations, this does not matter.

alternative might be to use a joint account but to specify carefully the terms on which the account is held, but in practice it would be easier to use separate accounts. However in practice joint accounts will frequently be used, and (as the frequent references in the manual to withheld text suggest) this is an area with many anomalies and therefore scope for tax planning.

## 64.9 Scottish joint account

The IHT Manual provides:

> **15050. Special destinations and proof of donation**
> If two or more persons purchase an asset jointly there may be a contractual agreement between them which determines how the property devolves on death.
> - If the title is just in their joint names, such as to A and B, they own an equal share which passes to their executors (IHTM05012) on their deaths and is part of their free estate.
> - But if the title is to A and B and the survivor and they have paid equally for the asset, the survivor will be entitled to the whole on the death of the first to die (*Perrett's Trs v Perrett* [1909] 46 SLR 453). This is known as special (or survivorship) destination.
>
> Both parties do, however, have the right to dispose of their shares in life (*Steele v Caldwell* [1979] SLT 228), which will defeat the operation of the special destination.
> If the price was not provided equally, it is a question of the donor's intention whether he has conferred an immediate beneficial interest (IHTM15011) on the other party. Such a donor can revoke the survivorship destination, explicitly, by will (IHTM12040) under s.30 Succession (Scotland) Act 1964. But the donee may not do the same to defeat the donor's right to the whole of the asset.
> If the whole of a joint asset was provided by one party he retains ownership of the whole till he delivers title, or, by intimation, indicates an intention to make an immediate gift to the other joint owner.
> - Proof of gift requires both intention and delivery. 'Intention' does not require writing as proof and delivery may be actual or constructive, for example by intimation to the donee or his agent.
> - If there is no immediate gift (by intention and delivery) the asset remains part of the provider's estate and will only pass to the other under the survivorship destination on his death, in the absence of any explicit testamentary revocation conforming to s 30 Succession (Scotland) Act 1964.
>
> **15051. Joint money accounts** [October 2007]
> The terms in which bank accounts and deposit receipts are held do not of themselves indicate the extent of common ownership (IHTM15093) nor do they imply the existence of a special destination (IHTM15054). The terms of a deposit receipt do not have a testamentary effect. The extent of each owner's interest will be a question of fact depending on

- the extent of their identifiable contributions, and
- if contributions are unequal whether there can successfully be established donation (IHTM15050) by the greater contributor to the other, or alternatively, whether the asset was held in joint names merely for administrative convenience

You should resist any suggestion by parties that the terms in which such monies are held can effect either a lifetime gift – or pass the property to a survivor, unless there is other supporting evidence. Any cases of difficulty should be referred to TG.

**15052. Land** [August 2006]

The title to heritage is proof of its ownership, and the owners interests in it – unless there is evidence to the contrary, normally by way of written document. If there is no special destination (IHTM15050) and there is equal provision of the price, each co-owner can dispose of his own share as part of his estate and there is no accretion among them.

If spouses or civil partners (IHTM11032) are the joint owners you should keep the 'related property' (IHTM09731) provisions in view (S.161 IHTA 1984).

If it is claimed the beneficial interests (IHTM15011) vary from those indicated by the title and the absence of gift is claimed, strong proof is required of parties intentions such as a contemporaneous writing. In cases of difficulty refer to TG (IHTM01081).

**15053. Which law to apply to joint investments owned by someone domiciled in Scotland** [October 2007]

Scottish law applies to shares of a company registered in Scotland. If the IHT 200 (IHT10021) or other account does not indicate whether a company is Scottish or not, ICES (IHT01023) will be able to provide this information. If the taxpayer is of Scots domicile (IHT13000) a joint holding in Government Stock may be regarded as subject to Scots law (*Cunningham's Trs v Cunningham* [1924] SLT 502).

**15054. Joint money accounts and special destination** [June 2006]

Under Scots Law where Bank or Building Society Accounts are held in joint names and the survivor the special (or survivorship) destination (IHTM15050) does not by itself pass the ownership of the money in the account to the survivor. An Account with a Bank or Building Society is not a document of title as it is not a Deed of Trust in terms of the Blank Bonds and Trusts Act 1696. Rather it is a contract between the Bank and the customer which regulates the conditions on which the Account is to be operated and is for administrative convenience only. See for example *Cairns v Davidson* 1913 SC 1054.

The result is therefore that the question of the ownership of the funds in the Account falls to be determined according to the ordinary principles of ownership. The owner of the funds deposited in the Account remains the owner unless and until some transfer of ownership has occurred.

***Example***

Where a Husband and Wife open an Account, governed by Scots law, in their joint names and the survivor and the Husband has provided the whole funds then on his death survived by his Wife:

- In the absence of some act of transfer of ownership to the Wife (e.g. a separate Deed of Gift) the whole Account should be included in the IHT 200

- If under the terms of the deceased's Will/Intestacy the Account passes to (say) the children then Inheritance Tax will prima facie be payable
- If under the terms of the Will/Intestacy the Account passes to the spouse or civil partner (IHTM11032) then exemption under S.18 IHTA 1984 will be appropriate

This applies to all Bank/Building Society Accounts governed by Scots Law. It will apply therefore to taxpayers living in England Wales and NI who have an Account which is governed by Scots Law.

I would appreciate the view of Scottish readers as to whether this is entirely correct. See too the discussion in the Trusts Discussion Forum May 2007 under the thread "Scottish bank accounts".

## 64.10 Associated operations on inter-spouse gift

The IHT Manual provides:

**14833 Gifts between spouses or civil partner** [September 2009]
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.
However, where the transfer between spouses or civil partners is part of a more complex series of transactions which taken together are the means whereby one of them makes a disposition to a third party, it may be more appropriate to use the associated operations to allocate the transfer(s) to the correct transferor.

## 64.11 IHT planning for mixed marriage

### 64.11.1 *Simple gift to foreign domiciled spouse*

A simple and obvious short- and medium-term course is:

(1) the UK domiciled spouse should give assets to their 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 54.17 (IHT spouse exemption defence to GWR death charge). This often makes simple gifts impractical.

### 64.11.2 *Gift to foreign domiciled spouse, followed by settlement by spouse*

A more sophisticated option is:

(1) the UK domiciled spouse gives assets to their 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 57.1 (IHT planning in anticipation of acquiring UK domicile). Another advantage is CGT planning. A third advantage is that this should avoid the gifts with reservation rule.[32] Of course this strategy only works if the UK domiciled spouse is not a settlor: see 69.33 (Planning to create trust with foreign domiciled settlor).

## 64.12 CGT spouse exemption

Section 58(1) TCGA provides:

> 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

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32 See 54.13 (Gift to foreign domiciled donee who creates a settlement).

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.

## 64.13 CGT planning for mixed marriage

### 64.13.1 *Asset yielding a gain*

Suppose the UK domiciled spouse owns an asset which will give rise to a gain on a disposal. A simple and obvious course is:

(1) The UK domiciled spouse transfers[33] the asset to their foreign domiciled spouse.

(2) The foreign domiciled spouse may be in a position to sell the asset without CGT: see 43.1 (Capital Gains Tax of individuals).

Watch *Furniss v Dawson*!

### 64.13.2 *Non-resident spouse*

The relief applies regardless of residence, so similar planning points arise if one spouse is UK resident and the other is not. CG Manual accepted this:

> **22300 NR spouse or NR civil partner** [June 2008]
> ... There is no longer any authority to treat a non-resident spouse as separated from a resident spouse merely because of their residence status. Similarly a non-resident civil partner may not be treated as separated from a resident civil partner merely because of their residence status. So the possibility of passing assets outside the UK tax net remains.

This paragraph has been quietly deleted[34] but the law is unchanged.

33 The transfer may be a gift or a sale at market value. The latter avoids the IHT problems discussed at 64.2 (Restriction on IHT spouse exemption for foreign domiciled spouse) and 54.8 (GWR spouse exemption) but take care on implementation, especially s.58(2) TCGA. In the case of a sale the spouse will need independent legal advice.

34 Probably in June 2008 when para 22300 was amended, or perhaps subsequently but by July 2009.

## 64.14 Income tax planning for mixed marriage

A simple and obvious course is:

(1) the UK domiciled spouse should give assets to their 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 they have "power to enjoy" their wife's income. This is because s.714(4) ITA provides:

> (4) In this Chapter references to individuals include their spouses or civil partners.

However, RI 201 provides relief:[35]

> Unless transactions are part of a wider arrangement, Revenue practice is not to seek to assess a UK domiciled individual on the income of a non-UK domiciled spouse, where that income arises from a transfer of assets by that spouse and would be outside the charge to tax under s 739 ICTA by virtue of the provisions of s 743(3) ICTA.

The gift would also be a "settlement" for the purposes of s.624 ITTOIA. However, s.626 ITTOIA normally provides relief:

> **626 Exception for outright gifts between spouses or civil partners**
> (1) The rule in s.624(1) does not apply in respect of an outright gift—
> (a) of property from which income arises,
> (b) made by one spouse to the other or one civil partner to the other, and
> (c) meeting conditions A and B.
> (2) Condition A is that the gift carries a right to the whole of the income.
> (3) Condition B is that the property is not wholly or substantially a right to income.
> (4) A gift is not an outright gift for the purposes of this section if—
> (a) it is subject to conditions, or
> (b) there are any circumstances in which the property, or any related

35 This is perhaps a concession but the better view is that the inter-spouse transfer is tax mitigation not tax avoidance so the motive defence applies. Tax Bulletin 81 states (obviously) that the same practice applies to civil partners.

property[36]—

(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.

36 s.626(5) ITTOIA provides that:

> "'Related property' has the same meaning in this section as in s.625."

So we turn to s.625(5) which provides:

> "In this section 'related property', in relation to any property, means income from that property or any other property directly or indirectly representing proceeds of, or of income from, that property or income from it."

CHAPTER SIXTY FIVE

# THE FAMILY HOME AND ITS CHATTELS

## 65.1 Home owned by foreign domiciliary

There are several ways to arrange the ownership of a UK family home for a foreign domiciled individual. The first possibility is that the individual should own the property directly. This has the attraction of simplicity. Also, some UK banks are said to be unwilling to lend to offshore companies. This may also be necessary, or at least desirable, in order to secure that the owner of a long lease acquires the right to enfranchisement.

The main disadvantage is that the property is in the individual's estate and in principle within the scope of IHT on his death. One possible method to mitigate this problem is to provide by will that the property should pass to the individual's surviving spouse, or to a trust under which she has an interest in possession. That normally postpones IHT until the occasion of the death of the survivor of the individual and his spouse.[1]

The risk of IHT may quite simply be covered by insurance. Watch that the insurance policy is not subject to IHT on the death of the individual. Perhaps arrange that the policy is not UK situate[2] (so the policy is excluded property) or transfer the policy to a trust (under which the individual is excluded). The amount to be insured will need to be reviewed from time to time in line with house inflation and possible changes in the rate of IHT.

It should be possible to transfer the property to a company so as to acquire excluded property status, even at very short notice, if the death of the owner became imminent. There is a SDLT charge. So in practice the IHT risk is limited to the risk of the sudden death of the individual (or the sudden joint deaths of individual and spouse).

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1 See 54.17 (IHT spouse exemption defence to GWR death charge).

2 See 70.19 (Insurance policy).

There will be no CGT on the sale of property if main private residence relief applies. If the individual has another residence inside or outside the UK, it may be appropriate to make an election under s.222 TCGA.

There is in principle a taxable remittance, if the purchase price is paid out of foreign income or chargeable gains within the scope of the remittance basis.

Similar points apply to chattels in the home except there is no CGT exemption, apart from the exemption for chattels under £6,000: s.262 TCGA.

## 65.2 Home owned by estate IP trust

This avoids the need for an English grant of probate after the death of the individual.

The IHT position is broadly the same as absolute ownership by the foreign domiciled individual. This course is only practical, however, for estate IPs where:

(1) the life tenant is the settlor; or
(2) the settlor is dead; or
(3) the settlor has no interest in the settlement; or
(4) the settlor can be excluded from a sub-fund (which will hold the UK home); or
(5) the settlement was made before 18 March 1986.

Otherwise HMRC may argue that there is a charge on the death of the settlor under the GWR rules.[3]

The use of a non-resident trust involves a capital payment received in the UK, giving a possible s.87 charge if chargeable gains accrue to the trust. Chargeable gains may arise on a disposal of the house, if the private residence exemption is not fully available, for instance if:

(1) the grounds exceed the "permitted area"; or
(2) there is another private residence which qualifies for the relief; or
(3) in relation to chattels which do not qualify for exemption.

3 See 54.7 (Gift of excluded property).

## 65.3 Home owned by discretionary trust

In principle a discretionary trust or non-estate IP trust could hold the UK home between ten year anniversaries. This might be a convenient short or medium term way to hold a family home. This course is only practical, however, where:
(1) the settlor is dead; or
(2) the settlor has no interest in the settlement; or
(3) the settlor can be excluded from a sub-fund (which will hold the UK home); or
(4) the settlement was made before 18 March 1986.
Otherwise HMRC may argue that there is a charge on the death of the settlor under the GWR rules.[4]

## 65.4 Loan secured on property

It clearly makes IHT sense for any existing loans to be secured on the UK property. It is also possible to borrow in order to mitigate IHT.[5] Commercial borrowing is likely to be an expensive solution to the IHT problem but borrowing from a friendly trust may be practical.

## 65.5 Home owned by non-resident company

### 65.5.1 *IHT advantages and sham*

For inheritance tax, the obvious course is for the UK home of a foreign domiciliary to be owned beneficially by a foreign company. The shares in the company are not UK situate, and qualify as excluded property for IHT. The company would usually be held by an offshore trust.

An argument that an arrangement of this kind was a sham was rejected in *Skyparks v Marks* [2001] WTLR 607. But sham is a question of fact in each case. In some badly created structures the taxpayer may wish to argue that the company is a sham (or at least that it holds its assets as nominee) to avoid a benefit in kind charge.

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4 See 54.7 (Gift of excluded property).
5 See 56.1 (IHT deduction for debts).

### 65.5.2 *Ownership by non-resident company: CGT*

The company will not be subject to CGT or corporation tax on chargeable gains provided it is not resident.

If the company is owned by an individual, the gains will be treated as accruing to the individual under s.13 TCGA.[6]

If the company is held by a trust, the gains would be treated as accruing to the trust, and so be s.2(2) amounts for s.87 purposes.

## 65.6 Home owned by company: benefit in kind charge

The charge on living accommodation is to be found in ss.97 and 102 ITEPA:

> **97 Living accommodation to which this Chapter applies**
> (1) This Chapter applies to living accommodation provided for—
> (a) an employee, or
> (b) a member of an employee's family or household,
> by reason of the employment.
> ...
> **102 Benefit of living accommodation treated as earnings**
> (1) If living accommodation to which this Chapter applies is provided in any period—
> (a) which consists of the whole or part of a tax year, and
> (b) throughout which the employee holds the employment,
> the cash equivalent of the benefit of the accommodation is to be treated as earnings from the employment for that year.
> (2) In this Chapter that period is referred to as "the taxable period".

The EI Manual contains much interesting material on these provisions which cannot be set out here for lack of space.

## 65.7 "Family" and "household"

### 65.7.1 *"Family"*

Section 721(4) ITEPA defines "family":

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6 See 47.24 (Private residence relief).

> 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) ITEPA.[7] This is anomalous by contemporary standards but it will not often be relevant and the parent of illegitimate children is not likely to complain. Stepchildren are also excluded, as are parents-in-law. They will however still qualify as family if they are dependants.

### 65.7.2 *"Household"*

Section 721(5) ITEPA 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.

## 65.8 "By reason of the employment"

The expression "by reason of the employment" is extended by s.97(2) ITEPA so it does not mean "by reason of the employment" at all:

> Living accommodation provided for any of those persons by the employer is to be regarded as provided by reason of the employment ...[8]

Thus:

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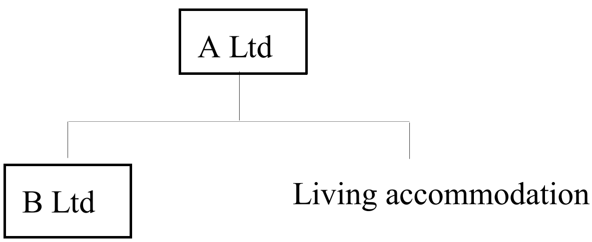
7 In Scots law there are no illegitimate children so this does not apply to Scots domiciled individuals: s.21 Family Law (Scotland) Act 2006.

8 The subsection continues:
"unless—
(a) the employer is an individual, and
(b) the provision is made in the normal course of the employer's domestic, family or personal relationships."
The exception is not relevant here.

(1) Where the accommodation is provided by the employer, one does not ask whether it is actually provided by reason of employment: it is deemed to be so provided.
(2) Where accommodation is provided by another, the living accommodation charge only applies if the accommodation is actually provided by the employer.

Suppose a company A owns living accommodation (occupied by T) and holds the shares in B Ltd:




If T is an employee of A Ltd T is in principle taxable on the living accommodation. The fact that the property is not provided by reason of the employment is irrelevant as the deeming provision in s.97(2) applies. If T is only an employee of B Ltd T is only taxed if T actually occupies the property by reason of T's employment.

B Ltd is (by definition) a person involved in providing the accommodation[9] but B Ltd is not deemed to provide the accommodation.

## 65.9 Accommodation available but not 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 s.145 ICTA 1988. (s.145 has now become part of Part 3 Chapter 5 ITEPA 2003). The word provided must be given its ordinary dictionary meaning of supplied or furnished with a thing.
> In some cases provided will mean available for use whereas in others it will mean actually used (see EIM11406 for more detail). The meaning

9 See 65.13.1 (Person involved in providing the accommodation).

of provided is often an issue in the case of provided holiday living accommodation.

**11406 Living accommodation: Meaning of provided: Practical considerations**

For details of the relevance of the word "provided" in living accommodation cases see EIM11405.

In deciding in a particular case whether provided means available for use, or means actually used, the following questions should be asked.

- Who can use the living accommodation? We accept that if living accommodation is genuinely available for use by more people than could actually use it at any one time then provided only means the periods actually used. For example if five unrelated employees were allowed to use an employer owned two bedroom holiday villa we would only seek a provided living accommodation charge on each employee for the period in which that employee actually used the villa.
- Why was the living accommodation bought or rented and how has it been used since acquisition? If the living accommodation was bought as holiday accommodation for a director and family, provided is likely to mean available for use. By contrast if it was bought as a genuine letting business by the employer and has been let out commercially then provided will only mean the periods of actual use by the employee.

For examples illustrating these points see example EIM11421 onwards.

EIM 11421 to 11423 provides three examples:

**11421. Living accommodation: Meaning of provided: Example 1** [March 2007]

[Example 1 is as follows:]

A UK company purchases a flat in a French ski resort for £200,000. It is agreed that a market rental for the property would be £500 per week during the 6 month skiing season and £100 per week during the rest of the year. A husband and wife who are both directors of the company use the flat for holidays with their children for 3 weeks during the ski season and one week in the rest of the year. Their children are neither employees nor directors of the company. *The employer advises that the sole reason the property was bought was as a holiday home for the husband and wife. It has only been used by them as a holiday home.*

[Emphasis added to show how example 1 differs from the others]

We would argue in this case that provided is equivalent to available for use. Assuming that the flat was habitable for the whole of the year we would seek a benefit under Part 3 Chapter 5 measured on availability for the whole of the year. The employer may argue that the husband and wife work full time and that this prevents them using the flat for more than the 4 weeks in the year of actual use and so they are effectively only provided with it for 4 weeks. We do not accept that argument.

If the cost of the accommodation exceeds £75,000, then the amount of the cash equivalent would be calculated in accordance with s.106 ITEPA 2003 (see EIM11472). As the annual value is based on the open market rental, under ESC A91b the Inland Revenue restricts the cash equivalent of the benefit to step 1 of s.106. This would mean that the cash equivalent for the tax year would be £15,600 (£500 × 26 + £100 × 26). Under s.108 that would be split between the husband and wife in whatever way was just and reasonable, presumably half each in this case (see EIM11472).

**11422. Living accommodation: Meaning of provided: Example 2** [March 2007]

[Example 2 is as follows:]

A UK company purchases a flat in a French ski resort for £200,000. It is agreed that a market rental for the property would be £500 per week during the 6 month skiing season and £100 per week during the rest of the year. A husband and wife who are both directors of the company use the flat for holidays with their children for 3 weeks during the ski season and one week in the rest of the year. Their children are neither employees nor directors of the company. *The company bought the property to let as a commercial letting business. They have employed professional agents to let the property and have managed to let the property for 12 weeks of the year in addition to the period it was used by the husband and wife directors.*

[Emphasis added to show how example 2 differs from the others]

In this case we would accept that provided is equivalent to actual use.

If the cost of the accommodation exceeds £75,000, then the amount of the cash equivalent would be calculated in accordance with s.106 ITEPA 2003 (see EIM11472). As the annual value is based on the open market rental, under ESC A91b the Inland Revenue restricts the cash equivalent of the benefit to step 1 of s.106. This would mean that the cash equivalent for the tax year would be £1,200 (£15,600 × 4/52). Under s.108 ITEPA 2003 that would be split between the husband and wife in whatever way was just and reasonable, presumably half each in this case (see EIM11472).

You may ask why the s.105 ITEPA 2003 charge is not £1,600 (being 3 weeks at £500 in the skiing season and 1 week at £100 outside the season). The answer is that the wording of s.105(3) requires us to look at a proportion of the annual rent rather than the rent for the actual weeks it was used.

**11423. Living accommodation: Meaning of provided: Example 3** [March 2007]

[Example 3 is as follows:]

A UK company purchases a flat in a French ski resort for £200,000. It is agreed that a market rental for the property would be £500 per week during the 6 month skiing season and £100 per week during the rest of the year. A husband and wife who are both directors of the company use the flat for holidays with their children for 3 weeks during the ski season and one week in the rest of the year. Their children are neither employees nor directors of the company. *The employer*

> *says that the property was bought to let commercially and for the use of other employees of the company. In fact there have been no commercial lettings during the year and it has only been used for one week of the year by an employee of the company who was the director's secretary.*
> [Emphasis added to show how example 3 differs from the others]
> This is a case where in practice we would seek to test whether what the employer was telling us was correct. For example, what if any evidence is there of attempts to let the property commercially or to advise other employees of the company of its availability for use by them? Based on that evidence it is then a matter of judgement whether in reality the sole reason the property was bought was as a holiday home for the husband and wife directors, in which case the tax consequences would be as in example EIM11421. Or it may be that genuine attempts have been made to let the property commercially and make it available for use by other employees of the company, in which case the tax consequences in example EIM11422 will follow.

## 65.10 Shadow directors

The House of Lords decided in *R v Dimsey & Allen* 74 TC 263 that the benefit in kind provisions apply to shadow directors.[10] The reasoning continues to apply under ITEPA. The charge is unfair to a shadow director who does no work for the company. Income tax should be a tax on income. This is a tax on nothing.[11]

EI Manual 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

10 This reversed an unreported Special Commissioners' decision that the provisions did not apply to shadow directors (or even properly appointed directors) unless they were actually employees. That decision remains relevant to penalty and negligence issues relating to periods before the decision in *Dimsey & Allen*.

11 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.

> the UK, have come to work and reside here. In order to avoid a possible charge to inheritance tax, which could be imposed if such an individual died whilst working in the UK, an arrangement is made to set up an offshore company that owns the UK property in which the individual lives. Where the individual is a shadow director of that offshore company s.97(2) ITEPA deems the UK property to be provided to the shadow director by reason of the deemed employment.

In practice taxpayers (if they have considered the matter at all) generally seem to have taken the view on their facts that they are not shadow directors. HMRC have themselves had to identify the cases suitable for investigation. But in the author's experience even cases that HMRC have identified are not often pursued with much gusto. Perhaps (this is surmise) HMRC "officially" take the point to deter IHT planning, but at the same time don't bother much about it in practice because of the unfairness of the charge. If so, the tactic (while contrary to the rule of law) works up to a point. Taxpayers cannot afford to plan on the assumption that HMRC's benign neglect of the provisions will apply to them.

## 65.11 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".[12]

In *Secretary of State for Trade and Industry v Deverell* Morritt LJ comments on this in numbered paragraphs:[13]

> (1) The definition of a shadow director is to be construed in the normal

12 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.

13 [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*, Hart Publishing, (2006) p.285.

> 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.

This paraphrase does not take us very far because it only raises the question as to what is meant by "real[14] 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.

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14 The dangerous and beguiling word "real" is normally an indicator of vague if not sloppy legal analysis.

> 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.

> (4) Non-professional advice may come within that statutory description. The proviso excepting advice given in a professional capacity[15] appears to assume that advice generally is or may be included.

This is equally extraordinary, for the concept of "directions or instructions" is the antithesis of the concept of "advice". The distinguishing feature is that the former is mandatory and the other is not. Of course, one may slide into the other. For instance, if a solicitor advises a company that a particular act is required by law, that failure to act would be a criminal offence, and that if the company broke the law the solicitor would refuse to act, such advice may arguably be characterised as a direction or an instruction. Since the proviso excepting advice given in a professional capacity can be taken to refer only to this situation it does not shed any light on the general meaning of "shadow director". The

15 See s.67(2) ITEPA:

> "... a person is not to be regarded as a person in accordance with whose directions or instructions the directors of the company are accustomed to act merely because the directors act on advice given by that person in a professional capacity."

inference from the proviso excepting advice is invalidly drawn.[16]

> Moreover the concepts of "direction" and "instruction" do not exclude the concept of "advice" for all three share the common feature of "guidance".

The less said about this line of reasoning the better.

> (5) It will, no doubt, be sufficient to show that in the face of "directions or instructions" from the alleged shadow director the properly appointed directors or some of them cast themselves in a subservient role or surrendered their respective discretions. But I do not consider that it is necessary to do so in all cases. Such a requirement would be to put a gloss on the statutory requirement that the board are "accustomed to act" "in accordance with" such directions or instructions. It appears to me that Judge Cooke, in looking for the additional ingredient of a subservient role or the surrender of discretion by the board, imposed a qualification beyond that justified by the statutory language.

If the statutory language were: "in accordance with whose *wishes* the directors were accustomed to act" this would be a fair comment. But the expression "directions or instructions" shows that the position must be one where the shadow director commands and the properly appointed directors obey.

The points made in the passage are wholly negative. That is, in determining the issue of "shadow directorship":

(1) The understanding or expectation of the parties is *not* conclusive.
(2) The label attached by the parties is *not* conclusive.

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16 The Court of Appeal overlooked the explanation in *Gore-Browne on Companies* Jordans Ltd, (1997), 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."

(3) The fact that the communication is "advice" is *not* conclusive (except in the case of professional advice).
(4) The fact that the properly appointed directors surrender their discretions or act in a "subservient" role is *not* essential.

This does not answer the question: how *does* one identify a shadow director? The mere fact that there is a stream of communications from the individual to the company, which is acted on by the company, is not conclusive. The author regularly sends "communications" to the internet bookshop Amazon, and Amazon act on those communications without fail. Yet the author is not a shadow director of Amazon. The author regularly sends directions (a cheque is a direction) to his bank and Barclays act on those directions without fail. Yet the author is not a shadow director of Barclays Bank. In the 4th edition of this work I therefore concluded:

> that one can expect some back-tracking, refinement or qualification from the Courts in cases they regard as more meritorious than that of Mr. Deverell.

This has now been confirmed by *Ultraframe v Fielding*:[17]

> 1267 ... In my judgment, where the alleged shadow director is also a creditor of the company, he is entitled to protect his own interests as creditor without necessarily becoming a shadow director.
> 1268 [Counsel] submitted that it is critical to distinguish the position of a lender (whether or not also a shareholder) from that of a director. A lender is entitled to keep a close eye on what is done with his money, and to impose conditions on his support for the company. This does not mean he is running the company or is emasculating the powers of the directors, even if (given their situation) the directors feel that they have little practical choice but to accede to his requests. Similarly with customers who may, because of their buying power, be able effectively to dictate conditions to their suppliers (or the other way around). In other words a position of influence (even a position of strong influence) is not necessarily a fiduciary position. To find otherwise would place a wholly unfair and unnatural burden on men of business. In broad terms, I accept this submission.

17 [2005] EWHC 1638, [2007] WTLR 835.

The approach which applies to a creditor of the company also applies to a beneficiary of a trust which holds the company: they are 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 [ie is not necessarily a shadow directorship]."

HMRC sometimes argue that where someone resides in a property held by a company which is held by a trust of which that person is a beneficiary, it is (at least) highly likely that that person must be a shadow director.[18] This is unjustified for the reason set out in *Ultraframe*.

Suppose a person treats the property owned by the company as their own and has no dealings with the directors: they just ignore 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. They give no instructions.

A non-resident person may be a "shadow director".

### 65.11.1 *When is an agent of a company a shadow director?*

HMRC accepted that the activities of an agent appointed by trustees to manage the day to day affairs of a trust are not normally relevant in determining the place of general administration (formerly relevant for the purposes of CGT trust residence).[19] It is suggested that a similar principle applies in the context of shadow directorship. An agency agreement under which the occupier of a property is 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.

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18 Note that there is no support for this view in the HMRC Manuals. Employment Income Manual 11413 states correctly that *where* an individual residing in property is a shadow director, there is a benefit-in-kind charge. It conspicuously does *not* state that the mere fact of occupation makes a shadow directorship "highly likely".

19 See the 5th edition of this book, para 5.6.2.

### 65.11.2 *Arranging that an occupier is not a shadow director*

Suppose an existing company purchases a home on the open market for a UK resident foreign domiciliary. The choice of a home is a personal one and the individual would normally have to give a "communication" to the company which HMRC may regard as "directions or instructions". So it would normally be difficult to ensure that the individual was not a shadow director (at least applying *Deverell* at face value).

The position is different if:

(1) trustees purchase property directly, and
(2) the trustees transfer the property to a foreign company on their own initiative and without reference to the occupier.

The trustees may reason that if the life tenant dies (or on a ten year anniversary), 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 them.[20] SDLT makes this expensive but the variant idea of assigning a contract entered into by the trustees may be 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,they should communicate their 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 sell the company. That has stamp duty advantages, and should 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.

20 I am grateful to Peter Vaines for this suggestion.

## 65.12 The cash equivalent: ss.105 and 106 computations

The charge is on the "cash equivalent". Section 103 ITEPA provides:

> **Method of calculating cash equivalent**
> (1) The cash equivalent is calculated—
> (a) under s.105 if the cost of providing the living accommodation does not exceed £75,000; and
> (b) under s.106 if the cost of providing the living accommodation exceeds £75,000.

Thus there are two methods of calculating the cash equivalent, here called a s.105 computation and a s.106 computation. This is for historical 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.

## 65.13 Cost of providing accommodation

One needs to know the "cost of providing living accommodation":
(1) in order to decide between the s.105 and s.106 computation;
(2) in order to make the s.106 computation (if applicable, as it usually is).
This expression is defined in s.104:

> **General[21] rule for calculating cost of providing accommodation**
> For any tax year the cost of providing living accommodation is given by the formula A + I – P

In short, *A* is **A**cquisition cost, *I* is **I**mprovement cost, and *P* is **P**ayment of reimbursement. In full detail:

> *A* is any expenditure incurred in acquiring the estate or interest in the property held by a person involved in providing the accommodation,
> *I* is any expenditure incurred on improvements to the property which has been incurred before the tax year in question by a person involved in providing the accommodation, and
> *P* is so much of any payment or payments made by the employee to a person involved in providing the accommodation as represents—

21 For the exception see 65.16 (Revaluation of cost in cases of delayed occupation).

(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 65.20 (Property purchase financed by the foreign domiciliary).

### 65.13.1 *Person involved in providing the accommodation*

Section 112 ITEPA provides the wide definition:

> For the purposes of this Chapter "person involved in providing the accommodation" means any of the following—
> (a) the person providing the accommodation;
> (b) the employee's employer (if not within para (a));
> (c) any person, other than the employee, who is connected[22] with a person within para (a) or (b).

This defined phrase is only used in the definition of "cost of providing living accommodation".[23] ITEPA EN explains:

> 412. This definition makes it clear that it is necessary to look beyond the employer and the apparent owner of an interest in the accommodation. This is anti-avoidance legislation to counter schemes which depress the cost to the employer by using intermediate owners of interests.

## 65.14 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

22 Section 718 ITEPA provides:
"Section 993 of ITA 2007 (how to tell whether persons are connected) applies for the purposes of this Act."

23 See 65.13 (Cost of providing accommodation) and 65.16 (Revaluation of cost in cases of delayed occupation).

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.

The key concepts are "rental value of the accommodation" and "making good" and I deal with these in turn.

65.14.1 "*Rental value of the accommodation*"

As from 22 April 2009, s.105 ITEPA provides:

> (3) The "rental value of the accommodation" for the taxable period is (subject to subsections (4) and (4A) the rent which would have been payable for that period if the property had been let to the employee at an annual rent equal to the annual value. ...
> (4) Subsection (4A) applies where—
> (a) a rental amount is payable by the person ("P") at whose cost the accommodation is provided in respect of the whole or part of the taxable period ("the relevant period"), and
> (b) the amount so payable is payable at an annual rate greater than the annual value.
> (4A) Where this subsection applies—
> (a) subsection (3) does not apply to the relevant period, and
> (b) instead the "rental value of the accommodation" for the relevant period is the rental amount payable by P in respect of the relevant period.
> (4B) A reference in subsection (4) or (4A) to a rental amount payable by P in respect of the relevant period is to the sum of—
> (a) any rent for the period payable by P, and
> (b) any amount attributed to the period in respect of a lease premium (see sections 105A and 105B)
> (5) If the rental value of the accommodation for the taxable period does not exceed any sum made good by the employee as mentioned in

subsection (2)(b), the cash equivalent is nil.

The key expression is "annual value". This is defined in s.110 ITEPA but it is not usually necessary to refer to that for UK property. ITEPA Explanatory Note states:

> 404. [Section 110] does not affect the Inland Revenue practice of using the gross rateable value as a proxy for "annual value". That practice will continue. The main use of this section is to provide guidance on how to arrive at the annual value of properties for which rent is not paid and in practice is only needed in cases where no gross rateable value can be found.[24]

The EI Manual provides:

> **11434 Living accommodation: Meaning of annual value for United Kingdom properties**
> The amount of annual value for UK properties is set out in the table below.

| Country | When first valued | Annual value to take |
|---|---|---|
| England & Wales | All cases | The 1973 gross rating value |
| Northern Ireland | All cases | The 1976 gross rating value |
| Scotland | | 100/270 × the 1985 gross rating value |
| Anywhere in the UK | No gross rating value set | Ask the appropriate District Valuer to confirm any estimated figure provided by the employer that you want to check.[25] |

24 Likewise the EN at Change 23:
"These provisions [ss.110 and 207 ITEPA] will clarify how to find annual values in respect of those properties for which the practice of using gross rateable values or a proxy for them is inapplicable – for example overseas properties. In the case of both these and other properties, all the current practices used in quantifying the cash equivalent of the benefit of living accommodation will continue."

25 The Manual continues:
"If no such estimate is provided or the estimate is not acceptable the District Valuer will provide a (not negotiated) figure. If the taxpayer does not accept that figure the District Valuer will try to agree a figure with the taxpayer. For the procedure for referring to the District Valuer see EI Manual 11437."

> 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 express all this in ITEPA. The rules are incoherent.

### 65.14.2 *"Making good": meaning*

The EI Manual provides:

> **21120 The benefits code: What is meant by "making good"** [June 2006]
> "Making good" simply means giving something in return for the benefit. What is being made good is the expense incurred by the employer or other person providing the benefit. It follows that in order to make good that expense the employee will give money, or something that can be measured in money. Usually the employee will "make good":
> - by a direct payment or
> - by deduction from salary or
> - by a suitable debit to the employee's current account in the employer's books and records.
>
> Any of these methods is acceptable.
> The giving of services by the employee, or anything that is not measured in money terms is not "making good", see *Stones v Hall* (60 TC 737).
> **(This text has been withheld because of exemptions in the Freedom**

> **of Information Act 2000)**[26]
> As regards "making good" by waiver of remuneration see EI Manual 21122.

It is clearly "making good" if:
(1) the company pays the costs of maintenance and insurance; and
(2) the individual reimburses the company by a cash payment.
Does the employee make good the cost if they pay the cost of maintenance and insurance directly? Section 110 ITEPA envisages that this expenditure will be paid by the employer. In addition, the maintenance of the building is probably not a "sum" made good. EIM Manual is equivocal:

> **11439. Living accommodation: annual value of UK property: Employee responsible for repairs or insurance.** [June 2006]
> ...
> An employee may be responsible for the cost of repairs or insurance under the terms of his or her lease or employment. *(This text has been withheld because of exemptions in the Freedom of Information Act 2000.)*[27] As regards the discharge of the employee's pecuniary liability in respect of such items *see* EIM00520.

Note that the payment of a sum "making good" may constitute taxable property income of the company which receives it. The IHT and CGT implications may also need to be considered, but the sums involved are not usually significant.

### 65.14.3 *Making good: timing*

EIM provides:

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26 [Author's Note] The "text withheld" announcement was added in June 2006. Previously the Manual stated "In any case where the taxpayer argues 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 withheld text.

27 The text formerly read:
"If an employee claims an adjustment to the annual value (derived from the table in EI Manual 11434) because the facts of an employee's case are not those envisaged by s.110 ITEPA, make a full report to Personal Tax (Technical), Solihull."
It seems a safe bet that that passage survives in the withheld text.

**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.

## 65.15 Accommodation over £75,000: section 106 computation

Section 106 ITEPA provides:

**Cash equivalent: cost of accommodation over £75,000**
(1) The cash equivalent is calculated under this section if the cost of providing the living accommodation exceeds £75,000.
(2) To calculate the cash equivalent—
*Step 1* Calculate the amount that would be the cash equivalent if s.105 applied (cash equivalent: cost of accommodation not over £75,000).

See 65.14 (Accommodation costing £75,000 or less: section 105 computation).

*Step 2* Calculate the following amount ("the additional yearly rent")—
ORI × (C – £75,000)

In short, *ORI* is **O**fficial **R**ate of **I**nterest; *C* is **C**ost. In full detail:

ORI is the official rate of interest in force for the purposes of Chapter 7 of this Part (taxable benefits: loans) on 6 April in the tax year, and
C is the cost of providing the accommodation calculated—
(a) in accordance with s.104 (general rule for calculating cost of accommodation),[28] or
(b) in a case where s.107 applies (special rule for calculating cost of

28 See 65.13 (Cost of providing accommodation).

> providing accommodation), in accordance with that section instead.[29]

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.
> (3) In step 4—
> (a) para (b) only applies if, in respect of the taxable period, the rent paid by the employee in respect of the accommodation to the person providing it exceeds the rental value of the accommodation for that period as set out in s.105(3) or (4)(b), as applicable, and
> (b) "the excess rent" means the total amount of that excess.

In short, the charge is (1) the s.105 computation (rateable value) and (2) (official rate of interest on purchase price less £75,000) less rent.

This works (more or less) where the s.105 computation is based on the nominal amount of rateable value. It gives double taxation where the s.105 computation is based on actual market rental value. ESC A91 gives relief here:

> *Living accommodation provided by reason of employment*
> This concession applies to living accommodation treated as earnings under ITEPA 2003 Part 3, Chapter 5. Where ITEPA 2003 s.106 applies and the cash equivalent of the benefit of the accommodation is calculated by reference to the annual rent the property might fetch on the open market, the Inland Revenue will disregard "the additional

29 See 65.16 (Revaluation of cost in cases of delayed occupation).

yearly rent". If "the additional yearly rent" is disregarded then the amount of "the excess rent" is deemed to be nil.[30]

## 65.16 Revaluation of cost in cases of delayed occupation

Normally the s.106 computation is based on the employer's acquisition cost (ie historic cost). Market value of the property later is not relevant. This rule could favour the taxpayer or HMRC, but as time passes it is likely to favour the taxpayer. In one case only there is an adjustment to market value. Section 107 ITEPA provides:

> **Special rule for calculating cost of providing accommodation**
> (1) This section contains a special rule for calculating the cost of providing living accommodation which—
> (a) operates for the purposes of step 2 of s.106(2) (calculating the additional yearly rent), and
> (b) accordingly only operates where the cost of provision for the purposes of s.106(1) (as calculated under s.104) exceeds £75,000.

In practice condition (b) will almost always be satisfied (except perhaps for property purchased many years ago).

> (2) This section applies if, throughout the period of 6 years ending with the date when the employee first occupied the accommodation ("the initial date"), an estate or interest in the property was held by a person involved in providing the accommodation.
> It does not matter whether it was the same estate, interest or person throughout.

In short, this condition is that the property has been owned by the company for six years before the employee moves in.

> (3) For any tax year the cost of providing the living accommodation for the purposes mentioned in subsection (1)(a) is given by the formula—
> $$MV + I - P$$

In short, *MV* is **M**arket **V**alue; *I* is **I**mprovement cost; *P* is **P**ayments in

30 I do not understand the point of the last sentence, for if the additional yearly rent is disregarded, the "excess rent" is irrelevant.

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.

## 65.17 Accommodation provided for more than one employee

Section 108 ITEPA provides:

> **Cash equivalent: accommodation provided for more than one employee**
> (1) If, for the whole or part of a tax year, the same living accommodation is provided for more than one employee at the same time, the total of the cash equivalents for all of the employees is to be limited to the amount that would be the cash equivalent if the accommodation was provided for one employee.
> (2) The cash equivalent for each of the employees is to be such part of that amount as is just and reasonable.

EIM provides at 11411:

> **11411 - Living accommodation: provided to more than one employee in the same period: practical points**
> The following is an example of how s.108 ITEPA 2003 works.
> An employer provides a ten room house for the shared use of three unrelated employees. Each employee has sole use of a bedroom and shared use of the other seven rooms. Without s.108 the cash equivalent of the benefit of the living accommodation provided to each employee would be 80% of the whole house. However s.108 limits the sum of the charges on the three of them to one full charge on the whole house. If there are no special factors each employee will be chargeable on the cash equivalent of a benefit of 33.3% of the cash equivalent for the whole house.
> Section 108 is not relevant in some family situations. For example a husband and wife both work for the same employer and live together in a house provided by their employer. The husband's job is the one that has accommodation provided with it and the wife's does not. The true construction here is that the living accommodation is only provided by the employer to the husband and the wife lives in it with her husband as part of normal domestic arrangements. So the full living accommodation charge would be on the husband with no charge on the wife.
> By contrast for an example of s.108 being relevant in a family situation see example EIM11421.

## 65.18 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 (ie 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.

## 65.19 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).

### 65.19.1 *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.

## 65.20 Property purchase financed by the foreign domiciliary

Sometimes a company structure is set up specifically for the purpose of purchasing the home. That is, there is an arrangement under which:
(1) The individual agrees in principle to purchase a property.
(2) The individual:
   (a) lends the purchase price to a company, or
   (b) transfers the purchase price to a trust which lends the purchase price to a wholly owned company.

(3) The company makes the purchase.

This section considers whether an arrangement of this kind offers a defence to the benefit in kind charge.

### 65.20.1 *"Making good" and s.105 computation*

The s.105 computation allows a deduction for:

> any sum made good by the employee to the person at whose cost the accommodation is provided that is properly attributable to its provision.

The taxpayer would have to show that the interest forgone on the interest-free loan from the individual (directly or indirectly to the company):

(1) is a "sum", and

(2) "makes good" the provision of the accommodation.[31]

Whether the interest forgone "makes good" the provision of accommodation is a question of fact. Assuming the reason the interest is forgone is to enable the company to provide the accommodation, this condition should be satisfied.

Whether the interest forgone is a "sum" is a question of law; it is suggested that the word should not be construed strictly or technically, and an amount of interest forgone may be a "sum". See 65.14.2 ("Making good": meaning).

### 65.20.2 *Loan to company as defence to section 106 computation*

Sums "made good" are not deductible as such in the s.106 computation. Rent is deductible in a s.106 computation but the interest forgone on an interest-free loan is not rent. No-one suggests that the company would be taxable on the interest forgone as property income!

It has been suggested that a company financed by an interest-free loan has not incurred expenditure. If this is so then it is a complete answer to the s.106 charge because the figure *A* in the formula for the cost of providing accommodation is reduced to zero. The suggestion is raised in Stephen Brandon QC's *Taxation of Non-UK Resident Companies and their Shareholders*, Key Haven Publications, paras 5.3.3.8 to 5.3.3.15

31 It is assumed that the interest forgone exceeds the annual or rateable value of the accommodation, which will normally be the case.

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*.

### 65.20.3 *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.[32] However, the interest forgone on the loan is not "reimbursement". In addition, it is also not a "payment".

### 65.20.4 *Release of loan*

A possible solution would be for the individual to release the debt which is due to them from the company.

Statute requires a "payment" representing a reimbursement. It is a moot point whether the release of the debt would be a "payment". One should take the cautious view that it may not be. The matter should be dealt with as follows:

(1) The individual transfers the funds to the company. They should be received in the company's bank account. This should be accompanied by a letter to the company saying: "I have today procured the payment of £X to your account. This is reimbursement for the expenditure you have incurred in acquiring [the property]. However, I require repayment of the debt due to me of £X."

32 See 65.19 (Reimbursement as solution to IT charge).

(2) The company may then use its funds to repay its debt due to the individual.

Although this is a circular transaction (the payment being matched by immediate repayment) that does not nullify it for tax purposes: compare *MacNiven v Westmoreland* [2001] STC 237.

If the company incurs additional improvement expenditure in the future, this should be matched by further reimbursements so the total cost of providing the living accommodation (A+I–P) remains less than £75,000.

The reimbursement of the company is not a transfer of value for IHT purposes if the individual is (or is treated as) the beneficial owner of the company. For the same reason the reimbursement is not a disposal by way of gift and so is outside the scope of s.102 FA 1986 (gifts with reservation).

The effect of the gift (the reimbursement) is to increase the value of the shares of the company without any corresponding rise in the CGT base cost. So the gift increases the chargeable gain on the disposal. This should not matter so long as the law remains in its current form.

### 65.20.5 *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.[33] In practice HMRC accept this.

## 65.21 Co-ownership defence to living accommodation charge

This section considers the position where an individual owns a share in the property jointly with the company.

Co-ownership raises similar but not identical issues for all provisions which charge tax on benefits, such as s.87 TCGA, s.731 ITA, s.203 ITEPA, and IHT gift with reservation rules as well as the living accommodation charge. The discussion here is limited to the case where an individual and a company are co-owners. Similar but not identical issues arise with these provisions where an individual and a trust are co-owners.

33 See 65.14.3 (Making good: timing)

### 65.21.1 *The land law position*[34]

The starting point is to ascertain the rights of the co-owners as a matter of land law. Co-owned land in England and Wales is always held on trust. The person(s) holding legal title to the land are here called "the trust-of-land trustees".[35] The position is governed by the Trusts of Land and Appointment of Trustees Act 1996.[36] Section 12(1) TLATA provides:

> A beneficiary who is beneficially entitled to an interest in possession in land subject to a trust of land is entitled by reason of his interest to occupy the land at any time if at that time—
> (a) the purposes of the trust include making the land available for his occupation (or for the occupation of beneficiaries of a class of which he is a member or of beneficiaries in general), or
> (b) the land is held by the trustees so as to be so available.

Prior to 1997, a co-owner of land had a right to occupy that land, in the absence of any contrary indication or agreement with the other co-owners:

> It has been well established law ... that a tenant-in-common under a trust for sale has the right to occupy the whole property without payment of rent ...[37]

This co-ownership right has been superseded and replaced by s.12 TLATA. In *IRC v Eversden*, Lightman J explained:

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34 I am grateful to Charles Harpum for his assistance on this section.

35 (The term used in the legislation is "the trustees of land".) The company may be the (or one of the) trust-of-land trustees; it makes little practical difference and no difference at all for tax. (If the company is not a trustee it can apply to court to require the trustees to exercise their powers.) The shares in the company may also be held on trust but that trust is not relevant here.

36 Further consideration is needed for:
(1) Land outside England and Wales.
(2) Jointly owned chattels.
(3) Periods before 1 January 1997, when the TLATA took effect, but that will not now normally be relevant.
I would be grateful to any reader who could inform me of the position in Scotland.

37 *IRC v Lloyds Private Banking* [1998] STC 559 at p.561; likewise *City of London Building Society v Flegg* [1988] AC 54 at 81.

> On and after 1 January 1997 when the TLATA came into force, a tenant in common in equity ... was no longer automatically entitled ... to occupation of the property purchased. Section 12 of the TLATA provided that he should only become so entitled if one of two alternative conditions were satisfied…[38]

He then set out s.12(1).

While arguments might be advanced to the contrary this analysis should be followed, because it is a clear and workable rule. Otherwise it would be necessary to consider the pre-1997 law and try to work out the combined effect of that when read with s.12.[39]

In the following discussion, the entitlement to occupy land conferred by s.12(1) is called the "statutory occupation right".

The individual will obviously have a statutory occupation right to occupy the property under s.12 because:

(1) they are a beneficiary under the trust-of-land.
(2) they are beneficially entitled to an interest in possession in the land.
(3) Both conditions (a) and (b) of s.12(1) are satisfied:[40]
    (a) the purposes of the trust-of-land include making the land

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38 [2002] STC 1109 at [24] reported 75 TC 340 under the name *IRC v Greenstock's Executors*.

39 Barnsley "Co-owner rights to occupy land" [1998] CLJ 123 is a minority view; contrast Roger Smith, *Plural Ownership* Oxford University Press (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 [2003] *The Conveyancer* 533.

40 Though it would suffice if only one of the conditions of s.12(1) were satisfied.
Section 12(2) provides: "Subsection (1) does not confer on a beneficiary a right to occupy land if it is either unavailable or unsuitable for occupation by him." This will not apply here.

available for their occupation; and

(b) the land is held by the trust for land trustees so as to be available for the purpose.

The company does not have a statutory occupation right. It does not meet the conditions of s.12(1). No third person would have a statutory occupation right even if the company sold or sub-let their interest under the trust-of-land to that person. The third person would not satisfy conditions (a) or (b) of s.12(1).[41]

The trust-of-land trustees have various powers, but they do not have power to override the individual's occupation right or to require them to pay an occupation rent. This is fundamental so I set out the provisions in detail.

Section 13(1) TLATA provides:

> Where two or more beneficiaries are (or apart from this subsection would be) entitled under s.12 to occupy land, the trustees of land [ie 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:

> Where the entitlement of any beneficiary to occupy land under s.12 has been excluded or restricted, the conditions which may be imposed on any other beneficiary under subsection (3) include, in particular, conditions requiring him to—
> (a) make payments by way of compensation to the beneficiary whose entitlement has been excluded or restricted, or
> (b) forgo any payment or other benefit to which he would otherwise be entitled under the trust so as to benefit that beneficiary.

The trust-of-land trustees cannot require the individual to pay compensation (an occupation rent) to the company under s.13(6) because the company has no statutory occupation right: s.13(6) assumes that compensation can only be required in a case where:

41 Also s.12(2) TLATA would probably apply, though it is not necessary to rely on that.

(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 [ie the trust-of-land trustees] may from time to time impose reasonable conditions on any beneficiary in relation to his occupation of land by reason of his entitlement under s.12.
>
> …
>
> (5) The conditions which may be imposed on a beneficiary under subsection (3) include, in particular, conditions requiring him—
> (a) to pay any outgoings or expenses in respect of the land, or
> (b) to assume any other obligation in relation to the land or to any activity which is or is proposed to be conducted there.

The trust-of-land trustees can do little under s.13(3) except to require the individual to pay outgoings.[42]

It is reasonably clear that ss.12–14 TLATA are a comprehensive code and there is no common law right to an occupation rent except in a case of ouster.

The trust-of-land trustees also have power to sell the property but the court has discretion either to prevent or to require a sale.[43] The question here is whether the court would require a sale of the property if the individual did not want a sale but the company did. In my opinion a court would not do so, unless either the individual no longer wished/ceased to occupy the property, or the company had a good reason for a sale, eg it was insolvent. Section 15(1) TLATA provides:

> The matters to which the court is to have regard in determining an application for an order under s.14 include—
> (a) the intentions of the person or persons (if any) who created the trust,
> (b) the purposes for which the property subject to the trust is held,
> (c) the welfare of any minor who occupies or might reasonably be expected to occupy any land subject to the trust as his home, and

42 In particular, the trust-of-land trustees cannot use this power to require the individual to pay an occupation rent, as that must be done under s.13(6) or not at all. Otherwise s.13(6) would be entirely otiose. There is a further restriction in s.13(7) but that is not so important here.

43 Sections 6, 14 TLATA.

(d) the interests of any secured creditor of any beneficiary.

None of these factors would support a sale.[44]

In short, the company, although co-owner, can do almost nothing while the individual remains in occupation, except require them 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.

In *IRC v Eversden*[45] the settlor gave a trustee co-owner a 95% share in a house, the settlor retaining 5%. The settlor continued to occupy. It was held that the trustee had not provided a benefit as the settlor was entitled to occupy. This took place before the TLATA 1996 but the position would be the same under the TLATA.

The matter is made more complicated by *Christensen v Vasili* 76 TC 116. This concerned a co-owned car. The question was whether there was a tax charge under (what is now) s.144 ITEPA which applies where a car is "made available" to an employee. The Special Commissioner held that the car was not made available:

> As co-owners the employer and employee each have the right to use the car, but they each have that right because they are each owners, not because one has "made available" the car to the other.[46]

This conclusion was with respect plainly right. Unfortunately it was flatly

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44 An individual's position is even stronger if they have more than a 50% share, as s.11(1) TLATA normally gives them 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.

45 [2002] STC 1109 reported 75 TC 340 under the name *IRC v Greenstock's Executors*.

46 76 TC 116 at p.124, para 22.

if unconvincingly rejected in the High Court:

> In their ordinary sense, the question "who made the car available to Mr. Vasili?" must be answered in the sense that his employer did so ...[47]

It is suggested that *Vasili* must be distinguished from the normal co-ownership situation because:

(1) in *Vasili* both employer and employee were entitled to possession of the car: in the co-ownership situation considered here the company is not entitled to occupation;

(2) in *Vasili* the car belonged to the employer before he sold a 5% share to the employee. In that sense the employer made the car available. The position would have been different if the car had been purchased in those shares from the outset.

It is unfortunate that *Eversden* was not cited in *Vasili* since the two cases are difficult to reconcile.

### 65.21.2 *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.[48]

If the company incurs costs of maintenance, that is an employment related benefit.

47 76 TC 116 at p.131, para 13.

48 It is considered that this particular benefit does not "consist of an asset being placed at the disposal of the employee" so the valuation is not in accordance with s.205 ITEPA.

### 65.21.3 *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?[49]

In *IRC v Eversden (Greenstock's Executors)* trustees purchased a 95% share in a house ("Meadows"), and the settlor purchased 5%. The judge said:

> Under the agreement with the trustees (providing as it did for the settlor to pay 5% of the purchase price of Meadows and acquire in consequence a right of occupation) *the trustees conferred on the settlor the right to occupy Meadows for an indefinite period rent free*.[50]
> (Emphasis added)

This took place before the TLATA 1996, but the position would be the same now.

In a case where the company provides its funds towards a joint purchase of a new property, and the individual holds as co-owner, the company has provided a benefit of indefinite rent-free occupation; more accurately the benefit is giving the individual the opportunity to acquire a right to indefinite rent-free occupation at a "knockdown price". The benefit is provided at the time the company completes the contract to purchase the land as co-owner.

The benefit would in principle be chargeable in co-ownership cases under s.87 TCGA or s.731 ITA. Since there are no express valuation rules the charge would be on the market value, which would have to be ascertained as best as one can in the light of the circumstances.

For employment income purposes the position is different. It is arguable that:

(1) The benefit is not the provision of living accommodation.
(2) The value of the benefit for IT purposes is nil because:

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49 This issue does not arise where the company receives its share of the land gratuitously.

50 75 TC 340, [2002] STC at p.1129. The point was rightly not appealed. Prior to purchasing Meadows another house in joint ownership had been sold. The position for Meadows would be different if the sale of the first house had been conditional on the purchase of Meadows (the new one), that is, if the settlor only agreed to join in the sale of the first if the trustee agreed to join in the purchase of Meadows.

(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.

65.21.4 *The HMRC view*

The EI Manual provides at 11414:

> **Living accommodation: Avoidance area: Co-ownership cases**
> [April 2007]
> In these cases the employer and employee co-own the living accommodation. The usual arrangement is that the employer and employee own the property as tenants in common through a trust.
> A tenant in common has a legal right to use 100% of the property 100% of the time even though a tenant in common may only own a much smaller interest in the property (say 30%). It is argued against us in such a case that the employee's rights to use the living accommodation come from the employee's legal rights as a tenant-in-common. So it is argued that no living accommodation has been provided by reason of the employment.
> There are arguments to support a benefit charge within Part 3 Chapter 5 ITEPA in these cases and the strength of those arguments will depend on the facts of the case. PAYE Technical for any case in which you want to argue the point.[51] Your submission should include a copy of any trust deed under which the land is held.

It is interesting to note that HMRC accept that there is not always a charge in co-ownership cases: "it depends on the facts of the case". That is consistent with the view taken here.

In the context of s.87 TCGA, the current HMRC view is that there is an annual benefit which is the difference between:
(1) the rental value of the property in question; and
(2) the hypothetical rental value of a hypothetical property of a value equal to the proportionate value of the taxpayer's share in the property, ie if the taxpayer holds a 50% share, one looks to the rental

51 *Sic*. Presumably a phrase such as "Please submit your papers to ..." was accidentally omitted from the start of this sentence.

value of a property worth 50% of the actual property.[52]

But this view is very difficult to defend.

## 65.22 Other defences to BiK charge

### 65.22.1 *The caretaker's defence*

Section 99 ITEPA provides:

> **Accommodation provided for performance of duties**
> (1) This Chapter does not apply to living accommodation provided for an employee if it is necessary for the proper performance of the employee's duties that the employee should reside in it.
> (2) This Chapter does not apply to living accommodation provided for an employee if—
> (a) it is provided for the better performance of the duties of the employment, and
> (b) the employment is one of the kinds of employment in the case of which it is customary for employers to provide living accommodation for employees.

It has been suggested that one can use this to avoid the charge. The idea is to enter into a contract whereby the individual who is to occupy the property does so as caretaker for the company. This does not work. While it may normally be necessary or customary for a caretaker to reside in accommodation, a person does not become a "caretaker" just by being labelled as such. If the individual is occupying an extremely valuable property with only nominal caretaking duties, this is not the same "type of employment" as a normal caretaker. The EI Manual rightly provides:

> **11342 Living accommodation exemption: Necessary for proper performance of the duties: Types of employee** [May 2010]
> 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:

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52 Private correspondence.

> ...
> Caretakers living on the premises. This only covers those with a genuine full time caretaking job. ...

### 65.22.2 *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.[53]

### 65.22.3 *Lease premiums*

The FA 2009 inserts the long and complex provisions of s. 105A, 105B ITEPA, which I hope to consider in a future edition.

The EIM suggests an argument that premiums should sometimes be treated as rent. This was discussed in detail in the 2008/09 edition of this work, but I expect that HMRC will generally abandon that point now (if indeed they ever took it seriously).

## 65.23 Foreign homes relief

Section 100A(1) ITEPA provides a relief which I call "**foreign homes relief**":

> This Chapter does not apply to living accommodation outside the UK provided by a company for a director or other officer of the company ("D") or a member of D's family or household if—
> (a) the company is wholly owned by D or D and other individuals (and no interest in the company is partnership property), and
> (b) the company has been the holding company of the property at all times after the relevant time.

I refer to the company providing the property as "**the provider company**". I refer to the condition in (1)(a) as"**the wholly owned condition**" and the

53 By contrast a market rent for the use of chattels will prevent there being a "benefit" for the purposes of the benefit in kind charge on chattels.

condition in (1)(b) as "**the holding company condition**". Thus the relief applies where:

(1) The provider company provides accommodation for a director[54] of the provider company ("D") or a member of D's family or household. If the accommodation is provided for an employee who is not a director (or a member of a director's family or household) of the provider company the relief will not apply. In practice that is not likely to matter.

(2) The provider company meets the wholly owned condition.

(3) The provider company meets the holding company condition.

### 65.23.1 *Wholly owned condition*

The relief does not apply if any shares in the provider company are held by a trust or partnership, or if some of the shares are held by a company. The position for 100% subsidiaries is considered below.

### 65.23.2 *Holding company condition*

Before considering the definition of "holding company of the property" it is necessary to set out a subsidiary definition. Section 100A(4) ITEPA defines "relevant interest in the property":

> "Relevant interest in the property" means an interest under the law of any territory that confers (or would but for any inferior interest confer) a right to exclusive possession of the property at all times or at certain times.

We can now turn to the definition of "holding company" of the property. Section 100A(2) ITEPA provides:

> The company is "the holding company of the property" when—
> (a) it owns a relevant interest in the property,
> (b) its main or only asset is that interest, and
> (c) the only activities undertaken by it are ones that are incidental to its ownership of that interest.

54 Or other officer; for brevity references to "directors" in this section include other officers.

### 65.23.3 *Subsidiary holding company*

Suppose the property is held via a subsidiary company thus:

*Parent company ("P")*

|

*Subsidiary Co ("S")*

|

*Property*

S is in principle the holding company of the property but it does not meet the wholly owned condition. P is not the holding company of the property within s. 100A(2). However s. 100A(3) ITEPA provides:

> The company is also "the holding company of the property" when—
> (a) a company ("the subsidiary") which is wholly owned by the company [*ie the parent company]* meets the conditions in paras (a) to (c) of subsection (2),
> (b) the company's [*ie the parent company's]* main or only asset is its interest in the subsidiary, and
> (c) the only activities undertaken by the company *[ie the parent company]* are ones that are incidental to its ownership of that interest.

Thus P also qualifies as "the holding company of the property." Strictly this does not help as P is not the company providing the accommodation but in practice the relief is clearly intended to apply here.

### 65.23.4 *"The relevant time"*

Section 100A(5)(6) ITEPA defines "relevant time":

> (5) "The relevant time" is the time the company first owned a relevant interest in the property; but this is subject to subsection (6).
> (6) If—
> (a) none of D's interest in the company was acquired directly or indirectly from a person connected with D, and
> (b) the company owned a relevant interest in the property at the time D first acquired an interest in the company,
> "the relevant time" is the time D first acquired such an interest.

### 65.23.5 *Exceptions*

Section 100B ITEPA sets out three wide exceptions to this narrow relief:

> (1) Section 100A(1) does not apply if subsection (2), (3) or (4) applies.

The first two exceptions concern connected[55] companies:

> (2) This subsection applies if—
> (a) the company's interest in the property was acquired[56] (directly or indirectly) from a connected company at an undervalue, or
> (b) the company's interest in the property derives from an interest[57] that was so acquired.
> (3) This subsection applies if, at any time after the relevant time—
> (a) expenditure in respect of the property has been incurred (directly or indirectly) by a connected company, or
> (b) any borrowing of the company (directly or indirectly) from a connected company has been outstanding (but see subsection (7). ...
> (7) For the purposes of subsection (3)(b), no account is to be taken of—
> (a) any borrowing at a commercial rate, or
> (b) any borrowing which results in D being treated under Chapter 7 (taxable benefits: loans) as receiving earnings.

Lastly there is an all-purpose tax motive restriction:

> (4) This subsection applies if the living accommodation is provided in

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55 "Connected" is very widely defined in s.100B(9) ITEPA:
"In this section 'connected company' means—
(a) a company connected with D, with a member of D's family or with an employer of D, or
(b) a company connected with such a company."

56 Section 100B(5) ITEPA provides a commonsense definition:
"In subsection (2), references to the acquisition of an interest include the grant of an interest."

57 Section 100B(6) ITEPA provides a commonsense definition:
"For the purposes of that subsection [subsection (2)], an interest is acquired at an undervalue if the total consideration for it is less than that which might reasonably have been expected to be obtained on a disposal of the interest on the open market; and 'consideration' here means consideration provided at any time (and, for example, includes payments by way of rent)."

pursuance of an arrangement[58] the main purpose, or one of the main purposes, of which is the avoidance of tax or national insurance contributions.

### 65.23.6 *Commentary*

Foreign homes relief would serve as a case study for what has gone wrong with tax reform in recent years. Almost every restriction on this relief is anomalous. Why should there be a relief for a company owning land and not for chattels? Yachts and aeroplanes are generally held through companies. Why should the relief apply to companies held by individuals and not by trusts? We need rationalisation and simplification, not yet another narrowly targeted relief. But there it is.

## 65.24 Benefit in kind: remittance basis taxpayer

This section deals with the position of a remittance basis taxpayer who is an employee, director or shadow director and receives the benefit in kind of living accommodation.

A specified amount (the cash equivalent) "is treated as earnings from the employment". I refer to this as "BiK earnings".

### 65.24.1 *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.[59] Thus one has to ascertain:

(1) what the duties are;
(2) where they are performed.

To ascertain the duties of an employee or formally appointed director is straightforward. To ascertain the duties of a shadow director is problematic. A shadow director has no positive "duties" in the normal sense of the word.

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58 Section 100B(8) ITEPA provides an unnecessary definition (this seems now to be in the Parliamentary drafter's handbook):

> "In subsection (4) 'arrangement' includes any scheme, agreement or understanding, whether or not enforceable."

59 See 12.11 (Chargeable overseas earnings).

It might be argued that a shadow director has no "duties" within the meaning of s.23 ITEPA. The consequence would be anomalous.[60] I think a court is not likely to accept this. If a shadow director is deemed to have an employment, it follows that they should be deemed to have some "duties".

The harder question is: exactly what are the (deemed) "duties" of the "employment" of a shadow director? The duties may be regarded as the instructions or directions which they give 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 their (deemed) "duties"; or alternatively everything they do if:

(1) they act with the consent of the formally appointed directors; or
(2) their actions concern matters which would (apart from them) 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, eg 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).

### 65.24.2 *Are BiK earnings remitted to the UK?*

If BiK earnings are "chargeable overseas earnings", they are taxable only if remitted to the UK.

If the accommodation is not in the UK then the BiK earnings are not on any view remitted here.

If the accommodation is in the UK, common sense suggests that there ought to be a charge. But there is a sound technical argument that the deemed earnings cannot be remitted because they do not exist. The tax charge arises only if the earnings are remitted. The property (or the benefit of its occupation) is not the same as the earnings.

HMRC may not agree. The EI Manual provides:

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60 (1) Benefits in kind of a UK resident foreign domiciled shadow director would never qualify as chargeable overseas earnings.
(2) Benefits in kind of a non-resident shadow director would never be subject to tax.

**20508 Expense payments to and benefits provided for a director or employee whose earnings are taxable on remittance**
The earnings of a director or employee, except in an excluded employment (EI Manual 20007), who is chargeable on remittances to the UK under either s.22 or s.26 ITEPA include
- expenses payments remitted to the UK
- expenses paid in the UK
- *benefits provided or enjoyed in the UK (for example, a motorbike available for use in the UK)...*

**40303 Meaning of "remitted to the United Kingdom": benefits in kind and UK-linked debts**[61]
*Benefits in kind*
The definition of "remitted to the United Kingdom" in Section 809L ITA 2007 (see EIM40302) includes general earnings brought to, received in or used in and enjoyed in the United Kingdom in a form other than money. The benefits code as defined by Section 63(1) ITEPA 2003 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.

This view was doubtful before 2008, but it is even harder to defend under the ITA remittance basis because where there is deemed income or gains, the statute specifically deals with the issue by deeming some assets to be derived from those income or gains.

## 65.25 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.[62] Thus one must ascertain:
(1) what the duties are;
(2) whether the earnings are in respect of the duties;

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61 I am not sure when this text was updated, though it was in place by August 2009. The term "UK-linked debts" is out of date after the 2008 reforms, but it does not matter.
62 See 12.16 (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 deemed duties there would be no earnings, but that is not enough. The benefit of living accommodation (which the earnings represent) would arise independently of the deemed duties. There is no income tax avoidance possibility here, because in the sort of case where substantial services were provided by a shadow director (as valuable as an actual director) then the earnings could be in respect of the duties.[63]

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.

## 65.26 DTA defence to BiK charge

This section considers whether DTAs may provide a defence to the BiK charge.

It is assumed in this section that although the individual is UK resident,[64] they are treaty-resident in another state ("the foreign state") under the DTA tie-breaker rules. A DTA may well be of assistance in these circumstances.

It is assumed that the foreign state has a DTA with an article in the form of Art. 15 of the OECD Model Treaty; of course the individual treaty will need to be reviewed.

Article 15 provides two reliefs for a person who is treaty-resident in a

63 See *R v Dimsey & Allen* [2002] 1 AC 509 at [19].

64 Otherwise there is no BiK problem.

foreign state and it is necessary to consider them separately.

65.26.1 *Article 15(1)*

Article 15(1) provides:

> 1. Subject to the provisions of Articles 16, 18 and 19,[65] salaries, wages and other similar remuneration derived by a resident of a Contracting State in respect of an employment shall be taxable only in that State unless the employment is exercised in the other Contracting State. If the employment is so exercised, such remuneration as is derived therefrom may be taxed in that other State.

To follow this one must bear in mind which Contracting State is which. It is easier to follow if rewritten with the UK in mind, thus:

> 1. ... salaries, wages and other similar remuneration derived by a resident of a *foreign* Contracting State in respect of an employment shall be taxable only in that *foreign* State unless the employment is exercised in *the UK* [the other Contracting State]. If the employment is so exercised *in the UK*, such remuneration as is derived therefrom may be taxed in *the UK* [that other State].

To qualify for relief under Art. 15(1) the following conditions must be met.

There must be an employment. A shadow directorship is an employment for UK tax purposes, and it is considered that it counts as an employment for treaty purposes.

The BiK charge must be a tax on "salaries, wages and other similar remuneration." This is the case. The OECD Model Commentary para 2.1 provides:

> Member countries have generally understood the term "salaries, wages and other similar remuneration" to include benefits in kind received in respect of an employment (e.g. stock-options, the use of a residence or automobile, health or life insurance coverage and club memberships).

The BiK must be in respect of the employment: it is considered that this

65 None of the three exceptions in Arts. 16, 18 or 19 is likely to be in point.

condition is satisfied.

Lastly, the employment must be exercised wholly in the foreign State (in which case full relief is applicable) or at least partly in the foreign state (in which partial relief applies). This is more problematic and in typical cases assuming the employment is exercised at all, it will be exercised at least partly in the UK. If that is the case only partial relief is available under article 15(1).

65.26.2 *Article 15(2)*

If relief is not available under Art.15(1) we turn to Art.15(2). For convenience I set it out as it applies to the UK:

> 2. Notwithstanding the provisions of para 1, remuneration derived by a resident of a *foreign* Contracting State in respect of an employment exercised in *the UK [*the other Contracting State*]* shall be taxable only in the *foreign [*first-mentioned*]* State if:
> a) the recipient is present in *the UK [*the other State*]* for a period or periods not exceeding in the aggregate 183 days in any twelve month period commencing or ending in the fiscal year concerned, and
> b) the remuneration is paid by, or on behalf of, an employer who is not a resident of *the UK [*the other State*]*, and
> c) the remuneration is not borne by a permanent establishment which the employer has in *the UK [*the other State*]*.

In principle this can offer exemption from the charge on benefits in kind, even if the employment is exercised wholly or partly in the UK. The three conditions in (a) to (c) must be met.

> *(a) the recipient is present in the UK for a period or periods not exceeding in the aggregate 183 days in any twelve month period commencing or ending in the fiscal year concerned*

Whether this condition is met depends on the facts.

> *(b) the remuneration is paid by, or on behalf of, an employer who is not a resident of the UK*

The employer is of course the company owning the property. The employer will not in principle be UK resident. In fact the BiK is not in the strict sense "paid" but it is suggested that the word should not be strictly construed and this requirement is satisfied.

> *(c) the remuneration is not borne by a permanent establishment which the employer has in the UK.*

This condition will be met, since the company will not have a permanent establishment (the UK home is not a permanent establishment as defined).

Accordingly individuals who are treaty-resident in a contracting state and present in the UK for less than 183 days can qualify for DTA relief under Art. 15(2).

## 65.27 Other planning possibilities using companies

More complex possibilities involve:
(1) acquiring a property,
(2) granting (say) a ten-year lease to trustees or to the individual, and
(3) transferring the freehold reversion to a company. Watch SDLT.
The living accommodation charge would not apply, because the company would not be providing living accommodation. Similar arrangements can be carried out with options. In practice, arrangements of this complexity would not often be needed.

## 65.28 Dealing with companies at risk of IT charge

Many company structures have been set up in the past. The risk of a living accommodation charge depends on the facts of every case, but in practice it is often a serious concern. What can be done?

### 65.28.1 *Planning involving winding-up of the company*

If practical, the safest course is to extract the property from the company so as to put an end to the charge (or risk of a charge) under the benefit in kind rules. One way to do this for trusts, where the occupier has a recognised interest in possession, is to liquidate the company.

The liquidation may give rise to a capital gain which may rule out this course. The property will be in the estate of the life tenant for IHT purposes but in practice that may not be too much of a problem: see 65.1 (Home owned by foreign domiciliary). Another company structure may be entered into later, as set out above.

Another possibility might be for a company to sell the property to the trust, the purchase price remaining outstanding as a loan. In principle the loan is deductible from the value of the property, thus substantially reducing any IHT exposure. See 56.9 (Deduction for debts of trustees). Watch SDLT. CGT may rule out this course.

Another possibility may be to reimburse the company for the cost of providing the accommodation. Watch the CGT implications.

### 65.28.2 *Planning not involving winding up the company*

CGT may make it impractical to wind up the company. In that case take stringent steps to ensure that the individual is not a shadow director.

## 65.29 Dealing with living accommodation enquiries in practice

In practice, as *Al Fayed v Advocate General* frankly reports,[66] 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 Tax Tribunal or beyond.

## 65.30 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.

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66 [2002] STC 910 para 44.

(3) The application of the charge to shadow directors who do no real work for the company is a nonsense. Given the widespread use of holding companies to hold wealth, *Dimsey & Allen* is arguably one of the worst tax decisions made by the House of Lords in recent times. Simply to abolish the charge (reversing *R v Dimsey & Allen*) would go too far the other way, since it is fair that a shadow director who receives what is in reality remuneration from a company should be charged. The solution is to restrict the rule that any benefit from an employer is deemed to be "by reason of employment". The deeming should not apply to a shadow director (whose connection with the company may be tenuous). That would strike the right balance.

The present BiK rules are being used by HMRC as a raid on ill-advised taxpayers or as a weapon to discourage IHT planning (placing homes in companies for IHT reasons). The latter is not the purpose for which the BiK rules were designed, and it is not surprising that they do not do this job well.

## 65.31 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. Otherwise the use of the property would be a benefit giving rise to an income tax charge on the occupier.[67] 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 (eg by a reimbursement of the company's expenditure). Whatever the charge is, it will avoid a taxable benefit under s.731.

## 65.32 Transfer pricing and non-resident company holding family home

The transfer pricing provisions (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

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67 See 27.4.4 (Interest-free loan and enjoyment of asset in kind).

"enterprises".[68] Where a non-resident company controlled by foreign

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68 Accepting the argument of Robert Venables QC in 8 OTR 165. See INTM 432090:
"**432090. The affected persons: Enterprises** [April 2010]
Paragraph 1(1) Schedule 28AA ICTA 1988 refers to provision made or imposed between any two (connected) persons, suggesting a broad scope for the schedule, as the term persons includes bodies corporate, partnerships and individuals. However, paragraph 1(2) and (3) require the actual provision to be compared with the arm's length provision that would have been made between independent enterprises.
Paragraph 2 requires the schedule to be construed in accordance with the OECD model convention, as interpreted by the OECD transfer pricing guidelines. Article 9 of the convention sets out the arm's length principle by reference to conditions made or imposed between enterprises. Article 3 defines enterprise as 'the carrying on of any business'.
This suggests that Schedule 28AA should be applied only where both parties are enterprises, but that this term should be interpreted broadly. The term encompasses more than trading activity, but a natural interpretation implies an intention to make profit or gain, or to undertake activity in a businesslike or commercial way.
In most situations where Schedule 28AA potentially applies there is likely to be little doubt that both the parties to a provision are enterprises. Situations where this may be less clear include the potential application of the schedule to individuals and to charities. It is clear that both individuals and charities can act in a way that would cause them to be regarded as enterprises. This conclusion will follow whenever a trade is being carried on or in other cases where activity is carried on in an organised way with a view to profit or gain. The nature of the activity and whether it carries a commercial flavour will also be relevant.
It is necessary to consider whether a particular provision to which Schedule 28AA potentially applies is one made between two enterprises. Hence it is possible that different conclusions will follow for different provisions made by the same person–some transactions may be made in a capacity unrelated to an enterprise that is being carried on while others may be made in the context of the enterprise.
Examples –Individuals:

- Participation in the management or control of a company does not in itself constitute the carrying on an enterprise. It follows that the office of director, or other employment by a controlled company would not normally constitute a provision made between two enterprises.
- And if a company provides residential accommodation rent free to a participant who just makes personal use of it as their home, transfer pricing rules would not generally apply (though other tax rules, eg relating to employee benefit or distributions, might well be relevant).
- Similarly, holding investments in a close investment holding company would not constitute an enterprise for the purpose of considering provisions made between the company and the individual.
- Holding properties for rent in general does constitute an enterprise. However, if an individual holds property principally for private purposes, incidental letting activity that is intended to offset costs rather than to generate income is not likely to constitute an enterprise.
- Lending to connected companies may or may not constitute an enterprise. If the activity is undertaken in a businesslike way with a view to generating gains on shares in the company, this is like to be represent a form of enterprise. On the other hand, isolated loans where the intention is to provide long term funding for a family business may well not be made in the context of an enterprise.
- Where an individual is carrying on an enterprise, it follows that the SME exemption will

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 provides:

> **432090 Schedule 28AA - how it works: The affected persons - enterprises** [April 2010]
> *Examples - Individuals*
> ...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".

## 65.33 SDLT on living accommodation charge

Para 12 Sch 4 FA 2003 provides:

> (1) Where a land transaction is entered into by reason of the purchaser's employment, or that of a person connected with him, then—
> (a) if the transaction gives rise to a charge to tax under Chapter 5 of Part 3 of the ITEPA (taxable benefits: living accommodation) and—
> (i) no rent is payable by the purchaser, or

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potentially apply, provided the employment and financial limits are met. These limits will apply on an aggregate basis, including the individual and all connected businesses, including those carried on by controlled companies."

> (ii) the rent payable by the purchaser is less than the cash equivalent of the benefit calculated under s.105 or 106 of that Act,
>
> there shall be taken to be payable by the purchaser as rent an amount equal to the cash equivalent chargeable under those sections;
>
> (b) if the transaction would give rise to a charge under that Chapter but for s.99 of that Act (accommodation provided for performance of duties), the consideration for the transaction is the actual consideration (if any); ...

This will not usually affect a foreign domiciliary who occupies a UK home through a company, even if the foreign domiciliary is a shadow director and within the BiK provisions. The reasons are:

(1) The acquisition of a licence (as opposed to a lease) is not a land transaction. The distinction between lease and licence is fraught but usually the individual will occupy under licence and not a lease.

(2) Even if the shadow director acquires a lease, they will not usually do so by reason of their employment. The extended definition in the BiK code[69] does not apply here.

## 65.34 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.

### 65.34.1 *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".

69 See 65.8 ("By reason of the employment").

### 65.34.2 *Employment-related benefit*

This is defined in s.201(2) ITEPA:

> In this Chapter—
> "benefit" means a benefit[70] 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.[71] EI Manual provides:

> **21002 What is meant by a "benefit"**
> 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,[72] 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.[73]

### 65.34.3 *"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[74] by the employee to the persons providing the benefit.

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70 For the meaning of "benefit" see 27.4 (Benefit).

71 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.

72 "Excluded benefit" is defined in s.202.

73 For the definitions of expressions used here see 12.2.1 ("Employer", "employee" and "employment").

74 "Made good" is discussed at 65.14.2 ("Making good": meaning).

This takes us to the elaborate definition of "cost of the benefit". The starting point is s.204 ITEPA:

> **Cost of the benefit: basic rule**
> The cost of an employment-related benefit is the expense incurred in or in connection with provision of the benefit (including a proper proportion of any expense relating partly to provision of the benefit and partly to other matters).

There are two exceptions to this basic rule:
(1) asset made available without transfer;
(2) transfer of used or depreciated asset.
Point (2) is not discussed here. The rule in (1) is in s.205 ITEPA:

> **Cost of the benefit: asset made available without transfer**
> (1) The cost of an employment-related benefit ("the taxable benefit") is determined in accordance with this section if—
> (a) the benefit consists in—
> (i) an asset being placed at the disposal of the employee, or at the disposal of a member of the employee's family or household, for the employee's or member's use, or
> (ii) an asset being used wholly or partly for the purposes of the 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;[75]
> (b) in any other case, 20% of the market value[76] of the asset at the time

75 "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.
76 "Market value" is defined in a commonsense way in s.208 ITEPA.

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). ...[77]

(4) In this section "additional expense" means the expense incurred in or in connection with provision of the taxable benefit (including a proper proportion of any expense relating partly to provision of the benefit and partly to other matters), other than—

(a) the expense of acquiring or producing the asset incurred by the person to whom the asset belongs, and

(b) any rent or hire charge payable for the asset by those providing the asset.[78]

### 65.34.4 *Asset available but not used*

EI Manual provides:

> **21631 Cash equivalent of assets placed at the disposal of a director or employee** [May 2010]
> Note that a tax charge may arise if the asset is available for the use of the director or employee. Whether or not it is used is immaterial. This is because the legislation refers to the benefit as being an asset "placed at the disposal of" the employee. Assets commonly placed at the disposal of directors and employees to which the rule applies are yachts, aircraft, paintings, furniture, TV sets and video machines.

This is correct. The EI Manual gives examples:

> **21633. 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.

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77 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.

78 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."

It immediately makes this available for the sole use of a director and his family throughout the tax year.

In the same year the company spends £2,400 on insurance, fuel, maintenance, servicing and mooring charges for the yacht. It also pays £4,500 interest on a loan obtained to purchase the yacht.

The company requires the director to pay £1,500 a year for the use of the yacht.

*Calculation of the benefit*

The amount chargeable on the director for the benefit from the yacht being made available for his and his family's use is:

| | £ |
|---|---|
| "Annual value of the use of" the yacht: 20% of its market value of £25,000 | 5,000 |
| Running costs borne by the employer | 2,400 |
| | 7,400 |
| Less "made good" by the director | 1,500 |
| Amount of the benefit | 5,900 |

*Notes on the example*

Note that in the example the "market value" of the yacht is taken as £25,000 as this was the open market price paid by the company immediately before it was first applied as a benefit.[79]

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** [May 2010]

Where an asset is not available for part of a year the annual value of its use has to be apportioned (s.204 ITEPA 2003).

For instance, if in the example at EIM21633 the yacht is only made available to the director from 6 October, the chargeable benefit is:

- one half (6/12 months) of the annual value of its use plus
- expenditure on the asset by the person providing it from 6 October to the following 5 April less
- any amount made good by the director (see EIM21120).

**21635 Particular benefits: Assets placed at the disposal of a director or employee: Asset also used in the business or by other employees**

An apportionment of the full amount of a benefit is required if an asset is made available to two or more directors and employees or is provided partly to the

79 [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.

employee as a benefit and is also used partly by the employer in its business (see EIM21200).

For example, if a yacht is made available to two directors and they agree that its availability is shared equally by them, apportion one half of the benefit to each of them. Similarly if the yacht is used partly for business purposes, such as hiring to customers, a proper proportion of the full annual value of its use would not be chargeable.

**21636 Particular benefits: Assets placed at the disposal of a director or employee: Asset used by the employee partly for private purposes and partly for work purposes**

When an asset is available for the private use of a director or employee but it also has to be used in the performance of his duties, the director or employee may be able to get relief for the work use. This is accomplished by treating the value of the benefit as if it were expenditure so that the business proportion can qualify for deduction under s.336 to 338 ITEPA 2003 (see EIM31620 onwards). Note that a deduction will not be due if the private and business use of the asset is concurrent, such as a suit of ordinary clothes worn at work (see EIM31660). Only if the use of the asset is at some times exclusively for business, such as a fax machine provided to the employee at home partly for work use, will a part deduction be due (see EIM31661). See example EIM31617.

**21637 Particular benefits: Assets placed at the disposal of a director or employee: Assets used partly for private purposes and partly for work purposes: Mixed use benefit; Background to example in EIM21638** [August 2006]

See EIM21638 for an example of the interaction between:

- the calculation of the cash equivalent of a benefit where an asset is placed at the disposal of a director or employee (s.205(1)(a)(i) ITEPA 2003) and
- making an apportionment of that benefit where it is available to a director and for "other matters" (s.204 ITEPA 2003).

Where a benefit is provided partly for the use of a director or employee and partly for "other matters" the cost of the benefit must be apportioned (see EIM21200) between the different uses.

**Note that an asset placed at the disposal of a director or employee represents a benefit (s.205(1)(a)(i)) regardless of the use, if any, to which the director or employee puts the asset. But see EIM21631 for details relating to the two alternative measures of charge and when to apply one or the other.**

**If the asset is used wholly for business purposes, this does not prevent the provision of the asset representing a benefit.** If the business use satisfies the terms of s.365(1) ITEPA 2003, the director or employee will be entitled to a deduction equivalent to the full amount of the benefit, leaving no amount chargeable to tax. **But this is not the same as there being no benefit.** A benefit has been provided but because of the deduction for business use, the chargeable amount has been reduced to nil.

**If the benefit is used by a director or employee for private purposes and for business purposes, the business use is not an "other matter" which can be included in the amount of the benefit to be apportioned under Section 204**

**ITEPA 2003.** The full amount of the mixed use of the benefit is chargeable to tax, subject to a deduction under s.365(1) ITEPA 2003 for any business use that meets the conditions of s.336 to 338 ITEPA 2003 (see EIM21210).

On the other hand, use of the asset by other employees, or by the employer company (for example, for transporting goods or customers), or hire to third parties, are "other matters" to be taken into account in an apportionment.

There are no hard and fast rules for calculating the proportion of cost attributable to different uses but the end result should produce an apportionment that is reasonable in the light of the facts of the case and the statutory context in s.204 (see EIM21200).

See the example at EIM21638.

**21638 Particular benefits: Assets placed at the disposal of a director or employee: Assets used partly for private purposes and partly for work: Example** [May 2010]

For some background information relevant to this example see EIM21637.

*Facts*

- On 6 June a company purchases a 10 seater aircraft for £800,000,
- the principal shareholder of the company and managing director (MD) holds a pilot's licence,
- the plane is kept at an airfield near to both the company premises and the MD's home. It is available to the MD to use at all times – sometimes, at weekends, he decides on the spur of the moment to take a flight on the plane. The plane is not available to any other director or employee unless given specific permission,
- the company incurs costs on the plane of £20,000 for the 9 months from 6 June to 5 April for landing fees, fuel, insurance, etc.,
- when he uses the plane for private purposes the MD reimburses the company £100 per day as a contribution towards the employer's costs.
- Inspection of the logbook for the period 6 June to 5 April (274 days) shows use as follows:
  1. 10 days – by the MD for travel to business meetings
  2. 20 days – by the company (using an outside pilot hired by the day) to deliver sensitive documents to customers in remote locations
  3. 10 days – commercial hire to third parties at £2,000 per day
  4. 10 days – another director of the company wishes to learn to fly and uses the plane for flying lessons with an instructor
  5. 60 days – private use by the MD.

*What is the amount of the benefit chargeable on the MD?*

Section 205(2)(a) ITEPA 2003 determines that when an asset is placed at the disposal of a director or employee (see EIM21631), the amount of the cash equivalent of the benefit is the annual value (s.205(3)(b)) plus additional expenses.

| | |
|---|---|
| Annual value of plane (£800,000 × 9/12 × 20%) | £120,000 |
| Additional expenses | £20,000 |
| Total amount of the benefit | £140,000 |

As the plane is made available for several different purposes, if any of those purposes amounts to an "other matter" (s.204), an apportionment of the benefit may be due. Use by the MD, whether for business or private purposes, is not an "other matter". But use by other employees, or use by the company, are "other matters" – 2, 3 and 4 above which amount to 40 days in total.

The amount of the benefit is based on the 274 days in the year when the plane was available for use. On 40 days it was used for "other matters" and the benefit must be apportioned accordingly. On the remaining 234 days it was entirely at the disposal of the director to use as and when he wished. If the plane was not available to the director, or not solely available to him, on all these days, the calculation of the benefit could be different (see EIM21639(. the calculation of the benefit must be:

- apportioned to take account of these other matters and
- reduced by any amount made good by the MD to the employer.

| | |
|---|---|
| Total amount of the benefit | £140,000 |
| Less proportion for "other matters" (40/274) | £20,438 |
| Benefit after apportionment | £119,562 |
| Less made good by MD (£100 × 60) | £6,000 |
| Amount of the benefit chargeable | £113,562 |

Finally, if the director's use of the plane satisfies the terms of s.336 ITEPA 2003 he will be due a deduction under s.365(1) for the amount of expenses on business purposes that could have been deducted if incurred by him. This figure may be quantified based on the facts of the case. In this instance the MD used the plane for a total of 70 days in the year, 10 days for business and 60 days for private purposes. A reasonable basis for calculating the deduction due under s.365(1) may be 10/70 of the chargeable benefit – 10/70 × 113,562 = 16,223.

| | |
|---|---|
| Less deduction for business use (10/70 days) | £16,223 |
| Amount chargeable on MD | £97,339 |

Note it is necessary to use judgement and common sense when determining the amount that would have been deductible for expenses under s.365(1).

In this case a deduction of approximately £1,600 per day has been allowed for the MD's travel to business meetings. This may seem a large amount but if the alternative is for the company to hire a similar plane for the day at the commercial rate of £2,000, for which the MD paid himself and was later reimbursed by the company, he would be entitled to a deduction for this amount. Apart from extreme cases, it is better not to become involved in a debate concerning what form of transport (and at what cost) is suitable for the director to use to attend meetings.

The other director who uses the plane for flying lessons will also be chargeable on a benefit based on his 10 days private use of the plane.

## 65.34.5 *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 fraud on creditors. However, it really does not matter if a transfer of chattels is void as against a trustee in bankruptcy, in the event that the individual became bankrupt. After all, every gift and transaction at an undervalue can in principle be set aside by a trustee in bankruptcy for two years, under s.339 Insolvency Act 1986, but no-one suggests that has significant tax implications for solvent taxpayers. Thus it is not necessary to register the transfer of the chattels (the "Bill of Sale") under the Act.

## 65.35 "Person providing benefit"

This is defined in s.209 ITEPA:

> **Meaning of "persons providing benefit"**
> For the purposes of this Chapter the persons providing a benefit are the person or persons at whose cost the benefit is provided.

CHAPTER SIXTY SIX

# PRE-OWNED ASSETS

## 66.1 Pre-owned assets – Introduction

This chapter considers the provisions in Schedule 15 FA 2004 ("**POA provisions**"). A full discussion of this topic needs a book to itself.[1] The supplementary regulations (whose title is so long it cannot sensibly be used)[2] are referred to as "**the 2005 POA Regulations**".

The HMRC website gives guidance ("**Website POA Guidance**").[3]

"**The CIOT Statement**" gives HMRC answers to a number of questions raised by CIOT, STEP and LITRG.[4]

The label "pre-owned assets" is convenient but inaccurate since the charge may apply to property not previously owned by the taxpayer.

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1 And indeed such a book has been written: Chamberlain & Whitehouse, *Pre-Owned Assets and Estate Planning* (3rd ed, 2009).

2 The Charge to Income Tax by Reference to Enjoyment of Property Previously Owned Regulations 2005.

3 Accessible *www.hmrc.gov.uk/poa/index.htm*. Rather discouragingly, the website (accessed November 2010) states:

> "The guidance notes reflect the current law and do not take account of any proposals contained in the 2006 Finance Bill. As soon as any changes proposed by the bill become law we will review the guidance to see if, and to what extent, amendments need to be made."

This neglect reflects the fact that HMRC are not seriously interested in administering or enforcing the POA provisions, except in relation to some specific IHT avoidance schemes at which they were aimed; of course that may change at any time without notice.

4 Accessible:http://www.step.org/resources/policy_and_technical/uk_policy/2006/pre-owned_assets_-_responses.aspx?link=contentMiddle. The current version of the statement is dated 31 August 2006; earlier versions were dated 13 October 2005 and 13 March 2006. The process of amendments has left a tangle and it would be better if this statement (and indeed all such statements) were replaced by guidance in a HMRC Manual or equivalent.

The provisions impose three charges to income tax which I call:

(1) "**The POA land charge**".

(2) "**The POA chattel charge**".

(3) "**The POA intangible property charge**".

Land, chattel and intangible property are given commonsense definitions.[5]

## 66.2 Human rights

The Parliamentary Joint Committee on Human Rights considered the POA provisions to be HR compliant except (intriguingly) in relation to the spouse exemptions (which deny relief to cohabitees).[6] This may not be the last word on the subject but the prospect of a successful appeal on human rights grounds seems slender.

## 66.3 POA land charge

Para 3(1) Sch 15 FA 2004 provides:

> This paragraph applies where—
> (a) an individual ("the chargeable person") occupies any land ("the relevant land"), whether alone or together with other persons, and
> (b) the disposal condition or the contribution condition is met as respects the land.

In the discussion below the "chargeable person" is called "T" and the land T occupies is called "land occupied by T" (rather than "the relevant land").

"Occupation" is a legal concept extensively discussed in rating cases. Website POA Guidance makes some general observations on the meaning of occupation at 4.6.

## 66.4 The disposal conditions

Para 3(2) Sch 15 FA 2004 provides:

> The disposal condition is that—

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5 Para 1 Sch 15 FA 2004.

6 *www.publications.parliament.uk/pa/jt200304/jtselect/jtrights/93/9305.htm.*

(a) at any time after 17 March 1986 the chargeable person owned an interest—
 (i) in the relevant land, or
 (ii) in other property the proceeds of the disposal of which were (directly or indirectly) applied by another person towards the acquisition of an interest in the relevant land, and

(b) the chargeable person has disposed[7] 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.

### 66.4.1 *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, eg if a foreign domiciliary transferred their house to a trust or company.

What if T enters into a contract to purchase land and then assigns that contract to a trust or company? The contract is an interest in land. However, on completion the contract ceases to exist. That will normally be before the valuation date. Since the asset cannot be valued on the valuation date, it is tentatively suggested that disposal condition (1) does not apply in this situation.

The disposal condition is satisfied by a disposal of land for full consideration. However, in such a case the exclusion for arm's length transactions may apply.

7 "Disposal" is defined in para 3(4) Sch 15 FA 2004.

### 66.4.2 *Disposal condition (ii)*

The essence of disposal condition (ii) is that:

> (a) T owned ... other property the proceeds of the disposal of which were (directly or indirectly) applied by another person towards the acquisition of an interest in the land occupied by T, and
> (b) T has disposed of all, or part of, his interest in the ... other property ...

Disposal condition (ii) is probably intended to deal with the situation where:
(1) T disposes of land to A.
(2) A sells the land and uses the proceeds to purchase other land occupied by T.
However, it may apply where:
(1) T disposes of any property (not land or cash) to A; and
(2) A disposes of that property and uses the proceeds to purchase land occupied by T.
This overlaps with the contribution conditions. The overlap matters because the excluded transaction defences to the contribution and disposal conditions are not the same.

## 66.5 The contribution conditions

Para 3(3) Sch 15 FA 2004 provides:

> The contribution condition is that at any time after 17 March 1986 the chargeable person has directly or indirectly provided, otherwise than by an excluded transaction, any of the consideration given by another person for the acquisition of—
> (a) an interest in the relevant land, or
> (b) an interest in any other property the proceeds of the disposal of which were (directly or indirectly) applied by another person towards the acquisition of an interest in the relevant land.

This is best regarded as two conditions, depending on whether (a) or (b) applies. I call them contribution conditions (a) and (b). Only one of them need be satisfied for the "contribution condition" to be met.

### 66.5.1 *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.

### 66.5.2 *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 (eg trustees);
(b) A transfers the funds to B (eg 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.

### 66.5.3 *Purpose of contribution conditions*

It is hard to see the purpose of the contribution conditions. *Ingram*, *Eversden* and double trust schemes would be caught by the disposal conditions. Perhaps it was meant to catch schemes set up on the occasion of purchase of a new property where the settlor would provide cash to a trust. But this was never done in the past; it would have been better to frame more targeted anti-avoidance provisions than this blunderbuss approach.

## 66.6 "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.[8]

It is considered that "provide" implies an element of bounty. So if T lends money on arm's length terms to A, who uses the money lent to buy the property, T has not "provided" the consideration and the contribution condition is not satisfied.

What if T lends interest-free to A, who uses the money lent to buy the property? At first sight T has provided the consideration. But it might be argued that A provides the consideration himself (by A's promise to repay T) and that T provides nothing.[9] In practice HMRC now[10] accept this.

---

8 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.

9 One might say that T has provided the interest foregone on the loan, but interest foregone does not exist, and it is difficult to see how one could provide something which does not exist.

10 This reverses the view taken in the CIOT Statement:

> "6.2 The meaning of the 'provision' of 'consideration' in the context of the contribution condition needs to be clarified. On the basis of the case law the word provided suggests some element of bounty.
>
> On this basis our view is that if there is a transfer of Whiteacre by A (or another asset) to his son at full market value which is then sold by son and the sale proceeds used to purchase Blackacre for A to occupy this is a breach of the disposal but not the contribution condition because it lacks the necessary element of bounty.
>
> Similarly the provision of a loan on commercial terms by A to his son to enable son to purchase a house which A then occupies in our view does not fall within the contribution condition.
>
> ***Question 32***

Website POA Guidance provides at 1.2.1:

> HMRC do not regard the contribution condition set out in Schedule 15, para 3(3) as being met where a lender resides in property purchased by another with money loaned to him by the lender. Our view is that since the outstanding debt will form part of his estate for IHT purposes,
> [1] it would not be reasonable to consider that the loan falls within the contribution condition
> [2] [and therefore not reasonably attributable to the consideration (Sch 15, para 4(2)(c)],[11]
> even where the loan was interest free. It follows that the 'lender', in such an arrangement, would not be caught by a charge under Schedule

---

Do HMRC agree with this analysis?

**HMRC answer to question 32**

In our view, it is arguable that the contribution condition does not depend on a degree of bounty for its application. If, on the contrary, a degree of bounty was necessary, might not the operation of the contribution condition provisions in paras 3(3) and 6(3) of Schedule 15 be circumvented by the relatively simple expedient of A, in your example, providing the wherewithal for the purchase of a house by his son by way of a loan, ostensibly on commercial terms, which is then left outstanding indefinitely?

Having said that, we have considered further the sort of case where a loan is made **and operated** on commercial terms eg a commercial rate of interest is specified and paid and there are provisions for repayment of the loan over the sort of period one would expect to find in a truly commercial loan. Having regard to paras 4(2)(c) or 7(2)(c) of Schedule 15, the chargeable amount would depend on the value of DV in R (or N)×DV/V: that's to say on 'such part of the value of the land/chattel as can reasonably be attributed to the consideration provided by the chargeable person'. In the case where the loan is on truly commercial terms and conducted in a truly commercial way, we would accept that the attributable amount is nil or de minimis. In determining 'reasonable attribution' for the purposes of para 4(2)(c), it is the terms on which the loan is made and operated that are relevant, as indicated above. In that context, the period over which the loan is repaid as well as whether a commercial rate of interest is charged is relevant.

Thus, where an interest-free loan is repaid over a typical 'commercial' period, it would be reasonable to regard the interest foregone as attributable to the consideration provided by the chargeable person. In cases where the principal of the loan was left outstanding indefinitely, such principal could reasonably be regarded as attributable to the consideration provided."

11 Words in square brackets are original. [2] refers to the rule which restricts the charge to "such part of the value of the land which is reasonably attributable to the consideration provided by T" see 66.26.4 (The proportion (DV ÷ V). But if, as HMRC accept, the lender has not provided the consideration, the point in [2] does not arise (unless the lender has provided some consideration and made a loan too).

15.

What if

(1) T lends interest-free to A,
(2) A purchases the property, and
(3) T later releases the loan or makes a gift to A which A uses to repay the loan (which comes to the same thing)?

Alternatively, more simply, what if:

(1) A purchases the property
(2) T makes a gift to A, or reimburses A for the expense (without being obliged to do so).

If T has not provided the consideration at the time that A purchases the property, T cannot provide it later. However if the steps form part of a single arrangement, it can probably be said that A has provided the consideration indirectly, even if slightly belatedly.

What if T subscribes for shares on arm's length terms? Probably T has provided funds to the company

### 66.6.1 *Arrangements involving third parties*

The position becomes more complex where more than two persons are involved.

Suppose T provides funds to A, an individual, who gives them to B, an individual, and B purchases the property. It is suggested that T has not provided the consideration if the "clean break" test is satisfied.[12]

Suppose T provides funds to a trust, who lend them to a company owned by the trust, which purchases the property. It is suggested that T has provided the consideration because the "clean break" test is not satisfied.

What if T gives funds to A and A borrows from a third party on the security of those funds, and uses the borrowed funds to buy the property? It is considered that T has not provided the consideration. If T provides fund X to a company or trust, which borrows fund Y from a third party, and the company or trust uses both funds to acquire the property, then T has provided fund X but not fund Y.

Traditional IHT planning for a foreign domiciliary's residence will often satisfy the contribution condition, for instance where:

(1) an individual gives to a trust which purchases the home (without a

12 See 69.4.1 (When is A an indirect settlor?).

company);
(2) a foreign domiciliary gifts funds to a trust which lends interest-free to the company which acquires the home.

In most cases one exemption or another will apply but it is possible to fall between the gaps.

### 66.6.2 *Provision of funds for purpose of acquisition*

What is the position if T provides funds but not for the purpose of the acquisition of the land? Suppose:

(1) In 1987 T created a trust. At the time T 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. They are probably to be regarded as having indirectly provided the consideration given for the acquisition of the land under the principle in *Muir v Muir*.[13] So contribution condition (a) is satisfied.

But if T gives funds to A, an individual, and A later uses those funds to buy a property, it is suggested that T has not provided the consideration, unless the two steps form a single arrangement.

### 66.6.3 *Guarantees*

Para 17 Sch 15 FA 2004 provides:

> 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 A's guarantee or deposits funds with a bank as a back-to-back loan.

---

13 [1943] AC 468. This is consistent with para 10(2)(c) Sch 15 FA 2004 which envisages a seven-year gap between the provisions of funds and the occupation of the land. But the contrary view is arguable.

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.

### 66.6.4 *Secondhand company*

The contribution condition will not be satisfied where:

(1) A has provided funds to a company to purchase a house.

(2) A sells the company to B who occupies the house.

B has not provided the funds for the purchase (unless the two steps form a single arrangement): see 25.8.1 (Purchase of secondhand company by individual).

## 66.7 POA chattel charge

Para 6 Sch 15 FA 2004 provides:

> (1) This paragraph applies where—
> (a) an individual ("the chargeable person") is in possession of, or has the use of, a chattel, whether alone or together with other persons, and
> (b) the disposal condition or the contribution condition is met as respects the chattel.
> (2) The disposal condition is that—
> (a) at any time after 17 March 1986 the chargeable person had (whether alone or jointly with others) owned—
> (i) the chattel, or
> (ii) any other property the proceeds of the disposal of which were (directly or indirectly) applied by another person towards the acquisition of the chattel, and
> (b) the chargeable person disposed[14] of all or part of his interest in the chattel or other property otherwise than by an excluded transaction.

14 "Disposal" is further defined in para 6(4) Sch 15 FA 2004.

(3) The contribution condition is that at any time after 17 March 1986 the chargeable person had directly or indirectly provided, otherwise than by an excluded transaction, any of the consideration given by another person for the acquisition of—
(a) the chattel, or
(b) any other property the proceeds of the disposal of which were (directly or indirectly) applied by another person towards the acquisition of the chattel

This follows the form of the POA land charge.

## 66.8 POA intangible property charge

Para 8 Sch 15 FA 2004 provides:

(1) This paragraph applies where—
(a) the terms of a settlement,[15] as they affect any property comprised in the settlement, are such that any income arising from the property would be treated by virtue of section 624 of ITTOIA (income arising under settlement where settlor retains an interest) as income of a person ("the chargeable person") who is for the purposes of Chapter 5 of Part 5 of that Act the settlor,
(b) any such income would be so treated even if section 625(1) of ITTOIA (settlor's retained interest) did not include any reference to the spouse or civil partner of the settlor, and
(c) that property includes any property as respects which the condition in sub-para (2) is met ("the relevant property").
(2) The condition mentioned in sub-para (1)(c) is that the property is intangible property which is or represents property which the chargeable person settled, or added to the settlement, after 17 March 1986.

In common form settlor-interested discretionary trusts the GWR exemption will apply.

If S lends on favourable terms to a settlement from which S is excluded,

15 "Settlement" here has the IHT meaning, not the settlement-arrangement meaning: para 1 Sch 15 FA 2004. See 69.2 (Definitions of "settlement").

s.624 applies[16] but para 8 does not apply.[17]

In common form trusts where the settlor has an IP, the GWR exemption (or for an estate IP, the estate exemption) will apply.

Accordingly, the POA intangible property charge will not usually affect foreign domiciliaries.

The charge does not apply to intangible property held by a company held by a trust, since that is not property comprised in a settlement, and not caught by s.624, but the shares in the company will be intangible property (except perhaps bearer shares?).

The charge is intended to catch *Eversden* schemes marketed by life insurance companies (which will not normally have been carried out by foreign domiciliaries). But it is much wider than that. It applies (in short) to (almost) any settlor-interested trust unless GWR also applies. If A creates a trust to A for life remainder to B absolutely, or to B for life remainder to A absolutely, the charge applies. However, if there is a power of appointment in favour of A, the charge does not apply as in this case there is a GWR. There is no sense in this. Since s.102ZA FA 1986 stops the *Eversden* schemes, the intangible property charge is an anti-avoidance provision that has lost its purpose[18] and only remains as clutter in the tax system which will occasionally trap the unwary (if anyone notices or cares).

## 66.9 Excluded transactions

A disposal of property by an excluded transaction is ignored for the disposal conditions; and the provision of property by an excluded transaction is ignored for the contribution conditions. Para 10(1) Sch 15 FA 2004 defines "excluded transaction" for the disposal conditions and para 10(2) Sch 15 FA 2004 defines the phrase for the contribution conditions. Each sub-paragraph contains five categories of excluded 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.

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16 See 24.3.2 ("Settlor-interested" for IT purposes).

17 Because s.624 only applies because of the loan and not because of the terms of the settlement (in the IHT sense).

18 Except for arrangements made before 22 March 2006.

## 66.10 Excluded transactions: disposal conditions

### 66.10.1 *Arm's length transactions*

Para 10(1) Sch 15 FA 2004 provides:

> For the purposes of ... [the disposal condition], the disposal of any property is an "excluded transaction" in relation to any person ("the chargeable person") if—
> (a) it was a disposal of his whole interest in the property, except for any right expressly reserved by him over the property, either—
> (i) by a transaction made at arm's length with a person not connected with him, or
> (ii) by a transaction such as might be expected to be made at arm's length between persons not connected with each other.

There is no equivalent of this category of excluded transaction for the purposes of the contribution conditions. The reason is that a disposal at arm's length is not likely to amount to "providing" consideration.

This is extended to part disposals by reg. 5(1) of the 2005 POA Regulations:

> Para 3 (land) and para 6 (chattels) do not apply to a person in relation to a disposal of part of an interest in any property if—
> (a) the disposal was by a transaction made at arm's length with a person not connected with him;
> (b) the disposal was by a transaction such as might be expected to be made at arm's length between persons not connected with each other, and
> (i) the disposal was for a consideration not in money or in the form of readily convertible assets[19], or
> (ii) the disposal was made before 7 March 2005.

One might think the word "not" is included accidentally in reg.5(1)(b)(i) but it was deliberate. A written ministerial statement of Hansard 7 March 2005 provides:

> We do not in general think it is appropriate to provide exemption for

19 Defined in reg.5(2).

> sales of a part interest which are made otherwise than at arm's length. If one member of a family needs to raise cash, and another member of the family is willing and able to provide it, there are other and more straightforward ways of structuring this than adopting the form of an equity release transaction.

Very few readers will find that satisfactory. But there it is. The statement continues:

> The point was however made in consultation that some intra-family part disposals can arise from patterns of behaviour adopted for good family or business reasons, for example where a child moves in to care for an aged parent and acquires an equitable interest in their shared home as a corollary of that, or where younger members of a family take over the active role in a family partnership, and in doing so acquire an interest from the partners who preceded them.

What is notable is that the drafter seems to have assumed that these are "transactions such as might be expected to be made at arm's length between persons not connected with each other".

The Website POA Guidance states (Appendix 1):

> If Miss B acquired her interest in the property by way of an equitable arrangement rather than for cash – for example, she had given up work to care for Mr A on the understanding that she would receive a share of the property in return – the income tax charge will not apply: Regulation 5
>
> In considering whether the conditions were satisfied, we would need information about how the essential elements of the transaction had been arrived at. We do recognise that there is a substantial body of case law dealing with the circumstances in which an interest in a house is acquired in consequence of a person acting to his detriment. The Ministerial Statement had these sorts of situations in mind and we would interpret Regulation 5 accordingly. In particular, we accept that the requirement that "the disposal was by a transaction such as might be expected to be made at arm's length between persons not connected with each other" would be interpreted with such cases in mind. Where the parties had sought separate advice and acted upon it or had obtained a court order confirming the property entitlement, that would reinforce the claim that the conditions were satisfied. But we would not expect parties to such an arrangement to have done this. We recognise that

> detriment that the acquirer can demonstrate he has suffered can provide consideration for the acquisition of the interest and prevent the transaction from being gratuitous.

It is straining credulity to describe this as a transaction that may have been expected to have been made at arm's length. But the legislation was not intended to catch this, and HMRC avoid the problem by informal concession dressed up as a statement of practice.

### 66.10.2 *Spouse exclusions*

The second and third categories of excluded transaction are in para 10(1)(b) and (c) Sch 15 FA 2004:

> (b) the property was transferred to his spouse or civil partner (or where the transfer has been ordered by a court, to his former spouse or civil partner),
> (c) it was a disposal by way of gift (or, where the transfer is for the benefit of his former spouse or civil partner, in accordance with a court order), by virtue of which the property became settled property in which his spouse or civil partner or former spouse or civil partner is beneficially entitled to an interest in possession.[20]

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 the reason is to stop some variants of the double trust scheme, which involves a sale of a house to an interest in possession trust for consideration.

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20 This is restricted by para 10(3) Sch 15 FA 2004:

> "A disposal is not an excluded transaction by virtue of sub-para (1)(c) or (2)(b), if the interest in possession of the spouse or civil partner or former spouse or civil partner has come to an end otherwise than on the death of the spouse or civil partner or former spouse or civil partner."

HMRC Website Guidance provides at 1.3.1:

> "In cases where the spouse or civil partner or former spouse or civil partner has become absolutely entitled to the property, we would accept that the benefit of the exclusion is not lost."

### 66.10.3 *Disposition for maintenance of family*

The fourth category of excluded transaction is in para 10(1)(d) Sch 15 FA 2004:

> the disposal was a disposition falling within section 11 of IHTA (dispositions for maintenance of family).

### 66.10.4 *Annual exemption and small gifts*

The fifth category of excluded transaction is in para 10(1)(e) Sch 15 FA 2004:

> the disposal is an outright gift[21] 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.

## 66.11 Excluded transactions: contribution conditions

### 66.11.1 *Four exclusions*

Para 10(2) Sch 15 FA 2004 provides:

> For the purposes of ... (the contribution condition) the provision by a person ("the chargeable person") of consideration for another's acquisition of any property is an "excluded transaction" in relation to the chargeable person if—
> (a) the other person was his spouse or civil partner (or, where the transfer has been ordered by the court, his former spouse or civil partner),
> (b) on its acquisition the property became settled property in which his spouse or civil partner or former spouse or civil partner is beneficially entitled to an interest in possession.

These are the equivalent of the exclusions discussed above, see 66.10.2 (Spouse exclusions). The spouse trust exclusion here is wider than the

21 See 66.12 (Meaning of "outright gift").

spouse trust exclusion for the disposal condition, as the words "by way of gift" do not appear. The last two exclusions in para 10(2) Sch 15 FA 2004 are:

> (d) the provision of the consideration is a disposition falling within section 11 of IHTA (dispositions for maintenance of family), or
> (e) the provision of the consideration is an outright gift to an individual and is for the purposes of IHTA a transfer of value that is wholly exempt by virtue of section 19 (annual exemption) or section 20 (small gifts).

These are the equivalent of 66.10.3 (Disposition for maintenance of family) and 66.10.4 (Annual exemption and small gifts).

### 66.11.2 *Outright gift of money*

The remaining exclusion is in para 10(2)(c) Sch 15 FA 2004 where:

> (c) the provision of the consideration constituted an outright gift[22] of money (in sterling or any other currency) by the chargeable person to the other person and was made at least seven years before the earliest date on which the chargeable person met the condition in para 3(1)(a)[23] or, as the case may be, 6(1)(a).[24]

Para (c) applies only to the contribution conditions.

The exemption only applies to gifts of money. I am unable to see any reason for that. Website POA Guidance provides at 1.3.1:

> As the earliest date the conditions can be met is 6 April 2005, any provision of consideration by way of an outright gift of cash made before 6 April 1998 will be an excluded transaction.

## 66.12 Meaning of "outright gift"

The expression "outright gift" is used in three of the ten categories of excluded transaction:

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22 See 66.12 (Meaning of "outright gift").
23 ie occupies the relevant land.
24 ie has possession of the chattels.

(1) Outright gifts to individuals within s.19 (annual exemption) or s.20 (small gifts) are excluded transactions for the disposal and contribution conditions.[25]
(2) Outright gifts of money (whether or not to an individual) are excluded for the disposal condition.[26]

"Outright gift" is not defined.[27] 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.

## 66.13 Exemptions from charge

Para 11 Sch 15 FA 2004 provides a set of exemptions from the POA charges which (in my terminology) are as follows:
(1) Estate exemptions.
(2) GWR exemptions.
(3) Para 11(5)(b) Sch 15 FA 2004 exemptions (charities and other specialist areas) not discussed here.
(4) Para 11(5)(c) Sch 15 FA 2004 exemption (jointly occupied property) not discussed here.
(5) Full consideration exemption.

## 66.14 "Relevant property"

A key concept in para 11 Sch 15 FA 2004 is "relevant property" defined in para 11(9) Sch 15 FA 2004. The expression has three possible meanings.

In relation to the POA land and chattel charges, "relevant property" means:

> (i) where the disposal condition ... is met, the property disposed of,

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25 See 66.10.4 (Annual exemption and small gifts); 66.11.1 (Four exclusions).
26 See 66.11.2 (Outright gift of money).
27 The term "outright gift" is partially defined in s.626 ITTOIA; see 64.14 (Income tax planning for mixed marriage), but that definition does not apply here.

> (ii) where the contribution condition ... is met, the property representing the consideration directly or indirectly provided.

In a contribution condition case, the relevant property is the property representing the consideration directly or indirectly provided. Since "provided" is a difficult concept,[28] this is also difficult.

If T gives money to A, who uses it to buy a house, the house represents the consideration provided.

What if T subscribes for shares in A Ltd which purchases the house. Is it the shares or the house which represent the property provided? It is suggested that the relevant property is the house, but the shares may be derived property: see below.

What if T lends money to A interest-free, who purchases a house? Is it the house or the benefit of the loan which represents the consideration provided? In this case HMRC accept that T does not provide the consideration so the contribution condition is not satisfied; but if it mattered, it is suggested that the relevant property is the house and the loan may be derived property.

In relation to the POA intangible property charge, "relevant property" has the meaning given in para 8 Sch 15 FA 2004 (roughly, the settled property).[29]

## 66.15 Estate exemptions

### 66.15.1 *Full estate exemption*

Para 11(1) Sch 15 FA 2004 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.

28 See 66.6 ("Provide").
29 See 66.8 (POA intangible property charge).

I refer to this as "**the estate exemption**" (or "the **full** estate exemption" if necessary to distinguish it from the partial exemption discussed below).

If T transfers funds to a trust under which T has an estate interest in possession, the estate exemption will apply. Transfers on or after 22 March 2006 will not normally give rise to an estate IP, so the exemption is of less importance to post 2006 trusts.

### 66.15.2 *Partial estate exemption*

Para 11(2) Sch 15 FA 2004 provides:

> Where the estate for the purposes of IHTA of a person to whom para 3, 6 or 8 applies includes property—
> (a) which derives its value from the relevant property, and
> (b) whose value, so far as attributable to the relevant property, is substantially less than the value of the relevant property,
> the appropriate rental value in para 4, the appropriate amount in para 7 or the chargeable amount in para 9 (as the case may be) is to be reduced by such proportion as is reasonable to take account of the inclusion of the property in his estate.

I refer to this as "**the partial estate exemption**".

The concluding words "such proportion as is reasonable to take into account of the inclusion of the property in his estate" are somewhat incoherent. One can speak of "a proportion of a property", but not of "a proportion of an inclusion". Presumably it means: "such proportion as is reasonable to take into account of the property which is included in his estate".

## 66.16 Derived property

In the following discussion:

(1) "**Fully derived property**" is property falling within para 11(1)(b) Sch 15 FA 2004.[30] 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

30 In para 11 Sch 15 FA 2004 this is simply called "derived property".

substantially less than the value of the relevant property.

(2) "**Partly derived property**" is property falling within para 11(2) Sch 15 FA 2004. That is property:

(a) which derives its value from the relevant property, and
(b) whose value, so far as attributable to the relevant property, is substantially less than the value of the relevant property.

Thus there are three steps to decide whether property is "derived property":
(1) Is its value derived from the relevant property (the house)? If so:
(2) Ascertain how far its value is attributable to the house.
(3) Is that value (the value attributable to the house) "substantially[31] less" than the value of the house?

66.16.1 *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;
(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

31 "Substantially" is, obviously, not a precise word. The Website POA Guidance states at 4.7:

> "The term 'substantially less' is not defined by the legalisation but by analogy with the CGT taper relief rules we would regard a reduction of value of less than 20% as not substantially less for the purposes of this Schedule. [Author's Note: see RI 228.] If the circumstances of a particular case suggest that the 'substantially less' provision should be triggered by a reduction of more or less than 20%, it will be judged on its individual merits."

from the house. They derive their value in part from the house and in part from other assets. However, the context shows that that satisfies the condition of para 11(1)(b)(i) Sch 15 FA 2004. Otherwise the condition in para 11(1)(b)(ii) Sch 15 FA 2004 is never satisfied.

Suppose the company owns only the house and is subject to a substantial debt. The shares are not fully derived property as their value is substantially less than the house. The shares are partly derived property.

Suppose the company owns the house and other assets, and is subject to a debt. It is suggested that the shares are fully derived property so long as the amount of the debt is less than the value of the other assets.

The estate exemption applies so long as T retains the shares in T's estate. If T gifts half the shares to T's spouse the estate exemption ceases to apply and POA land charge is due (but with some relief under the partial estate exemption). HMRC agree. Website POA Guidance provides at 1.3.2:

> For example if Mr B transfers his house to a company wholly owned by him, then provided there are no loans to the company one can say that the value attributable to the company is not less than the value of the house. But if Mr B gave the house to a company which was owned 25% by his wife then the value of the 75% shares he holds would be substantially less than the value of the house...

### 66.16.2 *Derived property: benefit of loan*

Suppose T lends interest-free to a company which purchases the house and has no other assets. Initially the loan is fully derived property as the shares have no value. The loan derives its value from the house as, if the loan is called in, it could only be paid by the company:

(1) selling the house and using the proceeds of sale, or
(2) borrowing on the strength of the house (in the sense that no lender would lend if the company did not hold the house) and repaying out of that loan.

Can HMRC argue that:

(1) the loan derives its value from the contractual undertaking that obliges the company to repay; and so
(2) the loan does not derive its value from the underlying property (the house).

Point (1) is correct but point (2) does not follow and is not correct. It is the existence of the house which gives value to the contractual obligation to repay.

If the value of the house increases substantially, the shares and loan (taken together) are fully derived property and taken separately they are partly-derived property.

Unfortunately HMRC disagree. The CIOT Statement provides:

> 6.3 Clarification is requested on the position where a house is owned by a company but the company is funded by way of loan. The concern is over paras 11(1)(b) and 11(3)(b).
>
> **Example 9**
>
> [1] B owns 100 £1 shares in X Limited and otherwise funds it by shareholder loan.
>
> [2] (Or the house is owned by a company held within an interest in possession trust for B and again the funding for the purchase comes by way of loan from trustees to company.)
>
> X Limited buys the house in which B lives. B *prima facie* falls within the para 3 charge.

In fact HMRC accept that case [1] does not fall within the POA land charge because the interest free loan is not providing consideration.[32] The CIOT Statement continues:

> 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. However, our response to

32 See 66.6 ("Provide"). Over time HMRC have softened their stance on a number of POA issues by amending their website POA guidance. One drawback of CIOT/STEP statements of this kind is that they are not susceptible to the same process of reflection and informal easy amendment.

> Q32 above would no doubt be applicable here in appropriate circumstances.[33]

This is plainly wrong and I would be surprised if HMRC tried to defend it if seriously challenged.[34] Website POA Guidance qualifies this view if the loan is charged on the land:

> 1.3.2 ... For example if Mr B transfers his house to a company wholly owned by him, then provided there are no loans to the company one can say that the value attributable to the company is not less than the value of the house. ... If he has lent money to the company and the company holds the house we take the view that the company's value is less than the house unless (possibly) the loan is charged on the house.

The last sentence confuses the value of the loan with the value of the company.

The position is more complicated if T lends to a company which purchases the house and has other assets. Suppose, for example, the company's assets and liabilities consist of a house worth £1m, investments of £1m, and a debt of £1m. It is still plainly the case that the benefit of the debt and the shares taken together are fully derived property. It is suggested that if the debt is charged on the house it derives its value from the house, and if it is not charged then it does not do so (but the shares do derive their value from the house).

What if T lends to a trust which purchases a house? If the loan is on limited recourse terms[35] the loan is fully derived property. It is suggested that the same applies even if the trustees are personally liable for the loan.

### 66.16.3 *Derived property: equitable interests*

If T transfers property to a trust for A for life, remainder to T, T has a reversionary interest which is derived property. The interest is part of T's estate so the full (or partial) estate exemptions apply (depending on whether the value of the reversionary interest is equal to 80% or more of the value of the trust fund).

---

33 See 66.6 ("Provide").

34 But one could avoid the issue by avoiding loans, eg subscribe for redeemable shares, which are commercially equivalent to loans.

35 ie the trustees' liability to repay is restricted to the trust assets or their value.

It T transfers property to a trust for T for life, remainder to A, T's life interest is derived property but it does not form part of T's estate (after 2006) so the estate exemption does not apply.

## 66.17 Excluded liability rule

Para 11(6) Sch 15 FA 2004 provides a restriction on the estate exemptions:

> Where at any time the value of a person's estate for the purposes of IHTA is reduced by an excluded liability affecting any property...

I call this "**the excluded liability rule**". The effect of the rule if it applies is:

> ... that property is not to be treated for the purposes of sub-para (1) or (2) as comprised in his estate except to the extent that the value of the property exceeds the amount of the excluded liability.

The excluded liability rule only applies for the purposes of the estate and partial estate exemptions. The question of to what extent debts may limit the GWR exemption is discussed at 54.16 (GWR property subject to debt).

### 66.17.1 *"Excluded liability"*

The term "excluded liability" is defined in para 11(7) Sch 15 FA 2004:

> For the purposes of sub-para (6) a liability is an excluded liability if—
> (a) the creation of the liability, and
> (b) any transaction
>     [i] by virtue of which the person's estate came to include
>         [A] the relevant property or
>         [B] property which derives its value from the relevant property or
>     [ii] by virtue of which the value of property in his estate came to be derived from the relevant property,
> were associated operations, as defined by section 268 of IHTA.

I am unable to think of any liability affecting property which is not associated with the transaction within (b). The definition of associated operations is extremely wide. On a number of occasions where anti-avoidance provisions use the concept of "associated operations" restrictions have been read in by implication. The most recent is *Reynaud v IRC* [1999] STC (SCD) 185. This concerned a gift of shares followed by a sale of those shares, two associated operations. The case considered the definition of "transfer of value". That term includes "a disposition effected by associated operations" which reduces the value of an estate. The Special Commissioners held that associated operations were only relevant if they were part of a scheme contributing to the reduction of the estate. See the decision at [17]. However, the decision was not based on the definition of associated operations. On the contrary, it was accepted that operations which do not form part of a scheme could nevertheless be associated. It was the concept of "*disposition effected by associated operations*" which was held to refer only to operations which formed part of a scheme. That is, the restriction was implied by the context of s.3(3) IHTA, not by the words of s.268.

One could argue that the context of para 11(7) Sch 15 FA 2004 implies a restriction that only associated operations forming part of a scheme are relevant for the definition of excluded liability. This would have to be a purposive construction since the words are not in fact there in para 11(7) Sch 15 FA 2004. But we know that the purpose of para 11(7) Sch 15 FA 2004 is to *catch* double trust plans. The effect of this construction would be to *defeat* the intention of the legislation. The argument asks the Courts to frustrate the actual intention of the legislation. So the argument is unlikely to succeed.

### 66.17.2 *"Affecting" property*

The rule only applies to a liability which "affects" property. It is suggested that a liability of an individual or company does not affect property of the individual or company unless secured on that property. A liability of a company does not affect the shares of the company (even if it may reduce their value). A liability of a trust does affect the trust property since the trustees have a lien over the trust fund to meet the liability.

## 66.18 Value of estate "reduced" by liability

The excluded liability rule only applies if the value of a person's estate is "reduced" by a liability. In what circumstances does a liability reduce the value of an estate? Plainly it does not do so if it is disallowed for IHT.[36]

### 66.18.1 *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.)

### 66.18.2 *Bank borrowing*

What if T (or trustees of a trust in which T has an estate IP) borrow money from a bank or third party? It is considered that T's estate is not "reduced" by the liability, since T's 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 T's house, which would be absurd.[37]

### 66.18.3 *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 T's 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.

### 66.18.4 *Double trust schemes*

The excluded liability rule was intended to catch double trust schemes. Suppose:

(1) T sells T's home to a trust under which T has an interest in possession

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36 See 56.2 (Liability of individual).

37 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.

in return for a debt.

At this point the excluded liability rule does not apply. The liability is an excluded liability as defined.[38] However, the benefit of the debt is in T's estate. It is considered that the value of T's estate is not "reduced" by the liability.

(2) T gives the benefit of the debt to T's 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.

### 66.18.5 *HMRC view*

The CIOT Statement provides:

> 2.5 A common scenario (both for foreign and UK domiciliaries) is where cash is settled into an interest in possession trust for the donor life tenant. The trustees then buy a house for the donor to live in using the gifted cash plus third party barrowings. Although not a home loan scheme, the legislation appears to affect such arrangements.
>
> **Example 4**
>
> E settles cash of £200,000 into an interest in possession trust for himself in 2003. The trustees purchase a property worth £500,000, borrowing £300,000 from a bank. There are other assets in the trust which can fund the interest but the borrowing is secured on the house which E then occupies.
>
> In these circumstances, one would not expect a POA charge. There is no inheritance tax scheme since the property is part of E's estate and the borrowing is not internal. One would argue that E's estate still includes the house and therefore protection is available under para 11(1). The difficulty is that on one view the loan is an excluded liability within para 11(7) reducing E's estate, albeit it is a loan on commercial terms with a bank.
>
> We would argue that the relevant property for the purposes of para 11 is simply the value of the property net of the commercial borrowing. As this is part of E's estate there is no POA charge.

38 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.

**Question 13**
Is the above analysis correct?
**HMRC**
We agree with your analysis in para 2.5.

It is quite correct that one would not expect a POA charge, as there is no IHT saving. However, what is the correct analysis of the provisions in this situation? The loan is clearly an excluded liability. It is quite wrong to say that the *property* for the purposes of para 11 Sch 15 FA 2004 is its *value* net of the liability, because that confuses two entirely different things: property and the value of property. It is also wrong to say that the asset for the purposes of para 11 Sch 15 FA 2004 is the asset net of the liability; if one said 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).

## 66.19 Reverter to settlor restriction

The FA 2004 introduced a restriction to the estate and GWR exemptions:

> (11) Sub-para (12) applies where at any time—
> (a) the relevant property has ceased to be comprised in a person's estate for the purposes of IHTA 1984, or
> (b) he has directly or indirectly provided any consideration for the acquisition of the relevant property,
> and at any subsequent time the relevant property or any derived[39] property is comprised in his estate for the purposes of IHTA 1984 as a result of section 49(1) of that Act (treatment of interests in possession).
> (12) Where this sub-paragraph applies, the relevant property and any derived property—
> (a) are not to be treated for the purposes of sub-paras (1) and (2) as comprised in his estate at that subsequent time, and
> (b) are not to be treated as falling within sub-para (5) in relation to him at that subsequent time.

I refer to this (somewhat inaccurately) as the "**reverter to settlor**

39 Para 11(13) Sch 15 FA 2004 defines "derived property" in terms which repeat the wording of para 11(1)(b) Sch 15 FA 2004 verbatim.

**restriction**". The effect of para 11(12) Sch 15 FA 2004 is to disapply the estate exemptions and the GWR exemption.

EN FB 2006 explains:

> 17. [The POA] income tax charge was designed to discourage disposals done in a contrived way to avoid IHT. The income tax charge does not therefore apply when the original owner has the property back in their estate for IHT purposes (para 11(1) Schedule 15 – for example, because it has been given back to them), or when it is treated as back in their estate (para 11(5) – for example, because the original transaction is caught by the IHT "gift with reservation" rules).

After this loose and colloquial explanation, the EN continues:

> 18. There is a mismatch between this relief and an existing IHT exemption for the settled property in "reverter-to-settlor" trusts. The property in such a trust is treated as part of the trust beneficiary's estate for IHT purposes, but it is not actually charged when their interest ends.
> 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;[40]
> - for IHT purposes, B is therefore treated as owning the house by virtue of section 49 IHTA and so para 11(1) Schedule 15 disapplies the "pre-owned asset" charge;
> - however, although the house is part of B's estate for IHT purposes, there is no IHT charge on B's death by virtue of the exemption in section 54(1) IHTA.
>
> 21. This clause is aimed at blocking such avoidance by ensuring that the income tax exemption does not apply where the property in question (or any derived property) is back in the chargeable person's estate for IHT purposes by virtue of their being beneficially entitled to an interest in

40 Author's Note: This is not of course generally possible after 22 March 2006.

> possession in it.
> 22. However, the clause also provides that, if the chargeable person does not wish to be subject to the income tax charge, they can elect (like other former owners otherwise liable to the "pre-owned asset" charge) that the property should fall back into their estate for IHT purposes. Thus the clause ensures an effective IHT charge in these circumstances by providing that the exemptions in sections 53(3), 53(4) and 54 IHTA will not apply.

Unfortunately there is only a passing resemblance between the terms of para 11(11) Sch 15 FA 2004 and the EN. The reverter to settlor restriction applies wherever a person has an estate in property if:

(1) relevant property has ceased to be comprised in a person's estate; or
(2) they have 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 <u>any</u> trust set up between March 1986 and 22 March 2006 where the settlor has a qualifying interest in possession and would in that event be subject to inheritance tax on his death.
> These difficulties arise because paras 11(11) and 11(12) catch not only those transactions where land has been given away and ceased to be comprised in the settlor's estate and then comes back into his estate (condition a above). They also catch transactions where a settlor contributed funds or property to a trust and the trust (or an underlying company) has then used those funds or property representing them to buy the relevant property i.e. the land now occupied (condition b above). There is nothing in the words about "any subsequent time" which suggests that under (b) the property had first to cease to be comprised in his estate before being caught by this provision. Indeed if that was the case the words in (a) would be redundant.
> Are the following cases caught by POAT from 5 December 2005 (the date the change came into effect):

1. In 1987, A sets up an interest in possession trust for himself into which he gifts his house. If the house is still held by the trustees now there is no POAT charge because nothing has left his estate. However assume that the house has since been sold but he retains an interest in possession. The trust holds a mixture of investments and another house that A occupies. Is para 11(11)(b) satisfied on the basis that A has provided consideration for the acquisition of the land which land has subsequently become comprised in his estate. ...
2. B is a foreign domiciliary who before 22 March 2006 set up a discretionary trust into which he transferred cash. He remains a beneficiary of the trust. The trust then funds a company which buys a house or possibly holds UK investments (and B will pay income tax under [s720 ITA] in respect of any UK income). The trust was before 22 March 2006 converted into an interest in possession trust. If there are any UK intangibles or UK property occupied by A which are held by the trustees within the interest in possession structure he is now subject to POAT. Even if one reads "subsequent time" to mean some time must elapse between the date when the gift is made and the date the property comes back into B's estate this would still not protect B in this example because the trust was originally discretionary.
3. In June 2006, C, a disabled person, sets up a trust for himself that qualifies as a disabled person's interest within s89B IHTA. C puts in cash and the trustees invest in equities or a house that C occupies. C will pay POAT. ...

**HMRC response**

As I understand your concern, it is that the new para 11(11)(b) in Schedule 15 FA 2004 will catch someone who has settled, say, cash on interest in possession trusts for themselves (either before 22 March 2006, or afterwards if it is a "disabled person's interest") and subsequently occupies property bought by the trustees; or where the property they settled initially has been sold and replaced by other property, while the settlor has retained their interest in possession.

The new paragraph refers to the chargeable person "directly or indirectly [providing] any consideration for the acquisition of the relevant property", and goes on to require that, "at any subsequent time", the relevant property is comprised in the settlor's IHT estate by virtue of their having an interest in possession in it.

In our view, the words "at any subsequent time" should be read as meaning that a POA charge will arise where the consideration leaves the donor's estate, as a result of which that estate is reduced, and later property acquired with such consideration becomes comprised in it again because of their interest in possession. This is consistent with the reasons for Schedule 15.

We do not, therefore, consider that there will be a charge in the scenarios numbered 1 and 3 in your letters, because the assets transferred into trust and any derived assets have always been in the settlor's estate for IHT purposes. We believe that also applies if, in your second scenario, B set up an interest in possession trust from the outset before Budget Day. The taxpayer should self-assess on the basis that no POAT is due and there is therefore no need to put anything about POAT on the tax return or for him to make the election where the settlor has retained an interest in possession throughout and settled the cash or property directly into trust himself (rather than through any other funding vehicle such as another trust). This is because no POAT charge arises under s80 FA 2006.

In summary we do not consider that s.80 FA 2006 has any implications for:

- a settlement of cash on interest in possession trusts for onself made before 22 March 2006, or made by a disabled person on or after that date, after which the trustees purchase a property in which the settlor resides; or
- the settlement of a house in the same way, which is subsequently sold by the trustees and replaced by other investments or another property.

That remains our view, on the basis that the words "at any subsequent time" mean that new para 11(11)(b) Schedule 15 FA 2004 will only be relevant where:

- the consideration in question leaves the donor's estate, as a result of which that estate is reduced; and
- later, property acquired with such consideration becomes comprised in the estate once more by virtue of an interest in possession.

We do not agree that this interpretation makes para 11(11)(a) redundant, since that relates to cases where the disposal condition is met and para 11(11)(b) to cases where the contribution condition is met.

We accept that a POA charge may arise where someone set up a discretionary trust that has subsequently been converted into an interest in possession trust for the benefit of the settlor. (Scenario 2 in your example). However, it remains possible in those circumstances to elect out of the charge. So, take the following example:

- H settles a property on discretionary trusts before 22 March 2006;
- also before that date, the trust is converted into an interest in possession trust for H's benefic, with remainder to his wife, W;
- A POA charge therefore arises because of s.80 FA 2006 but H elects.

As we see it, the effects of the election are:

- the chargeable proportion of the property will be treated as subject to a reservation, but only so far as H is not beneficially entitled to an interest in possession in the property (*para 21(2)(b)(i), Schedule 15 FA 2004*) – i.e. not at all;
- section 102(3) and (4) FA 1986 will apply, but only so far as H is not beneficially entitled to an interest in possession in the property (*para 21(2)(b)(ii)*) – i.e. not at all; and
- the reverter-to-settlor exemptions in s.53(3) and (4) and s.54 IHTA will not apply to the actual interest in possession (*para 21(2)(b)(iii)*).

We do not, therefore, consider that the election affects the availability of spouse exemption on H's interest in possession on his death – or on its termination during his lifetime. That is because, as we have just noted, the election will not cause s.102(3) and (4) FA 86 to apply because of H's interest in possession, so there will be no deemed PET.

## 66.20 GWR exemptions

### 66.20.1 *Full GWR exemption*

Para 11(3) and (5) Sch 15 FA 2004 provide:

> (3) Paras 3, 6 and 8 do not apply to a person at a time when—
> (a) the relevant property, or
> (b) any other property—
> (i) which derives its value from the relevant property, and
> (ii) whose value, so far as attributable to the relevant property, is not substantially less than the value of the relevant property,
>
> falls within sub-para (5) in relation to him.
>
> ...
>
> (5) Property falls within this sub-paragraph in relation to a person at a time when it—
> (a) would fall to be treated by virtue of any provision of Part 5 of the 1986 Act (inheritance tax) as property which in relation to him is property subject to a reservation,
> (b) would fall to be so treated but for any of paras (d) to (i) of subsection (5) of section 102 of the 1986 Act (certain cases where disposal by way of gift is an exempt transfer for purposes of inheritance tax),
> (c) would fall to be so treated but for subsection (4) of section 102B of the 1986 Act (gifts with reservation: share of interest in land), or would have fallen to be so treated but for that subsection if the disposal by way of gift of an undivided share of an interest in land had been made on or after 9 March 1999, or
> (d) would fall to be so treated but for section 102C(3) of, and para 6 of Schedule 20 to, the 1986 Act (exclusion of benefit).

In short, the POA charges do not apply to property subject to a reservation. (“**GWR property**”).

I refer to this as “**the full GWR exemption**”.

The question of whether property is GWR property (subject to a reservation) is considered at 54.2 (Terminology).[41]

41 For this purpose para 11(8) Sch 15 FA 2004 tinkers with the GWR tracing rules: “In determining whether any property falls within sub-para (5)(b), (c) or (d) in a case where the contribution condition in para 3(3) or 6(3) is met, para 2(2)(b) of Schedule 20 [FA 1986] (exclusion of gifts of money) is to be disregarded.”

Note that property may be GWR property even though it is excluded property. Suppose:

(1) T transfers funds to a discretionary trust under which T is a beneficiary (a GWR).[42]
(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 66.25 (Former foreign domiciliary).

### 66.20.2 *Partial GWR exemption*

Para 11(4) Sch 15 FA 2004 provides:

> Where any property which falls within sub-para (5) in relation to a person includes property—
> (a) which derives its value from the relevant property, and
> (b) whose value, so far as attributable to the relevant property, is substantially less than the value of the relevant property,
> the appropriate rental value in para 4, the appropriate amount in para 7 or the chargeable amount in para 9 (as the case may be) is to be reduced by such proportion as is reasonable to take account of that fact.

I refer to this as the "**partial GWR exemption**". It is the equivalent of the partial estate exemption discussed above (except that the words at the end of the subsection are grammatical).

## 66.21 Full consideration exemption

The full consideration exemption in para 11(5)(d) Sch 15 FA 2004 applies where (in my paraphrase) the relevant property or derived property:

> would fall to be treated as property subject to a reservation but for s.102C(3) and Schedule 20 para 6 FA 1986.

---

The Website POA Guidance gives an example at 4.2.

42 The position is the same for a non-estate IP trust if T is the object of a wide power of appointment (so there is a GWR).

There are two exemptions here:[43]

(1) where the GWR rule would apply but for s.102C(3) FA 1986; and
(2) where the GWR rule would apply but for para 6 Sch. 20 FA 1986.

Section 102C is not discussed here. Para 6(1) Sch 20 FA 1986 provides two exemptions to the GWR rule. The first is:

> In determining whether any property which is disposed of by way of gift is enjoyed to the entire exclusion, or virtually to the entire exclusion, of the donor and of any benefit to him by contract or otherwise—
> (a) in the case of property which is an interest in land or a chattel, retention or assumption by the donor of actual occupation of the land or actual enjoyment of an incorporeal right over the land, or actual possession of the chattel shall be disregarded if it is for full consideration in money or money's worth ...

I call this the "**full consideration exemption**". This is particularly important in relation to chattels because full consideration would be much less than the deemed income charge. As to the meaning of "full consideration" see RI 55 and the published IR letter of 18 May 1987. At present HMRC argue that the industry standard 1% guideline as the market rent for chattels is too low.

The full consideration exemption only applies if there would otherwise be a GWR. If an individual has carried out an *Eversden* scheme, they will not qualify for the full consideration exemption even if they pay full consideration for use of the land (though the rent paid will reduce the quantum of the POA charge).

The second exemption in para 6(1)(b) Sch 20 is less likely to be important in practice.

## 66.22 Partnerships

Website POA Guidance provides:

> The treatment of a share of a partnership interest for Schedule 15

43 Another possible reading is that the exemption only applies if s.102C(3) and Sch 20 para 6 both apply, ie it is not enough that Sch 20 para 6 applies if s.102C(3) does not. But a close reading of s.102C shows that s.102C(3) and para 6 Sch 15 FA 2004 are alternatives. They cannot both apply. *Hansard* confirms this (if it were necessary): HC 7 July 2004 col.881, 900. The Website POA Guidance agrees.

> purposes follows that applied for IHT purposes. In other words, we do not regard the partnership interest as transparent, and the disposal of a share is unlikely to give rise to a Schedule 15 charge in any circumstances.

This is not a view which bears much examination. If a partnership holds land, a partnership interest is an interest in land, and a disposal of that interest meets the disposal condition.[44] But the legislation was not intended to catch partnerships and HMRC avoid the problem by informal concession dressed up as a statement of practice.

## 66.23 Non-resident taxpayer

Para 12(1) Sch 15 FA 2004 provides:

> This Schedule does not apply in relation to any person for any year of assessment during which he is not resident in the UK.

This is straightforward.

## 66.24 UK resident foreign domiciliary

Para 12(2) Sch 15 FA 2004 provides:

> Where in any year of assessment a person is resident in the UK but is domiciled[45] outside the UK, this Schedule does not apply to him unless the property falling within para 3(1)(a), 6(1)(a) or 8(1)(c) is situated in the UK.

This provides three exemptions:
(1) exemption to POA land charge where T occupies non-UK situate land;

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44 Contrast the original HMRC guidance (so called "Technical Guidance" 2004) which took the correct (if worrying) line that the POA rules in principle apply "if C, an existing partner, brings his son D into partnership"; see the 6th edition of this work, para 43.10.1.

45 "Domiciled" is defined in para 12(4) Sch 15 FA 2004:
" For the purposes of this paragraph, a person is to be treated as domiciled in the UK at any time only if he would be so treated for the purposes of IHTA."

(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.[46]

Para 12 Sch 15 FA 2004 does not provide exemption where T transfers assets to a non-UK company which holds UK land occupied by T. But the GWR or estate exemption will usually apply.

## 66.25 Former foreign domiciliary

Para 12(3) Sch 15 FA 2004 provides:

> In the application of this Schedule to a person who was at any time domiciled[47] 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[48] by virtue of section 48(3)(a) of that Act.[49]

The words "was at any time domiciled outside the UK" refer to a person who was formerly foreign domiciled but who has become UK domiciled. The words do not refer to a person who was and remains foreign domiciled. (The words in isolation could, taken literally, apply in such a case, but the word *was* in para 12(3) Sch 15 FA 2004 is to be contrasted with *is* in para 12(2) Sch 15 FA 2004.)

Suppose:

(1) T (not UK domiciled) creates a discretionary trust of which T is a beneficiary;
(2) The trust holds:
    (a) Non-UK investments.
    (b) A company holding UK property occupied by T.

At this point, the conditions for the POA intangible property charge and the POA land charge are satisfied but the GWR exemption provides relief

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46 The exemption (anonymously) does not apply to exempt gilts and AUTs or OEICs which may be excluded property but which are UK situate.

47 See above footnote.

48 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.

49 The exemption (anonymously) does not apply to exempt gilts and AUTs or OEICs which may be excluded property, but not under s.48(3)(a) IHTA.

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.[50] This was certainly not foreseen at the time the legislation was passed. It is suggested that para 12(3) Sch 15 FA 2004 is, like a deeming provision, to be construed to have effect so far as intended but it was not intended to disapply the GWR and estate exemptions. The modern purposive approach to construction of tax statutes may on this occasion assist the taxpayer. The 17 March 1986 POA start date supports this view. That date shows that the object of the rules is to prevent GWR avoidance, not other kinds of IHT mitigation.

HMRC agree with this view. The CIOT Statement provides at para 7:

> Para 12(3) states that no regard is to be had to excluded property. In a case where a trust settled by a foreign domiciliary owns a UK house through a foreign registered company the shares in the company (and any loan to the company) are excluded property. Concern has been expressed that since para 12(3) says that no regard is to be had to these assets, this in turn means that the shares and loan have to be ignored in applying para 11 and in particular cannot be taken into account in determining whether there is derived property which is in the taxpayer's estate or GWR property in relation to him (which the shares and loans otherwise are). We think that this argument is misconceived but it has been advanced.
>
> **Question 42**
>
> Can HMRC confirm that they agree para 12(3) does not operate in this way and that para 11 can still work to protect the UK house or underlying assets owned by the offshore company in these circumstances?

50 A further tax charge would arise if (as some have argued) T is also caught by the GWR rules on his death; see 54.12 (GWR death charge: excluded property rules for settled property).

> *HMRC*
> We agree with what you say in para 7.1 about the interaction between paras 12(3) and 11.

Website POA Guidance provides at 4.1:

> Para 12(3) of the schedule provides that if any property situated outside the UK became comprised in a settlement when the person settling the property was domiciled outside the UK it will not be subject to the charge. Even if that person becomes domiciled in the UK at a later date this property will remain excluded from the charge.
> Para 12(3) provides that a charge under this Schedule shall not arise in relation to property regarded as excluded by virtue of section 48(3) IHTA'84. We do not regard this provision as having an impact on para 11 in determining whether there is derived property in the taxpayer's estate, or GWR property in relation to him (see foreign domiciliary example in appendix).

## 66.26 Quantum of charge – land

We find the usual cascade of definitions. Para 3(5) Sch 15 FA 2004 provides:

> Where this paragraph applies to a person in respect of the whole or part of a year of assessment, an amount equal to the chargeable amount determined under para 4 is to be treated as income of his chargeable to income tax.

### 66.26.1 *The chargeable amount and deductible expenses*

One therefore turns to para 4 Sch 15 FA 2004 to find the quantum of the charge. Para 4(1) Sch 15 FA 2004 provides:

> For any taxable period[51] the chargeable amount in relation to the relevant land is
> [a] the appropriate rental value ... less

51 "Taxable period" is defined in a commonsense way in para 4(6) Sch 15 FA 2004:
"In this paragraph—
'the taxable period' means the year of assessment, or part of a year of assessment, during which para 3 applies to the chargeable person."

[b] the amount of any payments which, in pursuance of any legal obligation, are made by the chargeable person during the period to the owner of the relevant land in respect of the occupation of the land by the chargeable person.

To obtain a deduction requires good paperwork:
(1) a legal obligation; and
(2) payment to the owner of the relevant land.
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)?

66.26.2 *"The appropriate rental value"*

This is defined in para 4(2) Sch 15 FA 2004. This provides:

The appropriate rental value is $R \times (DV \div V)$

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.

66.26.3 *"Rental value"*

R is the rental value of the relevant land for the taxable period. "Rental value" is defined in the same manner as the income tax benefit in kind rule: it means the "annual value". The "annual value" is in turn defined in para 5 Sch 15 FA 2004. That is copied from s.110 ITEPA, except that s.110(3), (4) are omitted. It is here called "the POA Annual Value". The POA Annual Value is defined as the rent which will be payable *on the assumption that the landlord (rather than the tenant) pays for all repairs and insurance*. The normal market rent will be lower than the POA Annual Value, because market practice is that the *tenant* pays the cost of repairs and insurance. The difference between POA annual value and normal market rent will vary from one property to another. The difference would be greater with large properties which are expensive to maintain and insure. In relation to other benefits in kind provisions, such as s.87 and s.731, 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 amount of 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.[52] 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.

### 66.26.4 *The proportion (DV ÷ V)*

The key expression is DV. Para 4(2) Sch 15 FA 2004 provides:

> DV is—
> (a) in a case falling within para 3(2)(a)(i),[53]
> [i] the value as at the valuation date of the interest in the relevant land that was disposed of as mentioned in para 3(2)(b) by the chargeable person or,
> [ii] where the disposal was a non-exempt sale, the appropriate proportion of that value,
> (b) in a case falling within para 3(2)(a)(ii),[54]
> [i] such part of the value of the relevant land at the valuation date as can reasonably be attributed to the property originally disposed of by the chargeable person or,
> [ii] where the original disposal was a non-exempt sale, to the appropriate proportion of that property, and
> (c) in a case falling within para 3(3),[55] 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.

52 See 65.14.1 (“Rental value of the accommodation”).
53 ie disposal condition (i), see 66.4.1 (Disposal condition (i)).
54 ie disposal condition (ii), see 66.4.2 (Disposal condition (ii)).
55 ie the contribution condition, see 66.5 (The contribution conditions).

The drafter does not deal with a case falling within the disposal and the contribution condition, eg if the individual disposes of an interest in a contract to purchase land to another person and also provides the purchase price.

### 66.26.5 *(DV÷V) and the valuation date*

The valuation date is determined by the 2005 POA Regulations. The Consultation Document "Taxation of Pre-Owned Assets: Further Consultation" 16 August 2004 explains:

> 5. In the case of land, the "cash equivalent" of enjoyment in a particular tax year is derived from market rental that would be paid for use of the land over the "taxable period" (that is, the tax year or any shorter period for which the asset is "caught" by Schedule 15). This figure is then scaled down, in cases where the taxpayer's "stake" in the caught asset is less than 100 per cent, in the proportion DV/V, where V is the value of the whole asset on the "valuation date" for the year, and DV is the value reasonably attributable to the taxpayer on that date. In many cases, however, we would expect that taxpayers and their advisors will be able to establish the ratio DV/V from the surrounding circumstances without necessarily establishing the absolute amount of V or DV.

### 66.26.6 *Non-exempt sale*

Para 4(4) Sch 15 FA 2004 provides a relief for a "non-exempt" sale. Para 4(4) Sch 15 FA 2004 begins with the definition of this term:

> The disposal by the chargeable person of an interest in land is a "non-exempt sale" if (although not an excluded transaction) it was a sale of his whole interest in the property for a consideration paid in money in sterling or any other currency;

The label ("non-exempt sale") is chosen, presumably, because the sale is not an excluded transaction. (Perhaps "non-excluded sale" would have been clearer.)

The relief is given by the method of re-defining "the appropriate proportion" to a smaller amount. Para 4(4) Sch 15 FA 2004 continues:

> and, in relation to a non-exempt sale, "the appropriate proportion" is

$(MV–P) \div MV$
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.

## 66.27 Quantum of charge – chattels

Para 6(5) Sch 15 FA 2004 provides:

> Where this paragraph applies to a person in respect of the whole or part of a year of assessment, an amount equal to the chargeable amount determined under para 7 is to be treated as income of his chargeable to income tax.

### 66.27.1 *The chargeable amount*

Para 7(1) Sch 15 FA 2004 provides:

> For any taxable period the chargeable amount in relation to any chattel is
> [a] the appropriate amount (as determined under sub-para (2)),
> [b] less the amount of any payments which, in pursuance of any legal obligation, are made by the chargeable person during the period to the owner of the chattel in respect of the possession or use of the chattel by the chargeable person.

This follows the format of the POA land charge.

### 66.27.2 *The appropriate amount*

Para 7(2) Sch 15 FA 2004 provides:

> The appropriate amount is $N \times (DV \div V)$

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[56] if interest were payable at the prescribed rate on an amount equal to the value of the chattel [at][57] the valuation date,

DV is—

(a) in a case falling within para 6(2)(a)(i),

[i] the value as at the valuation date of the interest in the chattel that was disposed of as mentioned in para 6(2)(b) by the chargeable person or,

[ii] where the disposal was a non-exempt sale,[58] the appropriate proportion of that value,

(b) in a case falling within para 6(2)(a)(ii),

[i] such part of the value of the chattel at the valuation date as can reasonably be attributed to the property originally disposed of by the chargeable person or,

[ii] where the original disposal was a non-exempt sale, to the appropriate proportion of that property, and

(c) in a case falling within para 6(3), such part of the value of the chattel at the valuation date as can reasonably be attributed to the consideration provided by the chargeable person, and

V is the value of the chattel at the valuation date.

## 66.28 Quantum of charge – intangible property

Para 8(3) Sch 15 FA 2004 provides:

> Where this paragraph applies in respect of the whole or part of a year of assessment, an amount equal to the chargeable amount determined under para 9 is to be treated as income of the chargeable person chargeable to income tax.

### 66.28.1 *The chargeable amount*

Para 9(1) Sch 15 FA 2004 provides:

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56 Para 7(5) Sch 15 FA 2004 provides that "the taxable period" means the year of assessment, or part of a year of assessment, during which para 6 Sch 15 FA 2004 applies to the chargeable person.

57 The statute erroneously reads "as".

58 Non-exempt sale is defined in para 7(3) Sch 15 FA 2004 following the form of the POA land charge: see 66.26.6 (Non-exempt sale).

> For any taxable period the chargeable amount in relation to the relevant 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[59] if interest were payable at the prescribed rate on an amount equal to the value of the relevant property at the valuation date, and
>
> T is the amount of any income tax or capital gains tax payable by the chargeable person in respect of the taxable period by virtue of any of the following provisions—
> (a) section 461 [ITTOIA],
> (b) section 624 [ITTOIA],
> (c) sections 720 to 730 [ITA],
> (d) section 77 [TCGA], and
> (e) section 86 [TCGA],
> so far as the tax is attributable to the relevant property.

Setting notional income against tax is penal and bizarre, but then, the POA charge is penal and bizarre.

There is no provision for carry forward or back if T exceeds N (but that will be rare).

If foreign income is unremitted and no tax is paid because of the s.624 remittance basis, it is considered that the amount of T is nil.

### 66.28.2 *The valuation date*

Para 9 Sch 15 FA 2004 continues:

> (2) Regulations may, in relation to any valuation date, provide for a valuation of the relevant property by reference to an earlier valuation date to apply subject to any prescribed adjustments.
> (3) In this paragraph—
> ...
> "the valuation date", in relation to a year of assessment, means such date as may be prescribed.

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59 Para 9(3) Sch 15 FA 2004 provides:

> "'the taxable period' means the year of assessment, or part of a year of assessment, during which para 8 applies to the chargeable person".

The date is prescribed in the 2005 POA Regulations.

## 66.29 Overlap of land and intangible property charges

Para 18 Sch 15 FA 2004 provides:

> *Persons chargeable under different provisions by reference to same property*
> (1) Where, in any year of assessment, a person ("the chargeable person") is (apart from this paragraph) chargeable to income tax both—
> (a) under para 3 (land) or para 6 (chattels) by reason of his occupation of any land or his possession or use of any chattel, and
> (b) under para 8 (intangible property) by reference to any intangible property which derives its value (whether in whole or part) from the land or the chattel,
> he is to be charged to income tax under whichever provision produces the higher chargeable amount in relation to him.
> (2) Where sub-para (1) applies, only the amount under the paragraph under which he is chargeable is to be taken into account in relation to the chargeable person for the purposes of para 13(2).

## 66.30 Interaction with benefit in kind charge

Para 19 Sch 15 FA 2004 provides:

> Where, in any year of assessment, a person is (apart from this paragraph) chargeable, in respect of his occupation of any land or his possession or use of any chattel, to income tax both—
> (a) under this Schedule, and
> (b) under Part 3 of ITEPA,
> the provisions of that Part shall have priority and he shall not be chargeable to income tax under this Schedule, except to the extent that the amount chargeable under this Schedule exceeds the amount to be treated as earnings under that Part.

## 66.31 *De minimis* exemption

The Press Release announcing the POA regime promised "a substantial *de minimis* exemption" (*sic*). This turns out to be £5,000 per annum. Para 13 Sch 15 FA 2004 provides:

> (1) This paragraph applies where, in relation to any person who would (apart from this para) be chargeable under this Schedule for any year of assessment, the aggregate of the amounts specified in sub-para (2) in respect of that year does not exceed £5,000.
> (2) Those amounts are—
> (a) in relation to any land to which para 3 applies in respect of him, the appropriate rental value as determined under para 4(2),
> (b) in relation to any chattel to which para 6 applies in respect of him, the appropriate amount as determined under para 7(2), and
> (c) in relation to any intangible property to which para 8 applies in respect of him, the chargeable amount determined under para 9.
> (3) Where this para applies, the person is not chargeable for that year of assessment under any of the following provisions—
> (a) para 3(5) (land),
> (b) para 6(5) (chattels), or
> (c) para 8(3) (intangible property).

This is significant if annual value is (contrary to my expectation) construed by concession to mean rateable value. It could also be significant where husband and wife entered into IHT planning arrangements jointly, since each have their own separate allowance. The exception applies to the "appropriate rental value", so deductible expenses are not relevant. Another problem here is that the £5,000 limit must be satisfied every year. It is not likely that the "substantial" £5,000 figure will be raised in line with inflation. The *de minimis* limit is not time apportioned so the full £5,000 can be set against a much shorter period of deemed income.

It is therefore necessary to ascertain "the appropriate rental value". That takes us to para 4(2) Sch 15 FA 2004:

> The appropriate rental value is R×(DV/V) where
> R is the rental value of the relevant land *for the taxable period*

The "taxable period" is defined in para 4(6) Sch 15 FA 2004:

> "the taxable period" means the year of assessment, or part of a year of assessment, during which para 3 applies to the chargeable person.

Thus it seems clear that if para 3 Sch 15 FA 2004 only applies for part of the year, the taxable period is reduced, so R is reduced, so the "appropriate rental value" is reduced and so (carrying the chain to the end) the *de* *minimis* exemption may apply. Note that the estate exemption in para 11(1) Sch 15 FA 2004 disapplies para 3 Sch 15 FA 2004: see para 11(1) Sch 15 FA 2004.

## 66.32 Election out of POA regime

One can elect out of the POA charges at an IHT cost. Para 21 Sch 15 FA 2004 deals with the POA land and chattels charges. Para 22 Sch 15 FA 2004 deals with intangible property. They are not quite the same but for reasons of space I shall only cover the former.

### 66.32.1 *Conditions for election*

Para 21(1) Sch 15 FA 2004 provides

> This paragraph applies where—
> (a) a person ("the chargeable person") would (apart from this paragraph) be chargeable under para 3 (land) or para 6 (chattels) for any year of assessment ("the initial year") by reference to his enjoyment[60] 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.

### 66.32.2 *Effect of election*

Para 21(2) Sch 15 FA 2004 provides:

> The chargeable person may elect in accordance with para 23 that—
> (a) the preceding provisions of this Schedule shall not apply to him

60 "Enjoyment" is defined in para 21(4) Sch 15 FA 2004:
"For the purposes of this paragraph a person 'enjoys' property if—
(a) in the case of an interest in land, he occupies the land, and
(b) in the case of an interest in a chattel, he is in possession of, or has the use of, the chattel."

> during the initial year and subsequent years of assessment by reference to his enjoyment of the relevant property or of any property which may be substituted for the relevant property ...

This disapplies Schedule 15. The price is in sub-para (b):

> ..., but
> (b) so long as the chargeable person continues to enjoy the relevant property or any property which is substituted for the relevant property—
> (i) the chargeable proportion of the property is to be treated for the purposes of Part 5 of FA 1986 (in relation to the chargeable person) as property subject to a reservation, but only so far as the chargeable person is not beneficially entitled to an interest in possession in the property,
> (ii) section 102(3) and (4) of that Act shall apply, but only so far as the chargeable person is not beneficially entitled to an interest in possession in the property, and
> (iii) if the chargeable person is beneficially entitled to an interest in possession in the property, sections 53(3) and (4) and 54 of IHTA 1984 (which deal with cases of property reverting to the settlor etc) shall not apply in relation to the chargeable proportion of the property.

Suppose a former foreign domiciliary makes an election in relation to a discretionary trust of which they are a beneficiary and the property is excluded property. How does s.102(3) apply? See 54.12 (GWR death charge: excluded property rules for settled property).

### 66.32.3 *The chargeable proportion*

This takes us to the definition of "chargeable proportion" in para 21(3) Sch 15 FA 2004:

> In this paragraph, "the chargeable proportion", in relation to any property, means DV ÷ V
> where DV and V are to be read in accordance with para 4(2) or 7(2), as the case requires, but as if—
> (a) any reference in para 4(2) or 7(2) to the valuation date were a reference—
> (i) in the case of property falling within subsection (3) of section

102 of the Finance Act 1986, to the date of the death of the chargeable person, and
(ii) in the case of property falling within subsection (4) of that section, to the date on which the property ceases to be treated as property subject to a reservation, and
(iii) in the case of property in which the chargeable person is beneficially entitled to an interest in possession, to the date of his death or if his interest comes to an end on an earlier date) that earlier date, and
(b) the transactions to be taken into account in calculating DV included transactions after the time when the election takes effect as well as transactions before that time.

I do not see the purpose or effect of para 21(3)(b) Sch 15 FA 2004. How does this work in the case of an *Ingram* scheme?

66.32.4 *Time limit for election*

Para 23(3) Sch 15 FA 2004 provides:

> The election must be made on or before—
> (a) the relevant filing date, or
> (b) such later date as an officer of Revenue and Customs may, in a particular case, allow..

The key expression is "relevant filing date" which is defined in para 23(1) Sch 15 FA 2004:

> "the relevant filing date" means 31 January in the year of assessment that immediately follows the initial year within the meaning of para 21 or (as the case requires) para 22.

Time runs from when the Schedule begins to apply. Normally that will be 6 April 2005,[61] because in the future no-one will deliberately enter into arrangements caught by the Schedule. But where a person is non-resident or domiciled, the Schedule may not begin to apply until a later time when they become UK resident or domiciled, and in such a case time for the

61 Or 6 April 2007 for those caught by the reverter to settlor restriction in the FA 2006; see 66.19 (Reverter to settlor restriction).

election starts at that later time; a sensible rule. The Website POA Guidance discusses when a late election is accepted at 3.4.

### 66.32.5 *Revocation of election*

Para 23(5) Sch 15 FA 2004 provides:

> The election may be withdrawn or amended, during the life of the chargeable person, at any time on or before the relevant filing date.

This will only be useful in very exceptional circumstances.

### 66.32.6 *Retrospective effect of election*

Para 23(6) Sch 15 FA 2004 provides:

> Subject to sub-para (5), the election takes effect for the purposes of inheritance tax from the beginning of the initial year within the meaning of para 21 or (as the case requires) para 22 or, if later, the date on which the chargeable person would (but for the election) have first become chargeable under this Schedule by reference to the property to which the election relates.

## 66.33 Election and *Eversden* schemes

If a client has lost their 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.

## 66.34 Election in case of double trust schemes

Suppose:

(1) The client ("H") has entered into a double trust plan: H has sold H's 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 H's widow ("W") after H's 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.

66.34.1 *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 H 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 H's 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.

66.34.2 *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.

## 66.35 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 66.26.1 (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.[62] Consider it if IHT is a long term problem (middle-aged clients). Perhaps a future Conservative government will scrap these rules in a decade or so's time?

It may be sensible to elect and retain the structure where:

(1) IHT is not a problem (eg 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

62 See 54.17 (IHT spouse exemption defence to GWR death charge).

66.6.4 (Secondhand company).

In most cases shadow directorship may be a problem; it will usually be better to liquidate the company if IHT, CGT and SDLT issues permit.

Best solution is usually unwinding, or reorganising so as to fall within the estate exemption.

## 66.36 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, they 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.

## 66.37 Commentary

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 their own property[63] then it is anomalous to charge income tax on the benefit of occupation through a trust or company. And since the POA intangible property charge applies even if the property also produces taxed income, it is obviously not income which Schedule 15 is seeking to tax.

The POA charge might be seen as an erratic *ersatz* annual IHT charge on property which has slipped through the IHT net. However, the quantum of the charge is penal (compared to IHT rates).

The true nature of the POA charge is that it is a penalty for carrying out 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.[64] 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

63 See Kay and King, *The British Tax System*, Clarendon Press (5th ed., 1990), p.80.

64 And to stop similar arrangements being made in the future.

a fee, levy or toll may in fact be a tax by another name.[65] 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.

One controversial aspect of the provisions is that they are retrospective in effect. (One should avoid semantic – indeed Orwellian – debate about the meaning of "retrospective" and look at the effect.) Retrospective legislation is pernicious when it entails liability for conduct which would have been different if the agent had known of the terms of the retrospective law. The POA rules are unashamedly targeted at taxpayers who have made the following arrangements since 1986:

(1) *Eversden*[66] schemes;
(2) *Ingram*[67] and similar shearing schemes;
(3) "double trust" schemes.

Those that carried out *Ingram* schemes were particularly unfairly treated. They entered into a package with an IHT advantage (generally) at a significant CGT cost. Parliament removed the benefit and left them with the cost.

In 2004 I said:

> This is unprecedented in the UK tax system, which has traditionally allowed taxpayers to plan their affairs more securely on the basis of the law of the day. One may approve of this as an attack on tax avoidance, or disapprove as contrary to the rule of law. Views may divide on party political lines.

Since 2004, however, retrospective tax legislation has become a matter of routine, having been applied to a somewhat arbitrary selection of tax avoidance cases and or simply as second thoughts to (what the need for retrospective legislation shows to be) ill thought out legislation.

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

65 *Re a By-law of the Auckland City Council* [1924] NZLR 907 at p.911.
66 *IRC v Eversden (Greenstock's Executors)* 75 TC 340.
67 *Ingram v IRC* [1999] STC 37.

had worked it out as the provisions were frantically amended and re-amended.

No doubt the POA rules 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.

Back in 2004, everyone who understood and cared about the UK tax system was aghast at the conception, enactment process and administration of the POA provisions.[68] Looking back with hindsight it can be seen that the provisions were not an aberration. They are the natural result of a fiscal policy with one and only one priority, the attack on tax avoidance, set against which any other *desiderata* of a tax system counted for very little and views of practitioners counted for nothing at all. The interesting question now is to what extent this approach will continue under the new government. Only time will tell.

68 "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 SIXTY SEVEN

# ESTATES OF DECEASED PERSONS - CGT

## 67.1 Succession law background

On the death of a person domiciled in England and Wales ("**the deceased**") their property passes to their personal representatives ("**PRs**").[1] The PRs 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". Thus on completion of the administration, the residuary legatee becomes entitled to the assets of the estate, and any income which the PRs have not expended in the course of administration. It is possible for PRs to assent specific assets before completion of administration.

During the period of administration, the PRs alone are said to be entitled to the assets which are comprised in the estate. The beneficiaries of the estate have the right to compel due administration of the estate, but it has been repeatedly held by courts of the highest authority that the beneficiaries have no legal or equitable interest in the assets of the estate.[2] Special taxation rules apply during this period of administration. The interplay of the rules produces some curious results where the deceased or a beneficiary is a remittance basis taxpayer or non-resident. There can sometimes be considerable scope for tax planning.

I consider CGT and in the following chapter income tax.

The starting point is that PRs are "persons" (though not "individuals")

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1 Further consideration is needed if a foreign law applies: see 67.11 (Succession governed by foreign law).

2 *Lord Sudeley v Attorney-General* [1897] AC 11; this (rather odd) principle was re-affirmed in *CSD v Livingston* [1965] AC 694.

so they are in principle subject to IT and CGT.

Similar issues arise where charities are beneficiaries of estates, as to which see Kessler & Brown, *Taxation of Charities and Non-Profit Organisations,* (8th ed., 2011) Chapters 31 and 32 (Estates of deceased persons).

### 67.1.1 *When is administration of estate completed?*

How long does the administration period last? This is a question of succession law, not tax law, but it often arises in tax contexts, including income tax, CGT, and estate duty, and has given rise to a substantial case law.

In *IRC v Aubrey Smith* 15 TC 661 Lord Hanworth MR said at p.672:

> In Lord Sudeley's case, [1897] AC at page 15, Lord Halsbury, then Lord Chancellor, says this:
>
> > The thing that the legatee was entitled to was one-fourth share of a residuary estate, consisting, it may be, of many things; and I think it was fallacious on the part of [counsel] 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. It remains 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 Tax Tribunal.

The CG Manual (published 7/94) provides:

> **30700 Period of administration**
> The period during which the PRs are settling the estate is called a period of administration. The period starts with the death of the deceased person. The date on which it ends is a question of fact which is often difficult to resolve. During this period the liability for Capital Gains Tax on sales of assets from the estate falls on the personal representatives unless they have taken specific steps to vest the ownership of the assets involved in legatees in advance of the sale, see CG30910.
> **30701 Attitude of courts**
> On questions of when administration is complete the Courts look for a construction of the law that leads to an early conclusion of administration. The leading case in this respect is *IRC v Aubrey Smith* 15 TC 661.
> **30702 Period of administration: Attitude of courts**
> 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 Period of administration Courts: attitude**

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 Confusion over terminology**

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.

**30780 Necessary to establish if residue ascertained**

There are a number of circumstances where it is important to establish whether residue has been ascertained, see CG30700, because it significantly affects the amount of Capital Gains Tax payable. Depending on the circumstances, the personal representatives and legatees may be arguing for residue having been ascertained at an early date or at a late date.

**30781 Early date**

Claims are sometimes made that administration has ceased and residue has been ascertained at an early date where disposal of assets have been made and the legatee under the will or intestacy is

- a charity that is exempt from tax or
- a taxpayer or taxpayers with unused annual exemption(s) that could be used to cover the whole or part of the gains arising.

**30782 Early date**

In the case of an intestacy the second of these categories may also be seen. The question of gifts to charity however will only arise in cases of intestacy if there has been a subsequent variation of the devolution of the estate since no charity will otherwise qualify as a legatee.

**30783 Early date**

Applying the rule that assets remain vested in the personal representatives until residue has been ascertained unless specific steps have been taken to vest the assets in advance of ascertainment of residue usually defeats unwarranted claims in this area.

**30790 Late date**

In contrast to the cases described in CG30781+ claims that there has been an extended period of administration are sometimes made when

- the legatee would be liable at the higher rate of tax as opposed to the basic rate applying for personal representatives, [This does not apply from 2008]
- the legatee has used his or her annual exemption against other gains but the personal representatives have unused annual exemption which could be set against the gains (although obviously there is little tax at stake in cases in this latter category).

**30791 Late date**

In considering such claims obtain the facts to establish precisely when residue was ascertained. In this context see also CG30840.

**30800 How residue is ascertained**

In order to ascertain residue the personal representatives must identify all the assets and liabilities of the estate. They then need to quantify these.

**30801 How residue is ascertained**

In the case of taxation liabilities this process will, in the first instance, involve agreeing with the Inspector the Income Tax and Capital Gains Tax positions to the date of death. If any income arises to the personal representatives or if they realise any chargeable gains during the period of administration they will also need to agree their liabilities relating to this period.

**30802 How residue is ascertained** [January 2010]

As far as Inheritance Tax is concerned the personal representatives will need to agree with CAR - IHT (formerly the Capital Taxes Office) whether any liability arises and if so in what amount. When seeking a grant of probate or letters of administration (or, in Scotland, a confirmation) the personal representatives have to supply CAR - IHT with a provisional computation of the Inheritance Tax due.

CAR - IHT will review this and, where necessary, check valuations. When it is either agreed there is no liability to Inheritance Tax or the amount has been quantified CAR - IHT will issue a clearance certificate. We would not normally accept that residue had been ascertained at a date before the date of issue of a clearance certificate.

**30810 Providing funds**

When the assets and liabilities have been quantified the personal representatives have to consider how they can pay

- the estate's liabilities and
- any pecuniary legacies provided for in the will.

**30811 Providing funds**

If they do not have sufficient liquid funds they will have to sell assets in order to raise funds. (Occasionally they may agree with legatees entitled to pecuniary legacies that the legatee should accept an asset in satisfaction or part satisfaction of the pecuniary legacy).

**30812 Providing funds**

Disposing of assets may give rise to further Capital Gains Tax liabilities which have to be agreed before residue can be ascertained.

**30813 Providing funds**

Residue is only ascertained when the personal representatives have both established the net worth of the estate and provided the liquid funds to pay liabilities and pecuniary legacies. Once that point is reached residue is ascertained and it is irrelevant that the assets have not been distributed.

**30820 Executor's year**

For estates in England and Wales, the personal representatives cannot be compelled to distribute the assets of the estate until at least one year has elapsed from the date of death (Section 44 Administration of Estates Act 1925). This is commonly referred to as the executor's year.

**30821 Executor's year**

When dealing with a dispute about whether a disposal was by personal representatives in that capacity or in their capacity as bare trustees for legatees we would not normally contend that the disposal was on behalf of the legatees if it took place during the executor's year.

**30822 Executor's year**

Although personal representatives cannot be compelled to distribute assets during the executor's year there is no bar to them doing so. In a simple estate they may have ascertained residue well before the year ends. If there is evidence that they have done and have then distributed assets to the legatees we can accept that the liability relating to disposals during that year but after the date assets were distributed does lie with legatees.

**30830 Scotland**

In Scotland the rule is that the personal representatives are entitled to distribute the estate after six months from the deceased's death if they have provided funds for payment of all the estate debts and made reasonable enquiries for claims.

**30840 Claims of prolonged administration**

When personal representatives claim that administration has continued for a prolonged period and either

- this will significantly affect the tax payable, see CG30781or
- there are likely to be collection difficulties making it vital to ensure that assessments are made on the correct person the claim should be critically examined.

**30841 Claims of prolonged administration**

Unless it is an exceptional case where there are good reasons for accepting that the period of administration must be extended beyond the date residue is ascertained, see CG30710 – CG30712, you should seek the full facts to enable you to determine when residue became ascertainable. You should then argue that the beneficial ownership of the assets vested in the legatees at that date. As stated in CG30701 the attitude of the Courts is to look for an interpretation that allows administration to be completed at an early date.

**30850 Unquantified debts**

One claim that is sometimes met is that there is an unquantified debt preventing residue being ascertained. This may not be sufficient to prevent the administration period being treated as at an end. Such a situation was considered in *IRC v Sir Aubrey Smith* 15 TC 661. Lord Hanworth commented at page 674

> For my own part I think the question of a mortgage debt or any other debt must take its proper place in perspective. It may be in some cases that that is a factor from which a strong inference may be drawn. It may be on the other hand that the device of leaving a debt unpaid is resorted to in order to pretend that the residue of the estate has not been ascertained and is not ascertainable. If such a device were resorted to in any case it ought to be held ineffective'.

**30851 Unquantified debts**

When a Solicitor or other professional person is employed by the personal representatives to deal with the administration of the estate, his or her fees will be one of the estate's debts. Sometimes when personal representatives wish to extend the period of administration they arrange that the Solicitor, etc, does not submit a bill in respect of at least some part of his or her fees. They then argue that this has prevented ascertainment of residue and has caused the period of administration to be extended. Any such claim should be resisted on the basis of the above quotation. It should be contended that the information to quantify the bill must be in the Solicitor's records and that administration should therefore be considered to have ended.

### 67.1.2 *Importance of assents*

PRs transfer assets to beneficiaries by means of an "assent". The assent is fundamental, since a sale after an assent to a non-resident or a remittance basis taxpayer may in broad terms be free of CGT and a sale before assent may not. (Conversely a sale by non-resident PRs or PRs with losses may be CGT free and a sale after an asset may be taxable.)

An assent of land in England and Wales must be in writing. An assent of other property may be oral or implied by conduct. No formal written assent is required if (say) shares are simply transferred to the name of a beneficiary by stock transfer form. If a portfolio of shares is registered in the names of PRs (or their nominees), and the legatee wants them to be sold, it may be administratively convenient if an assent is made under which the PRs (or their nominees) become nominees for the legatee. Then the shares can be sold without CGT and without the formality of a transfer of legal title to the legatee.

## 67.2 Meaning of "PRs" for CGT

Section 288 TCGA provides:

> "personal representatives" has the same meaning as in the Corporation Tax Acts (see section 1119 of CTA 2010);

Se we turn to s.1119 CTA 2010 which provides a commonsense definition:

> "personal representatives", in relation to a person who has died, means—
> (a) in the UK, persons responsible for administering the estate of the deceased, and
> (b) in a territory outside the UK, those persons having functions under its law equivalent to those of administering the estate of the deceased.

This is the same as the Income Tax definition.[3]

## 67.3 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

3 See 68.1.1 (Meaning of PRs for IT). If we had a taxes-act-wide definition the repetition would not have been necessary. However it is an improvement on the position before 2009, where there were different definitions of "PRs" for IT and for CGT.

[b] that body shall be treated as having the deceased's residence, ordinary residence, and domicile at the date of death.

The residence and domicile of the PRs in their private capacity is irrelevant. The definition of "residence" for PRs is different for IT.[4]

## 67.4 Acquisition by PRs

Section 62(1) TCGA provides:

> For the purposes of this Act the assets of which a deceased person was competent to dispose—
> (a) shall be deemed to be acquired on his death by the personal representatives or other person on whom they devolve for a consideration equal to their market value at the date of the death, but
> (b) shall not be deemed to be disposed of by him on his death (whether or not they were the subject of a testamentary disposition).

This is the so-called tax-free uplift on death.

## 67.5 Transfer from PRs to beneficiaries

### 67.5.1 *Transfer from PRs to legatee*

Section 62(4) TCGA provides:

> On a person acquiring any asset as legatee (as defined in section 64)—
> (a) no chargeable gain shall accrue to the personal representatives, and
> (b) the legatee shall be treated as if the personal representatives' acquisition of the asset had been his acquisition of it.

Section 64(2) TCGA defines legatee:

> In this Act, unless the context otherwise requires,
> [a] "legatee" includes any person taking under a testamentary disposition or on an intestacy or partial intestacy, whether he takes beneficially or as trustee, and

4 See 68.2 (Residence of PRs for IT).

[b] a person taking under a donatio mortis causa shall be treated (except for the purposes of section 62) as a legatee and his acquisition as made at the time of the donor's death.

### 67.5.2 *Appropriation of assets to beneficiary*

Section 64(3) TCGA provides:

> For the purposes of the definition of "legatee" above, and of any reference in this Act to a person acquiring an asset "as legatee", property taken under a testamentary disposition or on an intestacy or partial intestacy includes any asset appropriated by the personal representatives in or towards satisfaction of a pecuniary legacy or any other interest or share in the property devolving under the disposition or intestacy.

Thus, if PRs appropriate assets in satisfaction of a pecuniary legacy, the beneficiary acquires as legatee. This is so even if the appropriation needs the consent of the beneficiary.[5]

If the PRs had no power of appropriation, then an "appropriation" could be authorised only on the basis that it was in fact a sale of the asset to a beneficiary coupled with a payment of the legacy by way of set-off. In that case, the beneficiary would acquire as purchaser and not as legatee. Fortunately, PRs will generally have a power of appropriation: see s.41 Administration of Estates Act 1925.

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5 Although for stamp duty purposes that the transfer of the asset to a legatee amounted to a conveyance on sale where the consent of the legatee is required: *Jopling v IRC* [1940] 2 KB 282. CCAB Statement June 1967 provided:

> "The Revenue stated that in their view [TCGA s.62(4)] does not apply in all cases where assets are transferred to beneficiaries in specie. Where assets are appointed by personal representatives to satisfy a legacy in circumstances where such appropriation requires the legatee's consent, ie where the personal representatives do not have (whether by the terms of the will or under the Administration of Estates Act 1925 s.41) powers of appropriation without consent, the Revenue are advised that the acquisition of the asset has a contractual basis and is not strictly an acquisition qua legatee. In practice, however, the disposal of appropriated assets by the personal representatives to a legatee in these circumstances is not treated as an occasion of charge on the personal representatives provided that both they and the legatee agree that the legatee should be treated as acquiring the assets concerned as legatee for the purposes of [TCGA s.62(4)]."

This was written before the enactment of what is now s.64(3) TCGA (by the FA 1969). This brought the law into line with what was formerly HMRC practice.

### 67.5.3 *Appointment to beneficiary by executors under overriding powers*

Where executors exercise a power to appoint trust property to a beneficiary, that beneficiary takes under the appointment "as legatee". This follows from the trust law principle that, for the purposes of the rules relating to perpetuities, where trustees exercise a power of appointment, the deed of appointment is read back into the original trust instrument. It is treated as coming into operation at the date of the instrument that creates the power.[6] This rule has been applied for tax purposes, in a different context, in *Chinn v Collins* the exercise of a power of appointment merely "fills in a blank in the original settlement which left blank how the final distribution of a trust asset was to be made".[7]

Quite apart from that, the beneficiary would take as "legatee" in the general sense of the expression. The definition in s.64(2) is inclusive and not a comprehensive definition. The reason that the beneficiaries take as legatee is that they acquire under an assent. They acquire from the PRs acting in their capacity as PRs.

This conclusion is consistent with the general scheme of the TCGA. A person who acquires under an appropriation acquires "as legatee". It would be anomalous if a person who acquired under an appointment would not. (A power of appropriation is sometimes regarded as a dispositive power: *Re Freeston* [1978] Ch 741, though I would not regard that as an essential point.)

In CG Manual 31432–3 (although one might quibble with the language used) it seems that HMRC accept that an appointee acquires as legatee.

## 67.6 Deceased not UK resident

If the deceased was not UK resident at the time of their death (regardless of domicile) the PRs are in principle outside the scope of CGT. The estate is therefore a CGT free vehicle. In principle, it would be desirable to arrange that gains accrue to PRs. If the PRs assent assets to UK residents who sell the assets, the gain on the disposal is chargeable in full or on the remittance basis. If the PRs assent assets to non-resident trustees, who sell the assets, the gain is a s.2(2) amount. (By contrast, assets with losses

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6 *Muir v Muir* [1943] AC 468; *Pilkington v IRC* 40 TC 416 at 441.

7 54 TC 311 at p.357.

should be transferred *in specie*.) It is also desirable to extend the administration period as long as possible.

### 67.6.1 *Is an estate a "settlement" within s.87 TCGA?*

Could gains accruing to non-resident PRs be s.2(2) amounts for the purposes of s.87 TCGA? That could only be the case if a deceased's estate is a "settlement" for the purposes of s.87. Section 97(7) TCGA provides:

> "settlement" has the meaning given by s.620 of ITTOIA ...

In this book this is called the "**settlement-arrangement**" definition of settlement.[8]

In *IRC v Buchanan* 37 TC 366 at p.374, Lord Goddard said:

> I do not think for a minute that a will of a testator comes within section 20[9] at all; it is not a settlement to which the Act applies.

Lord Goddard did not actually say that a will is not a settlement-arrangement but if that is what he meant, the comment was *obiter* and surprising. One might have thought that a deceased's estate is a "settlement" in the sense of "arrangement". There is an element of bounty in that the deceased 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.[10] Accordingly CG Manual is right to provide:

> **14590 Connected persons: Trustees** [August 2009]
> A will trust cannot be a Settlement for these purposes [for the purposes of the settlement-arrangement definition].

For this reason a deceased's estate is not a "settlement" within s.87.

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8 See 69.2.1 (Terminology) and 69.2.3 (Settlement-arrangement definition of "settlement").

9 Section 20 FA 1943, the predecessor of s.644 ITTOIA.

10 *Willingdale v Islington Green Investment Co* 48 TC 547 at p.556. (The point was not argued on appeal.)

This is in fact the sensible result. The scheme of s.87 is designed with trusts in mind and would not work well if extended to estates. An assent by PRs in favour of a beneficiary is not (without a stretch) a capital payment. If, as is common, a will left legacies to (UK resident) legatees, and the residue on trust, it would be odd if the legatees were subject to CGT under s.87 by reference to gains accruing to the trust. Similarly suppose a testator left their estate for such of their children as attain the age of 30, and at the time of death one child has and one has not reached that age. The executors would transfer half of the estate to the older child and (on completion of administration) hold the other half on trust for the younger child until it reached the vesting age. It would be odd if the older child were subject to CGT under s.87 by reference to gains accruing to the younger child's share of the trust.

Section 87(6) TCGA provides:

> For the purposes of this section a settlement arising under a will or intestacy shall be treated as made by the testator or intestate at the time of death.

The wording makes more sense if one remembers that it goes back[11] to a time when "settlement" for s.86 purposes meant CGT settlement. Thus there would be no doubt that a will trust was a settlement. However there would be doubt as to who was the settlor and when the settlement was made. These matters are resolved by (what is now) s.87(6). This is still needed since the identity of the settlor is relevant for s.87, though the relevance is now for transitional relief only.

Another effect of the provision now is to make it clear that a will trust is a settlement for the purposes of s.87.

Returning to the case above of a will trust for children at the age of 30: If one child is over 30, and receives its half share during the administration period, there is (at the time) no settlement and no capital payment, and s.87(6) does not retrospectively alter the position. If the trust fund is entirely distributed, no settlement ever comes into existence and s.87 does not operate. Similarly, suppose a discretionary will trust makes a distribution to a beneficiary during the administration period. There is (at the time) no settlement and no capital payment, and again it is considered that s.87(6) does not retrospectively alter the position. That is not the

11 The wording was previously in s.s.97(7) TCGA but moved in the 2006 reforms.

purpose of the deeming provision.

## 67.7 Gains accruing to non-resident company held by non-resident PRs

Suppose:
(1) PRs hold a non-resident company.
(2) The company disposes of an asset and realises a gain, which I call "the company gain".

### 67.7.1 *Position of company and PRs*

The company is not subject to tax on the company gain because it is not UK resident. The PRs are participators. But if they are not UK resident, they are not treated as if the company gain had accrued to them. The condition in s.13(2)[a] TCGA is not satisfied.

### 67.7.2 *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) a UK resident legatee would be subject to tax on the gain under s.13(2) TCGA; or
(2) a non-resident trust legatee would be treated as receiving a s.2(2) amount under s.13(10) TCGA?

The first question is whether, at the time the gain accrues to the company (while the estate is still in the course of administration) the legatee is a participator. Section 13(12) TCGA provides:

> In this section "participator", in relation to a company, has the meaning given by section 454 of CTA 2010.

A legatee is a participator under this definition.[12]

However s.13(3) TCGA (identifying the part of the chargeable gain which is deemed to accrue to the participator) provides:

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12 See 73.15.4 (Personal representatives and beneficiaries of estates).

> 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.

*Sudeley* and *Livingston*[13] decided that residuary[14] beneficiaries of an estate have no legal or equitable interest in the assets of the estate. They have the right to enforce its proper administration but that right is not properly described as an "interest" in the assets. It is therefore considered that during the course of administration the legatee does not have an "interest" as a participator.[15] Thus it does not matter that they are participators because nothing can be attributed to them under s.13.

The context can show that the word "interest" is to be understood in a loose or non-technical sense, in which case it might include the rights of a beneficiary in an estate. But there is no reason here to say the word is used loosely or non-technically. My conclusion is supported by the fact that it is not clear what would be the "just and reasonable" apportionment of the gain as between UK resident PRs and legatees. Also if the will creates a will trust, the trust does not come into existence until completion of the administration of the estate.

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?

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13 See 67.1 (Succession law background).

14 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 specific legatee as to a residuary legatee.

15 See *Willingdale v Islington Green Investment Co* 48 TC 547 at p.562D.
"The expressions used in s.13(3) are partially defined in s.13(13):
In this section—
(a) references to a person's interest as a participator in a company are references to the interest in the company which is represented by all the factors by reference to which he falls to be treated as such a participator; and
(b) references to the extent of such an interest are references to the proportion of the interests as participators of all the participators in the company (including any who are not resident or ordinarily resident in the UK) which on a just and reasonable apportionment is represented by that interest.
Section 13(13)(a) does not turn the legatee's right into an "interest" if it is not already an interest.

The legatee is treated as having acquired the shares on the death.[16] Does it follow that the legatee is treated as if they 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 them? It is the old question of how far one carries through the deeming.[17] 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 company to a legatee. (Section 62(4)(b) TCGA states that the *legatee* shall be treated as if the PRs acquisition had been theirs. 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 them. The relief under s.13(5A) TCGA would not work properly.

(3) There would be an anomalous distinction between:
   (a) an assent of the shares (s.13 applies to the legatee); and
   (b) sale (or liquidation) of the company and assent of the proceeds to the legatee (s.13 TCGA does not apply).

For these reasons it is suggested that the deeming of s.62(4)(b) TCGA does not extend to deem the legatee to receive the company gains under s.13. This construction is also consistent with the limited view of the deeming provision taken in *Marshall* v *Kerr* 67 TC 56.

## 67.8 Deceased UK resident

If the deceased was UK resident and domiciled, the PRs are UK resident and domiciled, and so subject to CGT on all chargeable gains (less losses).

16 See 67.5.1 (Transfer from PRs to legatee).

17 See 54.11.1 (Construction of deeming provisions).

### 67.8.1 *Deceased UK resident not UK domiciled*

Suppose at the time of their death the deceased was UK resident but foreign domiciled. The PRs are treated as UK resident but not UK domiciled. CG Manual provides:

> **30660 Remittance basis not in administration period**
> If the deceased was resident and/or ordinarily resident but not domiciled in the UK before his or her death, then on disposing of assets outside the UK he or she would have benefited from the application of the remittance basis in Section 12 TCGA ... . Although the PRs have the same residence and domicile status as the deceased had, if they realise chargeable gains from disposals of assets situated outside the UK but do not remit those gains to the UK immediately they cannot benefit from this treatment. This is because the remittance basis applies only to individuals but Section 65(2) says that the body of PRs is not to be treated as an individual.

This remains valid after the 2008 reforms. At first sight this seems surprising, but on reflection, it is not absurd to draw a distinction between:
(1) a UK resident foreign domiciled individual, taxed on the remittance basis, and
(2) the PRs of that individual, taxed on an arising basis.
A remittance basis makes less sense for PRs whose role is generally short term.[18]

Of course, if the PRs are actually outside the UK, especially if they are outside the EU, HMRC may not, in practice, be able to recover the tax.

DTR is in principle available to treaty non-resident PRs which may solve this problem.

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18 It has been argued that the HMRC view is wrong. The argument was largely based on a supposed anomalous position of PRs. Following the 2008 reforms, the anomalies work the other way (for if the remittance basis applied, it would be anomalous that PRs did not pay the £30k remittance basis charge). The argument would require the word "individual" in s.12(1) TCGA to be construed so as to include PRs, which is quite contrary to general statutory usage. So I do not think the argument now merits serious attention (but readers can find further discussion in the 2008/09 edition of this work).

## 67.9 CGT planning for UK resident PRs

If PRs sell assets in the course of administration, then any gain will be subject to CGT, even though the net proceeds of sale will in due course pass to a remittance basis taxpayer. If, by contrast, PRs transfer an asset *in specie* to a legatee to whom it has been bequeathed, whether specifically or as part of residue, then the PRs will not realise any chargeable gain but the base cost of the recipient beneficiary will be that of the PRs.[19] Where the legatee is a remittance basis taxpayer (or a non-UK resident, or a charity), they will often be able to dispose of the asset free of CGT.

It is thus a fundamental principle of CGT planning that PRs should generally avoid, wherever possible, making disposals of assets which pass under the will to remittance basis taxpayers, non-residents or charities, if a gain (less losses) arises on the disposal.

Suppose that a remittance basis taxpayer is entitled to a pecuniary legacy of £1,000,000 under a will. The estate holds a foreign situate asset which had a value of £600,000 at the date of the death of the deceased and which is now worth £1,000,000. If the PRs sell the asset in order to pay the legacy, they will be liable to CGT. This liability can be avoided by the PRs agreeing to transfer the property to the legatee in satisfaction of their pecuniary legacy.

Suppose the PRs inherit an asset belonging to the deceased which is the subject matter of a specific gift in their will; that they then sell the asset, the sale giving rise to a charge to CGT, and that they subsequently transfer the whole or part of the proceeds of sale to the specific legatee. The common law doctrine of relation back does not apply here. This doctrine would appear to operate only where an asset owned by the deceased is subsequently vested in the legatee. In any case, the express provisions of the statutory code deal so comprehensively with the situation that any application of the doctrine of relation back to CGT is by necessary implication excluded. So if there is such a sale, the PRs bear the CGT and transferring the proceeds of sale to the remittance basis taxpayer does not confer any exemption.

It may be necessary to sell some assets to pay liabilities of the PRs, and it may be that the assets available for sale will give rise to a chargeable gain.

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19 See 67.5 (Transfer from PRs to beneficiaries).

One solution is as follows:

(1) The PRs assent the asset to the beneficiary subject to a charge for their liabilities under s.36(10) Administration of Estates Act 1925.
(2) The beneficiary then sells the asset: any gain on the sale accrues to the beneficiary: s.26(2) TCGA.
(3) Under the charge the proceeds are used to pay the PRs' liability.

## 67.10 CGT planning by IoV

Where there is more than one residuary legatee and some are remittance basis taxpayers, non-residents or charities, it would often make sense for assets with inherent capital gains to be transferred to them rather than to UK resident and domiciled individuals. This can often be done by means of an appropriation under s.41 Administration of Estates Act 1925, but (depending on the terms of the will) an instrument of variation may be necessary. The variation must be made within two years of the death of the deceased.

The basic strategy should be to redirect foreign assets of the estate with inherent capital gains to the remittance basis taxpayer. UK resident and domiciled beneficiaries would instead receive cash or assets without inherent gains. The remittance basis taxpayer might in due course realise the gains free of tax. There would be an overall tax saving, which could be shared between the remittance basis taxpayer and the other beneficiaries by negotiation, or which could be allowed to accrue entirely to the remittance basis taxpayer if the other beneficiaries were so minded.

## 67.11 Succession governed by foreign law

Further consideration is needed if the succession is governed by a foreign law. Section 62(1) TCGA provides:

> For the purposes of this Act the assets of which a deceased person was competent to dispose—
> (a) shall be deemed to be acquired on his death by the personal representatives *or other person on whom they devolve* for a consideration equal to their market value at the date of the death...

Under civil law jurisdictions property devolves directly on the beneficiary without the intervention of PRs during an administration period. *Bentley* *v Pike* 53 TC 590 concerned the position under German law (the deceased having died intestate owning a share of land in Germany). The evidence showed:

> ... the principle of *Universalsukzession* ... means that on the death of a person, his or her entire property passes immediately and automatically to his or her heirs. ... No distinction is made between movable and immovable property: on the death of the deceased person both types of property are automatically and without any interval in time or any further outward action of any kind vested in the heirs, whoever they may be, no matter whether they are known or whether it is necessary to take steps to ascertain their identity.

In these circumstances, the ownership of the property devolved on the beneficiary immediately on the death. The gain on the subsequent sale of the property therefore accrued to the beneficiary and not to the German equivalent of Prs.

CHAPTER SIXTY EIGHT

# ESTATES OF DECEASED PERSONS: INCOME TAX

## 68.1 Income taxation of estates: introduction

This chapter considers the income taxation of personal representatives and beneficiaries of estates of deceased persons. A full discussion needs a book to itself. I try to focus on matters closest to the themes of this book, but that can only be done in the context of a more general discussion of the rules.

I do not consider the equivalent provisions applicable for corporation tax which would apply to UK corporate beneficiaries.

For the succession law background, see 67.1 (Succession law background).

### 68.1.1 *Meaning of "PRs" for income tax*

Section 989 ITA provides a commonsense definition of PRs:

> The following definitions apply for the purposes of the Income Tax Acts—
> "personal representatives" in relation to a person who has died, means—
> (a) in the UK, persons responsible for administering the estate of the deceased, and
> (b) in a territory outside the UK, those persons having functions under its law equivalent to those of administering the estate of the deceased.

There is no rule that PRs are a single and continuing body of persons separate from the persons who are actually the PRs. This is anomalous, for such a rule applies to PRs for CGT and applies to trustees for both taxes.[1] However it will not often matter.

## 68.2 Residence of PRs for income tax

PRs are UK resident for income tax if they are all UK resident in their personal capacity. They are non-resident if they are all non-resident in their personal capacity. HMRC agree. Form SA 906(Notes) 2011 (Notes on form SA 906 Trust and Estate Non-residence 2010/11) provides:

> ***Deciding the personal representatives' residence status for Income Tax purposes***
> You can find out the personal representatives' residence status for Income Tax purposes by working through Questions 4 to 6.
> 4. Were **all** the personal representatives resident in the UK throughout the year to 5 April 2011?
> If 'YES', the personal representatives as a whole are resident in the UK for Income Tax purposes. Tick box 6.1 [Resident in the UK for Income Tax purposes]. Go to Question 7.
> If 'NO', go to Question 5.
> 5. Were **all** the personal representatives not resident in the UK throughout the year to 5 April 2011?
> If 'YES', the personal representatives as a whole are not resident in the UK for Income Tax purposes. Tick box 6.2 [Not resident in the UK for Income Tax purposes.] Please also complete boxes 6.7 to 6.12 as appropriate. Go to Question 7.
> If 'NO', go to Question 6 [mixed resident PRs].[2]

The position where an estate has both resident and non-resident PRs is governed by s.834 ITA:

> (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

1 See 67.2 (Meaning of "PRs" for CGT).

2 Accessible *www.hmrc.gov.uk/worksheets/sa906-notes.pdf.*

> resident or domiciled in the UK.
> (4) If that condition is not met, the person or persons who are UK resident are treated, in their capacity as personal representatives, as non-UK resident.

Thus it is possible to arrange that PRs are not UK resident for income tax purposes. All of the PRs must be non-resident in their private capacities, (except in the case of a non-resident, non-ordinarily resident, non-domiciled testator where only one PR need be non-resident).

There are no statutory rules for domicile but the domicile of PRs will not often matter for IT purposes.

The position is different for CGT.[3]

## 68.3 Income taxation of PRs

PRs are "persons" and so pay income tax at the basic or dividend ordinary rate on the income of the estate if:
(1) the PRs are UK resident, or
(2) the income has a UK source.

### 68.3.1 *Foreign domiciled testator*

Form SA 906(Notes) 2011 (Notes on form SA 906 Trust and Estate Non-residence 2010/11) provides under the heading "Personal representatives: application to Income Tax":

> [1] If the personal representatives are resident in the UK, their taxable income will depend on the domicile of the deceased, whose estate is being administered, at the date of death.
> [2] If the deceased was domiciled in the UK, then the personal representatives will be taxable in the normal way on both UK and overseas income.
> [3] If the deceased was domiciled outside the UK, they will only be taxable on UK income. In such circumstances, you should not include such income. Please also tick box 6.6.[4]

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3 See 67.3 (Residence and domicile of PRs for CGT).

4 Accessible *www.hmrc.gov.uk/worksheets/sa906-notes.pdf.* The reference is to box 6.6 in form SA106 (Trust and Estate Non-residence) which reads: "Tick box 6.6 if the deceased whose estate is being administered was domiciled outside the UK at the date

Point [3] is not right as a matter of law. UK resident PRs are as a matter of law liable to income tax on foreign income regardless of the domicile of the deceased. (Domicile of the deceased is sometimes relevant to the separate question of whether PRs are UK resident, but it is possible for a foreign domiciled deceased to have UK resident PRs.)

One is nevertheless entitled (perhaps bound) to assume that HMRC mean what they say, in a document as formal as guidance notes to a tax return, unless it is clear that there has been a blunder, ie unless it is clear that they cannot really mean what the sentence appears to say. HMRC clearly do mean what they say as they say it more than once and have said it for many years.[5]

There is therefore an informal concessionary practice. A concession is logical where the beneficiary of the estate is non-resident since income tax paid on foreign income would be reclaimed later when the income is paid to the beneficiary. The concession does raise a puzzle where the beneficiary is UK resident and the income is paid to the beneficiary: one might think that the foreign income should not be taken into account in computing the beneficiary's estate income, but that must be too good to be true. I think the effect of the concession should be to treat the PRs as non-resident for IT purposes and that should be followed through for payments made by the PRs (who therefore constitute a foreign estate). Thus a payment of the income to a UK resident beneficiary is taxable under the estate income regime, but a payment to a non-resident (or treaty non-resident) is not.

## 68.4 Income from specific legacy

If the PRs assent to the asset and its income vesting in the beneficiary, something rather peculiar happens. The beneficiary is deemed to have been the owner of the asset since the death. This rule – the doctrine of relation back – operates for income tax purposes: *IRC v Hawley* 13 TC 327. Thus, the beneficiary will, retrospectively, be treated as having

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of death".

5 The point has been made in the equivalent notes going back at least to the 2005 notes. Similar wording is found in form SA904(Notes) (Notes on form SA904 Trust and Estate Foreign 2009/10) under the heading "Special circumstances – Personal representatives."

received the income year by year as it arose and the PRs will be treated as if they had not received it. The PRs may have paid UK tax. This will retrospectively be treated as being paid by the PRs on behalf of the beneficiary. Thus a beneficiary who is a remittance basis taxpayer can reclaim tax paid by UK resident PRs on unremitted foreign income. A non-resident beneficiary can also reclaim tax (it is not necessary to rely on ESC A14).

TSE Manual provides:

> **7490 Beneficiaries of estates: legacies** [January 2008]
> *Tax rules for specific legacies.*
> A legacy may take the form of an asset that does not produce income – for example a picture or a piece of jewellery. The beneficiary does not receive income and has no tax liability in respect of the legacy.
> Other assets can produce income – for example a bank account, shareholding or land. The general rule is that the beneficiary is entitled to the income arising to that asset from the death of the deceased person. Sometimes however the personal representatives may by law be entitled to use the income for some other purpose.
> If the beneficiary gets the income it should be treated as his income for the year in which it arises. The authority for this is *IRC v Hawley* 13 TC 327. The beneficiary cannot however be taxed on or given repayment on income that he did not receive.

## 68.5 Income from residuary estate

In order to appreciate the law it is helpful to understand its history. In *R v Special Commissioners, ex p. Dr Barnado's Homes* 7 TC 646, the residuary legatee was a charity. Income arose to the PRs during the period of administration on which the PRs paid income tax. The residuary legatee was not entitled to the income of the residuary estate as it arose during the period of administration, so it could not at that time reclaim income tax paid. Instead it sought to recover the tax when it actually received the income, on completion of administration. The House of Lords held that although the sum received by the charity represented (or was derived from) the PR's income, it was received by the charity as a capital receipt (like accumulated income of a trust). The payment on the completion of administration did not confer retrospective title on the residuary legatee to such income as income. So income tax paid by the PRs could never be recovered by the charity. The doctrine of relation back was not extended to gifts of residue. That was a victory for the Revenue, who were no doubt unperturbed about the unfairness to the charity. But subsequently, predictably, individual residuary legatees successfully contended that they were not liable to super-tax (which became surtax in 1927 and is now higher rate tax) on the income of a residuary estate arising during the administration period.[6] The Revenue then realised they had made a rod for their own back. Legislation was therefore brought in which is now to be found in Chapter 6 Part 5 ITTOIA.

## 68.6 Absolute/limited/discretionary interest in residue

The legislation distinguishes absolute/limited/discretionary interests in residue.

### 68.6.1 *Absolute interest in residue*

Section 650(1) ITTOIA provides a fairly commonsense definition:

> 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.

### 68.6.2 *Limited interest in residue*

Section 650(2) ITTOIA provides a fairly commonsense definition:

> A person has a limited interest in the whole or part of the residue of an estate during any period for the purposes of this Chapter if—
> (a) the person does not have an absolute interest in it, and
> (b) the income from it would be properly payable to the person if the residue had been ascertained at the beginning of that period.

In practice the usual example of a limited interest is a life interest.

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6 eg *Corbett v IRC* 21 TC 449. There are several income tax cases on the issue of whether administration was completed.

### 68.6.3 *Discretionary interest in residue*

Section 650(3) ITTOIA provides a fairly commonsense definition:

> 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.

## 68.7 "UK estate" and "foreign estate"

The legislation distinguishes "UK estates" and "foreign estates". The distinction matters for two purposes:
(1) Computation of the basic amount.
(2) Source of income (relevant to remittance basis taxpayers and non-residents).
These terms are defined in s.651(1) ITTOIA:

> "UK estate", in relation to a tax year, means an estate[7] which meets conditions A and B, or condition C, for that year, and
> "foreign estate", in relation to a tax year, means an estate which is not a UK estate in relation to that year.

I refer below to "**UK estate conditions A to C**" to distinguish them from the myriad other conditions in ITTOIA. Unfortunately these conditions are in a tangle. An estate may be a UK estate in one year and a foreign estate in another year. The question must be addressed each year.

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7 Section 649(2) ITTOIA provides a commonsense definition of "estate":
In this Chapter—
"estate" means the estate of a deceased person (whether a UK estate or a foreign estate).

### 68.7.1 *UK estate conditions A and B*

Section 651 ITTOIA provides:

> (2) Condition A is that all the income of the estate either—
> (a) has borne UK income tax by deduction, or
> (b) is income in respect of which the personal representatives are directly assessable to UK income tax for the tax year.
> (3) Condition B is that none of the income of the estate is income for which the personal representatives are not liable to UK income tax for the tax year because they are not UK resident or not ordinarily UK resident.

If the PRs are UK resident, condition A is satisfied (they are directly assessable to IT) and condition B is satisfied[8] so the estate is a UK estate.

If the PRs are UK resident but the testator was foreign domiciled, it appears that the estate is by concession treated as a foreign estate.[9]

If the PRs are non-resident, and have some foreign source income:
(a) condition A is not satisfied (some of their income is not taxable)
(b) it does not matter whether condition B is satisfied
(c) condition C is not satisfied
so the estate is not a UK estate.

If the PRs are non-resident but have only UK source taxable income, condition A is satisfied (they are assessable) and condition B is satisfied (no foreign income) so the estate is a UK estate.

If the PRs are non resident and have some UK income which qualifies for exemption (eg gilts) the estate is a foreign estate.

It is easy to procure that an estate with non-resident PRs qualifies as a

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8 It takes more than one reading to comprehend the triple negative in condition B (the source legislation was clearer before the ITTOIA rewrite). Suppose PRs are not UK resident and receive foreign source income. The position is that condition B is not satisfied because:
(1) The PRs are not liable to IT on that income
(2) The reason they are not liable is that they are not UK resident: had they been UK resident, they would have been liable.
(3) Thus it is not the case that "none of the income of the estate is income for which the personal representatives are not liable to UK income tax for the tax year because they are not UK resident".
The same applies if non ordinarily resident PRs receive income from exempt gilts.

9 See 68.3.1 (Foreign domiciled testator).

"foreign estate" by arranging that there is some foreign income or FOTRA securities.

### 68.7.2 *Disregarded income and condition C*

Section 651(4) ITTOIA provides:

> For the purposes of conditions A and B sums within section 680(3) or (4) (sums treated as bearing tax) are ignored.

The list of disregards in s.680 ITTOIA is as follows:

> (3) The following sums are treated as bearing income tax at the dividend ordinary rate—
> (a) a sum charged under Chapter 3 of Part 4 (dividends etc. from UK resident companies etc.), or
> (b) a sum that is part of the aggregate income of the estate because of falling within—
> (i) section 664(2)(c) (stock dividends), or
> (ii) section 664(2)(d) (release of loan to participator in close company where debt due from personal representatives).
> (4) A sum that is part of the aggregate income of the estate because of falling within section 664(2)(e) (gains from life insurance contracts etc) is treated as bearing income tax at the basic rate.

It is convenient to have a term to describe these categories of income, so I call it "**disregarded income**".
Why is this income disregarded? Prior to 1996, s.233(1) ICTA 1988 (repealed) provided:

> *Where in any year of assessment the income of any person, not being a company resident in the UK, includes a distribution in respect of which that person is not entitled to a tax credit*
> *(a) no assessment shall be made on that person in respect of income tax at the basic rate on the amount or value of the distribution ...*

Thus non-resident PRs who received dividend income would not be assessable and so would count as a foreign estate.
Section 651(5) ITTOIA provides:

Condition C is that the aggregate income of the estate for the tax year consists only of sums within section 680(3) or (4).

## 68.8 "Payment"

The legislation uses the word "payment" but (like "capital payment" for s.87) this is widely defined. Section 681 ITTOIA provides:

> (1) For the purposes of this Chapter—
> (a) a transfer of assets, or
> (b) the appropriation of assets by personal representatives to themselves,
> is treated as the payment of an amount equal to the assets' value at the date of transfer or appropriation.
> (2) The set off or release of a debt is treated for the purposes of this Chapter as the payment of an amount equal to it.
> (3) If at the end of the administration period—
> (a) there is an obligation to transfer assets to any person, or
> (b) personal representatives are entitled to appropriate assets to themselves,
> an amount equal to the assets' value at that time is treated as payable then for the purposes of this Chapter.
> (4) If at the end of the administration period—
> (a) there is an obligation to release or set off a debt owed by any person, or
> (b) personal representatives are entitled to release or set off a debt in their own favour,
> a sum equal to the debt is treated as payable then for the purposes of this Chapter.

## 68.9 Charge to tax on estate income

Beneficiaries are subject to tax on estate income. There are essentially three parts to the legislation:
(1) The charge to tax on estate income.
(2) The definition of when estate income arises.
(3) The quantification of the amount of estate income.
Section 649(1) ITTOIA provides the charge to tax:

> Income tax is charged on estate income.

## 68.10 Estate income

Estate income is a label which brings in different rules for the different types of interest in residue. Section 649(2) ITTOIA provides a referential definition:

> (2) In this Chapter—
> "estate income" means the income treated under this Chapter as arising from an absolute, limited or discretionary interest in the whole or part of the residue of an estate ...
> (3) Estate income is treated as income for income tax purposes.
> (4) If different parts of an estate are subject to different residuary dispositions, those parts are treated for the purposes of this Chapter as if they were separate estates.

The circumstances in which estate income is treated as arising depend on the type of interest in residue. These are set out in ss.652–655 ITTOIA. These provisions state *when* estate income is treated as arising. The question of the *amount* of estate income is addressed separately.

### 68.10.1 *When estate income arises: absolute interest in residue*

Section 652 ITTOIA provides:

> (1) Income is treated as arising in a tax year from a person's absolute interest in the whole or part of the residue of an estate if—
> (a) the person has an assumed income entitlement for the tax year in respect of the interest (see sections 665 to 670), and
> (b) condition A or B is met.
> (2) Condition A is that a payment is made in respect of the interest in the tax year and before the end of the administration period (see section 653).
> (3) Condition B is that the tax year is the final tax year (see section 653).
> (4) Income treated as arising as a result of this section is estate income for the purposes of this Chapter.

The key term here is "assumed income entitlement;" see 68.14 (Assumed income entitlement).

For completeness, s.653 ITTOIA provides commonsense definitions of "administration period" and "final tax year":

> (1) In this Chapter "the administration period", in relation to the estate of a deceased person, means the period beginning with the deceased's death and ending with the completion of the administration of the estate.
> (2) In the application of subsection (1) to Scotland, the reference to the completion of the administration is to be taken as a reference to the date at which, after discharge of, or provision for, liabilities falling to be met out of the deceased's estate, the free balance held in trust for the residuary legatees or for the persons with the right to the intestate estate has been ascertained.
> (3) In this Chapter "the final tax year" means the tax year in which the administration period ends.

### 68.10.2 *When estate income arises: limited interest in residue*

Section 654 ITTOIA provides:

> (1) Income is treated as arising in a tax year from a person's limited interest in the whole or part of the residue of an estate in cases A, B and C.
> (2) Case A is where—
> (a) the interest has not ceased before the beginning of the tax year, and
> (b) a sum is paid in respect of the interest in that year and before the end of the administration period.
> (3) Case B is where—
> (a) the tax year is the final tax year,
> (b) the interest has not ceased before the beginning of that year, and
> (c) a sum remains payable in respect of the interest at the end of the administration period.
> (4) Case C is where—
> (a) the tax year is a year before the final tax year,
> (b) the interest ceases in the tax year, and
> (c) a sum is paid in respect of the interest in a later tax year but before the end of the administration period, or remains payable in respect of it at the end of that period. ...
> (6) Income treated as arising as a result of this section or section 674 is estate income for the purposes of this Chapter.

### 68.10.3 *When estate income arises: discretionary interest in residue*

Section 655 ITTOIA provides:

> (1) Income is treated as arising in a tax year from a person's discretionary interest in the whole or part of the residue of an estate if a payment is made in the tax year in exercise of the discretion in that person's favour.
> (2) Income treated as arising as a result of this section is estate income for the purposes of this Chapter.

## 68.11 Amount of estate income

There are two aspects to the rules: quantifying the "basic amount", and grossing up.

### 68.11.1 *UK estate*

Section 656(1) ITTOIA provides:

> In the case of a UK estate, tax is charged under section 649 on the amount of estate income treated as arising in the tax year.

Section 656 defines the amount of estate income:

> (2) That amount is the basic amount of that income for the tax year (see subsection (4)) grossed up by reference to the applicable rate for that year (see section 663).
> (3) The gross amount is treated as having borne income tax at that rate.

The applicable rate is not discussed here. The key term is the "basic amount" of estate income. Section 656(4) ITTOIA provides four referential definitions.

> In this Chapter "the basic amount", in relation to estate income, has the meaning given by—
> (a) section 660 (basic amount of estate income: absolute interests),
> (b) section 661 (basic amount of estate income: limited interests),
> (c) section 662 (basic amount of estate income: discretionary interests), and
> (d) section 675 (basic amount of estate income: successive limited interests).

### 68.11.2 *Foreign estate*

Section 657(1) ITTOIA provides:

> In the case of a foreign estate, tax is charged under section 649 on the full[10] amount of estate income treated as arising in the tax year.

The section goes on to specify the amount:

> (2) That amount depends on whether the estate income arising in the tax year is paid from sums within section 680(3) or (4) (sums treated as bearing income tax).
> (3) So far as the estate income is paid from such sums, that amount is the basic amount of that income for the tax year grossed up by reference to the applicable rate for that year (see section 663).
> (4) That gross amount is treated as having borne income tax at that rate.
> (5) So far as the estate income is not paid from sums within section 680(3) or (4), the amount of estate income treated as arising in the tax year is the basic amount of that income for that year.

The difference between UK and foreign estates is that in the latter case there is no grossing up.

## 68.12 Person liable

Section 659 ITTOIA identifies the person liable:

> (1) If the estate income is from a person's absolute interest or limited interest, that person is liable for any tax charged under section 649 unless subsection (3) or (4) provides that another person is liable.
> (2) If the estate income is from a discretionary interest, the person in whose favour the discretion is exercised in making the payment in question is liable for any tax charged under section 649.

That seems self-evident. Subsection (3)(4) (not set out here) deal with successive interests. We turn at last to the key concept "basic amount".

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10 Section 657 refers to the "full amount" and s.656 refers only to the "amount", but the word "full" is clearly otiose: there is no difference in meaning.

## 68.13 "Basic amount of estate income"

The quantum of the "basic amount of estate income" depends on the type of interest in residue, ie whether there is an absolute, limited or discretionary interest.

### 68.13.1 *Basic amount of estate income: absolute interest*

Section 660 ITTOIA provides:

> (1) The basic amount of estate income relating to a person's absolute interest in the whole or part of the residue of an estate for a tax year before the final tax year is the lower of—
> (a) the total of all sums paid in the tax year in respect of that interest, and
> (b) the amount of the person's assumed income entitlement for the tax year in respect of it.
> (2) The basic amount for the final tax year is equal to the amount of the person's assumed income entitlement for that year in respect of that interest.

The next key term is "assumed income entitlement".

### 68.13.2 *Basic amount of estate income: limited interest*

Section 661(1) ITTOIA provides:

> (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.

### 68.13.3 *Basic amount of estate income: discretionary interest*

Section 662 ITTOIA provides:

> 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.

### 68.13.4 *HMRC practice*

These rules are too complicated and in practice no-one takes much notice of them. The TSEM provides:

> **7655. Statutory - conventional basis of taxation [February 2009]**
> ***The statutory basis***
> The statutory basis is provided in ITTOIA/Ss654, 656 and 661. This requires all sums paid during or payable on completion of the administration period to be taxed over the course of the administration period. The amounts are allocated to tax years as follows:-
> 1. where
>    - the interest has not ceased before the beginning of the tax year
>    - the administration period continues after the end of the tax year
>
>    then the amount is the sum paid in the tax year
> 2. where
>    - the interest has not ceased before the beginning of the tax year
>    - the administration period ends in the tax year
>
>    then the amount is the total of any sum paid in the tax year before the end of the administration period plus any amount still due to the beneficiary at the end of the administration period
> 3. where
>    - the interest ceases in the tax year
>    - the administration period continues after the end of the tax year
>
>    then the amount is the total of any sum paid in the tax year plus any amount still due when the interest ceases
>
> The amounts allocated to each year are then deemed to be the net income of the beneficiary for that year. The amount concerned is grossed at the applicable rate...
> ***The conventional basis***
> The beneficiary is treated as if he had been entitled to the income of the estate (or an appropriate part of the estate) as and when the income arose to the personal representatives. The basis applies for all purposes including repayments.
> It is unlikely that there will be cases where it is worthwhile insisting on the statutory basis. If the beneficiary asks for the statutory basis to be applied, you should ask for a computation on that basis. If you have any problems with such a computation, ask HMRC Trusts Edinburgh for advice.

## 68.14 Assumed income entitlement

The key term "assumed income entitlement" is relevant to computation of the basic amount. For absolute interests, this is (in brief) calculated as follows.

First one calculates the "aggregate income of the estate". This has a broadly commonsense definition in s.664 ITTOIA:

> (1) For the purposes of this Chapter the aggregate income of the estate for a tax year is
> [a] the total of the income and amounts specified in subsection (2), but
> [b] excluding the income specified in subsection (5).
> (2) The income and amounts are—
> (a) the income of the deceased's personal representatives in that capacity which is charged to UK income tax for the tax year,
> (b) the income of the deceased's personal representatives in that capacity on which such tax would have been charged for the tax year if—
> (i) it was income of a UK resident who was ordinarily UK resident, and
> (ii) it was income from a source in the UK,[11]
> (c) any amount of income treated as arising to the personal representatives under section 410(4) (stock dividends) that would be charged to income tax under Chapter 5 of Part 4 if income arising to personal representatives were so charged (see section 411),
> (d) in a case where section 419(2) applies (release of loans to participator in close company: loans and advances to persons who die), the amount that would be charged to income tax under Chapter 6 of Part 4 apart from that section, and
> (e) any amount that would have been treated as income of the personal representatives in that capacity under section 466 if the condition in section 466(2) had been met (gains from contracts for life insurance).
> (3) In calculating the amount of the income within subsection (2)(a), any allowable deductions are to be taken into account.
> (4) In calculating the amount of the income within subsection (2)(b), any deductions which would be allowable if the income had been charged to UK income tax are to be deducted from the full amount of

11 I cannot see the point in (ii). If it is income of a UK resident, why does the source matter?

the income actually arising in the tax year.

Section 664(5) identifies income not included in "estate income":

> The excluded income is—
> (a) income to which any person is or may become entitled under a specific disposition[12], and
> (b) income from property devolving on the personal representatives otherwise than as assets for payment of the deceased's debts.

Armed with the figure for the aggregate income of the estate, one next computes "the residuary income of the estate". This brings in rules for allowable deductions. Section 666(1) ITTOIA provides:

> For the purposes of this Chapter the residuary income of an estate for a tax year is
> [1] the aggregate income of the estate for that year, less
> [2] the allowable estate deductions for that year.
> This is subject to section 669 (reduction in residuary income: inheritance tax on accrued income).

Section 666(2) ITTOIA identifies the deductions:

> The allowable estate deductions for a tax year are—
> (a) all interest paid in that year by the personal representatives in that capacity (but see section 233 of IHTA 1984: exclusion of interest on unpaid inheritance tax),
> (b) all annual payments for that year which are properly payable out of residue,
> (c) all payments made in that year in respect of expenses incurred by the personal representatives in that capacity in the management of the assets of the estate, and

12 Defined in subsection (6): "In subsection (5)(a) 'specific disposition' means a gift of specific property under a will, including—
(a) the disposition of personal chattels by section 46 of the Administration of Estates Act 1925 (c 23) (succession on intestacy), and
(b) any disposition which under the law of another country has a similar effect to a gift of specific property by will under the law of England and Wales,
but excluding real property included in a residuary gift made by will by a specific or general description of it or, in Scotland, heritable estate included in such a gift."

> (d) any excess deductions from the previous tax year.[13]
> This is subject to subsections (3) to (5).

Subsections (3) - (5) have some commonsense rules:

> (3) No sum is to be treated as an allowable estate deduction if it is allowable in calculating the aggregate income of the estate.
> (4) No sum is to be counted twice as an allowable estate deduction.
> (5) Payments in respect of expenses are only allowable estate deductions if they are properly chargeable to income (ignoring any specific direction in a will).

In short, one deducts "allowable estate deductions" to obtain the "residuary income of the estate."

Armed with the figure for the residuary income of the estate, we are at last in a position to compute the assumed income entitlement. Section 665 ITTOIA provides:

> (1) Whether a person has an assumed income entitlement for a tax year in respect of an absolute interest in the whole or part of the residue of an estate depends on the results of the following steps.
> *Step 1* Find the amount of the person's share of the residuary income of the estate that is attributable to that interest for that tax year and each previous tax year during which the person had that interest (see sections 666 to 669).
> *Step 2* If the estate is a UK estate in relation to any tax year for which an amount has been found under step 1, deduct from that amount income tax on that amount at the applicable rate for that year (see section 670).
> *Step 3* Add together the amounts found under step 1 after making any deductions necessary under step 2.
> *Step 4* Add together the basic amounts relating to the person's absolute interest in respect of which the person was liable for income tax for all previous tax years (or would have been so liable if the person had been a person liable for income tax for those years).

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13 This is defined in s.666(6):

> "In this section 'excess deductions from the previous tax year' means so much of the allowable deductions for the previous tax year as exceeded the aggregate income of the estate for that year."

This allows unused expenses to be carried forward.

(2) For the purposes of this Chapter the person has an assumed income entitlement for the tax year if the amount resulting from step 3 exceeds the amount resulting from step 4.
(3) The assumed income entitlement is equal to the excess.
(4) [This deals with successive interests].

## 68.15 Beneficiary a trustee of a discretionary trust

Section 483 ITA provides:

> (1) This section applies if, during or at the end of the administration period for an estate—
> (a) the personal representatives pay the trustees of a settlement a sum representing income of the personal representatives, and
> (b) if this Chapter had applied to personal representatives, income tax would have been charged on that income at the dividend trust rate or at the trust rate.
> (2) The sum is treated as—
> (a) being paid as income, and
> (b) having borne income tax at the applicable rate.

Lastly we have some definitions by reference (which would have been unnecessary had there been taxes-act-wide definitions):

> (3) In this section—
> "administration period" has the meaning given by section 653 of ITTOIA 2005, and
> "the applicable rate" means the rate referred to in section 663(1) of ITTOIA 2005 (the applicable rate for grossing up basic amounts of estate income).

The drafter has failed to incorporate the extended definition of "payment" but perhaps that may be implied.

## 68.16 Beneficiary a remittance basis taxpayer

Section 658 ITTOIA brings in the remittance basis:

> (1) The charge to tax under section 649 on the amount of income arising in a tax year is subject to Part 8 (foreign income: special rules).
> (2) For the purposes of section 830(1) (meaning of "relevant foreign

income") amounts charged to tax under section 649—

(a) are treated as arising from a source outside the UK if the estate is a foreign estate, and

(b) are treated as not arising from such a source if the estate is a UK estate.

The section uses the words "treated as" because the income (being fictional income) does not have a source.[14]

If a beneficiary is a remittance basis taxpayer, it is important to ensure that the estate is a "foreign estate" and not a "UK estate" because the remittance basis only applies to a foreign estate.

Since the estate income is deemed income, not real income, it cannot be remitted. There is no rule that the PRs income or the beneficiary's actual receipts are is deemed to be derived from the estate income.

## 68.17 Non-resident beneficiary of UK estate: DTA relief

International Manual provides:

> **367510 Claims by beneficiaries of a UK estate** [June 2004]
> A distribution made to a beneficiary of income received by a UK estate during its administration period is considered to be a source of income in its own right.
> Where a beneficiary receives a distribution of income that has arisen during the administration of a UK estate, that beneficiary may be entitled to relief on the income under a Double Taxation treaty. Relief will be available in one of two ways:
> • Other Income article: where an other income article of a treaty does not exclude income paid out of a UK estate, that income is considered as other income. ...
> The beneficiary is entitled to full relief from the total tax deemed to have been paid on the income.
> • Extra Statutory Concession A14: where it is not possible to relieve the income under an other income article, Extra Statutory Concession A14 allows us to look through to the underlying sources of income received by an estate and allow relief as if the beneficiary owned the sources of income in their own right.[15] ...

14 See 16.4.2 (Location of source of income when there is no source).

15 See 68.18 (Non-resident beneficiary of UK estate: concessionary relief).

International Manual para 367530 sets out a list of countries where relief is available under the Other Income article on distributions made by UK estates. For this list see 22.11.1 (DTAs with OECD model "other income" article).

> **367540 How to give relief by 'looking through'** [July 2005]
> A repayment claim will be supported by an R185 (Estate Income) (or an R185E) tax certificate prepared by the personal representative(s) showing the rate(s) at which the sources of income have been taxed.
> It should be possible to identify the sources of income from the R185 (Estate Income). If so, you should apply relief at the treaty rate for the type of income. It may not be possible to identify the sources of income on an R185E; if so you will need to find out what they are. Remember that you will have to open an SA enquiry to ask for the information you need. See INTM331200 for guidance on how to open an enquiry. You should ask the claimant or their representative for a breakdown of the underlying sources of income arising to the estate.
> (This text has been withheld because of exemptions in the Freedom of Information Act 2000)

## 68.18 Non-resident beneficiary of UK estate: concessionary relief

ESC A14 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, 658(2) 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—
> [1] could claim relief under TA 1988 s.278 (claim to personal reliefs by certain non residents); or
> [2] could claim entitlement to exemption in respect of FOTRA Securities issued in accordance with ITTOIA s.714; or
> [3] could claim relief under the terms of a double taxation agreement; or
> [4] would not have been chargeable to income tax.

The ESC goes on to specify the conditions for the relief.

> 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.

This is the equivalent of ESC B18 for trusts.[16]

## 68.19 Non-resident beneficiary of foreign estate

Section 577 ITTOIA provides the necessary exemption for non-residents:

> (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...

The wording is the same as the equivalent exemption for savings and investment income, in part 4 ITTOIA; for a discussion see 16.4 (Why does location of source matter?).

## 68.20 Time limits for claims and assessments

Section 682 ITTOIA provides:

16 See 22.9 (Discretionary trusts treated as transparent to allow beneficiaries reliefs).

(1) This subsection applies if after the administration period ends it is apparent that a person is liable for income tax on estate income for any tax year who previously appeared not to be so liable or to be liable for tax on a lesser amount.
(2) If subsection (1) applies—
(a) the person may be assessed and taxed for the tax year, and
(b) any relief or additional relief to which the person may be entitled for the tax year is to be allowed if a claim is made.
(3) This subsection applies if after the administration period ends it is apparent that a person who previously appeared to be liable for income tax on estate income for any tax year is not so liable or is liable for tax on a lesser amount.
(4) If subsection (3) applies—
(a) all necessary adjustments and repayments of income tax for the tax year are to be made, and
(b) if the person has been allowed relief which exceeds the relief that could have been given by reference to the amount actually charged for the tax year, income tax is charged on the person for that year under this subsection on the excess.
(4A) The excess charged under subsection (4)(b) is treated as an amount of income for income tax purposes, except so far as it represents a tax reduction given effect at Step 6 of the calculation in section 23 of ITA 2007.
(5) An assessment or adjustment made for the purposes of this Chapter or a claim made as a result of this Chapter may be made after the end of the period otherwise allowed if it is made on or before the third anniversary of the normal self-assessment filing date for the tax year in which the administration period ends.

International Manual provides:

**367560 Statutory time limit for claims by beneficiaries** [April 2004]
It is possible that a beneficiary may receive a distribution from an estate which includes income received by the personal representative outside the normal statutory time limit. However, Section 700(3) ICTA 1988 allows beneficiaries until 3 years from 31 January following the year in which administration was completed to make their claims. This means that a beneficiary is not prevented from claiming relief from UK tax because of the time taken to complete the administration of the estate.
For example, a death occurs during 1994/95. In the normal course of events, the time limit for a beneficiary to claim on administration period income arising in that year would have expired on 5 April 2001.

However, if the administration of the estate is not completed until 2002/03 the time limit is extended and the beneficiary has until 31 January 2007 to make the claim.

CHAPTER SIXTY NINE

# WHO IS THE SETTLOR?

## 69.1 Why does it matter who is the settlor?

The identity of the settlor(s) of a settlement is relevant for many tax purposes. It is not practical to compile a full list, but the rules include the following:

(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 trustees and 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 a settlor.

(4) Reverter to settlor rules.[3]

Subsidiary questions may also arise:

- Where a settlement has two settlors, what property each settlor has provided.
- Whether a settlor provides additional property
- When a person provides property.

The person named as “the settlor” in the trust document is not necessarily a settlor, or the only settlor, for tax purposes.[4]

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1 See 24.1 (Settlor-interested trusts) and 44.2 (Fundamental s.86 conditions).

2 See 53.1 (Excluded property for IHT).

3 See s.54 IHTA.

4 On nominal settlors see Kessler & Sartin, *Drafting Trusts and Will Trusts*, (10th ed., 2010) para 10.14.

## 69.2 Definitions of "settlement"

Before discussing "settlor" we need to discuss "settlement".

For most purposes the words "settlement" and "trust" are interchangeable,[5] though when referring to statutory provisions it is clearer to use the statutory terminology.

### 69.2.1 *Terminology*

There are three different definitions of "settlement". We need labels to distinguish them, and I use the following terms:

(1) *Classic settlements*

(a) ***Standard IT/CGT definition of "settlement"***
This definition applies in the Income Tax Acts and TCGA unless the context otherwise requires. In some cases the context does "otherwise require" because the settlement-arrangement definition is applied. I cannot think of any other case where the context would "otherwise require".

(b) ***IHT definition***: the definition for IHT purposes.
For present purposes (identifying the settlor) the IHT definition is effectively the same as the standard IT/CGT definition, there is no need to distinguish between them.

I use the term "**classic settlement**" to describe a trust which is a settlement within the standard IT/CGT and IHT definitions.[6]

(2) ***Settlement-arrangement***
This is the definition which applies for the purposes of the IT settlement provisions. It is also applied in various other contexts. In earlier editions I called this the IT definition but that terminology became inappropriate following the introduction of the standard IT/CGT definition in 2006; also the settlement-arrangement definition is adopted for several purposes for CGT.

Equipped with this terminology we can now consider the various definitions of "settlement".

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5 See Kessler & Sartin, *Drafting Trusts and Will Trusts* (10th ed., 2010) p. *lvii* (Terminology).

6 This terminology is from Lord Walker's speech in *Jones v Garnett* 78 TC 1.

### 69.2.2 *Standard IT/CGT definition of settlement*

Section 466 ITA provides:

> **466 Meaning of "settled property" etc**
> (1) This section applies for the purposes of the Income Tax Acts, except so far as, in those Acts, the context otherwise requires.
> (2) "Settled property" means any property held in trust other than property excluded by subsection (3)...
> (4) References, however expressed, to property comprised in a settlement are references to settled property.[7]

This is formally a definition of "settled property" not "settlement" but, as subs.(4) illustrates, the definition also governs the meaning of the word "settlement".

The exemption in s.466(3) relates to nominees or bare trustees, see 72.4 (Nomineeships).

### 69.2.3 *Settlement-arrangement definition of settlement*

Section 620(1) ITTOIA provides:

> In this Chapter "settlement" includes[8] any disposition, trust, covenant, agreement, arrangement or transfer of assets...

In *Jones v Garnett*, Lord Hoffmann explains:

> Not every transfer of property is a settlement for the purposes of [the settlement-arrangement definition]. There has to be an "element of bounty" in the transaction. This old-fashioned phrase, apparently derived from the judgment of Plowman J in *IRC v Leiner* 41 TC 589 and approved by the House of Lords in *IRC v Plummer* [1980] AC 896, conjuring up the image of Lady Bountiful in *The Beaux' Stratagem*, is perhaps not the happiest way of describing a provision for a spouse or

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7 The legislation is set out in full in ITA and TCGA, but there are no significant differences, so I give the text of ITA only. The CGT equivalent is in ss.60, 68 TCGA 1992.

8 The context shows this is an exhaustive definition, ie the word "includes" really means "means".

> minor children. ... It is nevertheless exactly the kind of thing at which the anti-avoidance provisions are aimed. In *Chinn v Hochstrasser* [1981] AC 533 Lord Roskill cautioned against treating the word "bounty" as if it had been included in the statute. It seems to me that the general effect of the cases is that, under the arrangement, the settlor must provide a benefit which would not have been provided in a transaction at arms' length.[9]

The term "bounty" was criticised by Lady Hale in the same case, but it is likely to continue in use as a technical term. It is short, accurate, and memorable if archaic.[10]

The bounty requirement is not quite the same as a "commercial" requirement, but the concepts overlap. In *IRC v Levy* the judge stated that "a commercial transaction devoid of any element of bounty is not within the definition". In that case an interest-free loan to a company wholly owned by the lender was held to be a *simple case of a commercial transaction devoid of any element of bounty* and hence not a settlement-arrangement.[11]

By contrast, the standard IT/CGT and IHT definitions of "settlement" do not include a bounty requirement.

Is an estate of a deceased person, or a trust under a will or intestacy a settlement-arrangement? This question does not arise for the purposes of the IT settlement provisions. Even if it is a settlement-arrangement the settlor, that is, testator (being dead) will not be subject to tax. The settlement-arrangement definition is used in other contexts where the issue

9 78 TC 1 at [7]. HMRC agree. TSE Manual:

> "**4110 Restrictions to the definition of settlement** [February 2011]
>
> ...A purely commercial transaction at arms length is outside the meaning of 'settlement'.
>
> Settlement must include an element of bounty, as decided in the tax case of *IRC v Plummer* (54 TC 1). Bounty is the provision of value without any corresponding quid pro quo, usually a gift or a transfer at less than full value."

10 Lord Neuberger agreed in Jones v Garnett 78 TC 1 at [76]:

> "The word 'bounty' rings slightly uncomfortably, at least to my ears. ... However, in the light of the judicial decisions on these provisions, it seems to me that the law is now tolerably clear and sensible, and, particularly given the need for clarity and the room for difficulties in this area, it would be inappropriate to risk introducing uncertainty or new complications by redefining the principles, even if only linguistically."

11 56 TC 68 at p.87.

does arise: see 67.6.1 (Is an estate a "settlement" within s.87 TCGA?).

### 69.2.4 *IHT definition of settlement*

The IHT definition of "settlement" is different again. However for the purposes of this chapter (who is the settlor) it is equivalent to the standard IT/CGT definition.[12]

## 69.3 Definitions of "settlor"

### 69.3.1 *Terminology*

There are four different definitions of "settlor". We need labels to distinguish them, and I use the following terms:

(1) ***The standard IT/CGT definition of settlor***. This definition applies in the Income Tax Acts and TCGA "unless the context otherwise requires". In some cases the context does "otherwise require" because there is a separate definition of settlor. I cannot think of any other case where the context would "otherwise require". The standard IT/CGT definition does not apply for the IT settlement provisions or for s.86 TCGA, so it is not usually very important.

(2) ***The settlement-arrangement definition of settlor***. This is the definition which applies for the purposes of the IT settlement provisions. It is applied by reference in various other contexts.

(3) ***The CGT s.86 definition of settlor****:* the definition for the purposes of s.86 TCGA.

(4) ***The IHT definition of settlor****:* the definition for the purposes of IHT.

Equipped with this terminology we can now consider the various definitions of settlor.

### 69.3.2 *Standard IT/CGT definition of settlor*

Section 467(1) ITA provides:[13]

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12 The differences matter for issues relating to categorisation of foreign institutions; the IHT definition is discussed in 72.2 (Definition of "IHT-settlement".

13 The legislation is set out in full in ITA and TCGA, but there are no significant differences, so I give the text of ITA only. The CGT equivalent here is s.68A TCGA.

> In the Income Tax Acts (except where the context otherwise requires) "settlor", in relation to a settlement, means the person, or any of the persons, who has made the settlement.

Section 467 ITA sets out various circumstances in which a person is treated as having made a settlement:

> (3) A person ("S") is treated for the purposes of the Income Tax Acts as having made a settlement if—
> (a) S has made or entered into the settlement (directly or indirectly), ...

There are four possibilities here:
(1) S is treated as having made a settlement if S has made the settlement directly. This is a tautology.
(2) S is treated as having made a settlement if S has made a settlement indirectly. I am unable to see how one can make a settlement indirectly.
(3) and (4) S is treated as making a settlement if S has entered into it (directly or indirectly). These words have been lifted from the context of the settlement-arrangement definitions of settlement and are not apt here. I conclude that s.467(3)(a) achieves nothing, but it does no harm. One might take from it a general intent that "making a settlement" is not to be construed narrowly.

Section 467 ITA continues:

> (3) A person ("S") is treated for the purposes of the Income Tax Acts as having made a settlement if ...
> (b) the settled property, or property from which the settled property derives, is or includes property within subsection (4).
> (4) Property is within this subsection if—
> (a) the settlement arose on S's death (whether by S's will, on S's intestacy or in any other way), and
> (b) immediately before S's death, the property was property of S—
> (i) which was disposable property (see section 468), or
> (ii) which represented S's severable share in any property to which S was beneficially entitled as joint tenant.

This is necessary because an intestate does not "make or enter into" the trusts arising on intestacy; and it might perhaps be argued that a testator does not "make or enter into" the trusts arising under their will.[14]

Section 467 continues:

> (5) In particular, S is treated for the purposes of the Income Tax Acts as having made a settlement if—
> (a) S has provided property for the purposes of the settlement (directly or indirectly), or
> (b) S has undertaken to do that.
> (6) If a person ("A") makes or enters into a settlement in accordance with reciprocal arrangements with another person ("B")—
> (a) B is treated for the purposes of the Income Tax Acts as having made the settlement, and
> (b) A is not to be treated for the purposes of the Income Tax Acts as having made the settlement just because of the reciprocal arrangements.

So far this definition of settlor is almost the same as the settlement-arrangement definition, the only difference is that the wording is recast in accordance with the conventions of plain English drafting and will trusts are included.

### 69.3.3 *Settlement-arrangement definition of settlor*

Section 620 ITTOIA provides the settlement-arrangement definition:

> (1) In this Chapter ...
> "settlor", in relation to a settlement, means any person by whom the settlement was made.
> (2) A person is treated for the purposes of this Chapter as having made a settlement if the person has made or entered into the settlement directly or indirectly.
> (3) A person is, in particular, treated as having made a settlement if the person—
> (a) has provided funds directly or indirectly for the purpose of the settlement,
> (b) has undertaken to provide funds directly or indirectly for the purpose of the settlement, or
> (c) has made a reciprocal arrangement with another person for the other

14 See 67.6.1 (Is an estate a "settlement" within s.87 TCGA?).

person to make or enter into the settlement.

One can identify five parts of the definition. A person is a settlor if and only[15] if they have:
(1) made the settlement directly or indirectly;
(2) "entered into"[16] 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;[17] or
(5) made a reciprocal arrangement with another person to make or enter into the settlement.

### 69.3.4 *IHT definition of settlor*

Section 44(1) IHTA provides the IHT definition:

> In this Act "settlor", in relation to a settlement, includes[18] 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

15 "Means" in s.620(1) is the term used for an exhaustive definition. The context shows that the words "is treated as" in s.620(2)(3) also constitute an exhaustive (not inclusive) definition.

16 The words "entered into" are not found in the CGT s.86 or IHT definitions of "settlor". The reason is that (in the context of the settlement-arrangement definition) the word "settlement" includes an agreement or arrangement. One is said to "enter into" an agreement or arrangement even though it is not normal usage to say that one "enters into" a settlement (in the classic sense).
The drafter of the standard IT/CGT definition did not realise this, so they included the words infelicitously, though no harm is done.

17 In practice HMRC may ignore this. TSE Manual formerly 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." The passage was quietly deleted in February 2011, but with no announcement of a change of practice. 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 thought to be unnecessary. The drafter of the standard IT/CGT definition included the words; if they had thought about this they would probably have omitted them, but no harm is done.

18 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.

> any person who has provided funds directly or indirectly for the purpose of or in connection with the settlement or has made with any other person a reciprocal arrangement for that other person to make the settlement.

The IHT definition expands "for the purpose of the settlement" into "for the purpose of *or in connection with* the settlement". It is considered that 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.[19] The attraction of this view is that it makes the "who is the settlor" area of tax law more coherent if (so far as possible) the same test applies for all the taxes.[20]

There are specific IHT provisions which may affect the identity of the settlement and settlor for IHT. So sometimes a person who is the actual settlor in the general sense is not regarded as the settlor for IHT. This chapter considers the general sense of settlor; for the IHT provisions see 55.1 (Transfers between trusts).

### 69.3.5 *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—

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19 See 69.24 (Purpose: minor settlor).

20 Why then did the drafter use a different form of words, if they wanted the same result? Perhaps the reason is that "settlement" for IHT is narrower than settlement-arrangement. The drafter may have considered cases where it may have been argued that A is a settlor of a settlement-arrangement (providing property for the purpose of the *arrangement*) but A is not a settlor for IHT purposes (not providing for the purposes of the IHT settlement). For instance in *Crossland v Hawkins* the taxpayer would have accepted that he was the settlor of the "arrangement" but (unsuccessfully) denied being the settlor of the classic settlement. To anticipate such arguments the drafter added the words "or in connection with".

> (a) property provided by that person;
> (b) property representing property falling within para (a) above;
> (c) so much of any property representing both property falling within para (a) above and other property as, on a just apportionment, can be taken to represent property so falling.
>
> ...
>
> (3) Where a person who is a settlor in relation to a settlement makes reciprocal arrangements with another person for the provision of property or income, for the purposes of this paragraph—
> (a) property or income provided by the other person in pursuance of the arrangements shall be treated as provided by the settlor, but
> (b) property or income provided by the settlor in pursuance of the arrangements shall be treated as provided by the other person (and not by the settlor).
>
> ...
>
> (6) For the purposes of this paragraph references to property representing other property include references to property representing accumulated income from that other property.
> (7) For the purposes of this paragraph property or income is provided by a person if it is provided directly or indirectly by the person.

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).

Very similar to this definition is para 9(3) sch 5 TCGA, which sets out one of the conditions for a "qualifying settlement" (in short, a settlement which falls within the scope of s.86 TCGA as extended in 1998):

> The first condition is that on or after 19th March 1991 property or income is provided directly or indirectly for the purposes of the settlement;[21]

HMRC guidance on para 9(3) (which is quite extensive) is therefore

21 For completeness, the provision continues:
"(a) otherwise than under a transaction entered into at arm's length, and
(b) otherwise than in pursuance of a liability incurred by any person before that date but if the settlement's expenses relating to administration and taxation for a year of assessment exceed its income for the year, property or income provided towards meeting those expenses shall be ignored for the purposes of this condition if the value of the property or income so provided does not exceed the difference between the amount of those expenses and the amount of the settlement's income for the year."
But that is not relevant for the purposes of this chapter.

relevant to the definitions of settlor more generally.

### 69.3.6 *Person ceasing to be settlor*

Section 469 ITA provides for someone to cease to be a settlor:

> **Person ceasing to be a settlor**
> (1) A person ("S") who is a settlor in relation to a settlement ceases to be so when the following condition is met.
> (2) The condition is that—
> (a) no property of which S is the settlor[22] 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.[23]

This section is not expressed to apply only to the standard IT/CGT definition of settlor, so it is considered that it also applies to the settlement-arrangement definition.

This has no equivalent in the IHT definition of "settlor", though (if it mattered) it might, perhaps, be implied.

The CG manual provides:

> **33245 Settlor: from 6 April 2006: Basic principles** [November 2009]
> [The Manual paraphrases s.469 ITA and continues:] For example A and B execute a deed of variation under which property left to them by their father's will is resettled on behalf of their children. Broadly speaking

22 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)."
This expression is defined for the purposes of the IT Acts, but it is only used here in s.469 apart from the (unimportant) IoV provisions.
The CGT equivalent is s.68A(1)(b) TCGA.

23 The CGT equivalent is s.68A(6) TCGA.

half the income and capital is held for the children of A and the other half for the children of B. From the time the variation is made, A and B are settlors of the settlement (see CG 33248). In due course the share relating to A's children has been wholly distributed. In this case we should say that A was no longer a settlor.

### 69.3.7 *Relevance of case law and HMRC statements*

In keeping with the patchwork nature of UK tax law, the three definitions of settlor are based on a common framework but they each have slight differences to the others. The settlement-arrangement definition originated in 1936 and is the ancestor of the other definitions. In IHT there has been a little tidying up of the settlement-arrangement definition; the CGT s.86 definition is perhaps an attempt to extract its essence. There is a single concept underlying all the definitions which also represents the normal meaning of "settlor" in trust law.[24] In most cases the differences in wording between the definitions do not matter.

Cases on one statutory provision will generally be relevant to them all. Similarly, HMRC statements made in connection with one provision are generally applicable to the other provisions.

There is also a link between the concept of bounty which is a requirement of a settlement-arrangement and the concept of providing property for the purposes of a settlement, so cases discussing "settlement-arrangement" can also be relevant to the question of who is the settlor.[25]

There are circumstances where a person is a settlor of a settlement-arrangement but not the settlor of the classic settlement but this is not because of differences in the definitions of "settlor": it is because the of differences in the definitions of "settlement".[26]

### 69.3.8 *Two settlors*

A trust may have two settlors in various circumstances:

(1) A provides property and B provides other property.

(2) A provides property and B has "made" or "entered into" the

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24 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").

25 See 69.2.3 (Settlement-arrangement definition of "settlement").

26 See 69.9 (Assignment or surrender of equitable interest).

settlement without providing property.

(3) Possibly, if A provides property directly and B provides the same property indirectly.[27]

The consequences are discussed in 24.8 (Two or more settlors**);** 44.12 (Two settlors for CGT s.86 charge); 55.4 (The separate settlements fiction).

### 69.3.9 *Tainting*

It does not generally matter if a person provides a trivial amount of property to a trust (whether the settlor adding to the trust or a third person adding to a trust made by another.) But occasionally penal tax rules apply if even trivial value is added. This is known as "**tainting**" a trust.

The most common examples are:

(1) A post-1991 provision of funds to a pre-1991 trust may lose the benefit of 1991 transitional relief for s.86 TCGA: Schedule 5 para 9(3).

(2) A provisions of funds by a UK domiciled person will lose the benefit of 1998 transitional relief for s.87.[28]

(3) A provision of funds by a UK-linked person may lose a beneficial mixed resident trustee rule for trustee residence.[29]

In these cases, the question of when funds are provided may also arise.

### 69.3.10 *Commentary*

Three definitions of "settlement" seems complicated, but there are material differences between them and each definition is appropriate in its own context. However, four definitions of "settlor" is extravagant, for there is little difference between them.

A rational tax system would have one standard definition of settlor, which would apply for all taxes. Until 2006 we had a number of definitions of settlor in different contexts, which had developed piecemeal as the tax system evolved. The FA 2006 introduced the standard IT/CGT definition but only applied it for some (not all) purposes of IT and CGT. It has therefore increased the number of definitions of "settlor" and made

27 See 69.4 (Gift from A to B followed by gift to trust by B)

28 See 45.21 (1998 transitional relief).

29 See 4.7 (Trustee residence condition C).

a complex situation rather more complex. This is particularly curious because the authors of the proposals were emphatic that the two former definitions of trustee residence (a CGT and an IT definition) should be replaced by a single definition. We live in bad times for UK tax policy, but eventually, perhaps, someone will tidy up this mess. It would not be very hard to introduce a single definition.

## 69.4 Gift from A to B followed by gift to trust by B

Suppose:
(1) A gives property to B unconditionally;[30] and
(2) B gives the same[31] property to a trust.
Two "settlor" questions arise:[32]
(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*.[33] 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").

30 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 (Trust made by instrument of variation).
31 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.
32 Other issues may also arise. If A is a beneficiary of the trust, A's gift to B may become a gift with reservation: see 54.5.2 (Gift from A to B followed by gift to trust by B). Note that even if A is a settlor of the discretionary trust, A has not made a chargeable transfer and no IHT is payable by A on the gift to the trust by B.
33 67 TC 759. For another aspect of this decision see 69.25 (Purpose: advisers and agents of settlor).

So this was in essence a case of a gift to B followed by gift to trust by B. It is important to note the background facts:

> Once the first settlement had been executed ... it was a virtual certainty that the second would be made on the following day provided that [the mother] was then still living.[34]

### 69.4.1 *When is A an indirect settlor?*

The Special Commissioners found:

> [the mother] was a settlor of the second settlement having directly or indirectly provided the only funds which were subjected to it.[35]

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

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34 67 TC at 771. The Special Commissioners added:

> [The daughter] was content to leave the details to [the mother's advisers]. There was no real likelihood that she would reject the suggestion that she should make the second settlement when Mr Willcox [her adviser] put it to her.

> But nothing turns on that.

35 At p.768G.

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.

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*.[36] 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 69.33 (Planning to create trust with foreign domiciled settlor). However, the planning is not all that easy! No looser test can be applied without considerable uncertainty. Moreover (see below), the consequences of A being an indirect settlor is that B is not a settlor; this strongly suggests a narrower test is appropriate for if B is a genuinely independent agent B should be the settlor.

### 69.4.2 *If A is indirect settlor, is B also the settlor?*

In *Hatton* the Special Commissioners held that the daughter did not provide the funds for the second settlement.[37] The reason was, it appears, that the mother had provided the funds indirectly and this excluded the possibility that the daughter had provided them.

Chadwick J held on the appeal that it was immaterial (for the purposes of the IHT provisions being considered) whether the daughter was also a

36 See 69.6 (Appointment from old trust to B followed by gift to new trust by B).

37 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.

settlor of the settlement.[38] 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[39] and, in our system of precedent, it is wrong to carefully weigh up ambiguous *obiter dicta* in order to extract a view.

Approaching the matter as one of principle, untrammelled by authority, it is respectfully suggested that the Special Commissioners' approach is to be preferred. While as a matter of logic it is possible for A to provide property indirectly, and B to provide it directly, the legislation is framed on the basis that trust property can have only one "provider". This is clearly the case for the IT and CGT settlement provisions.[40] 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.

### 69.4.3 *HMRC views*

TSEM 4300 [April 2010] provides:

> **Example 15– children –indirect gift of shares from parent**
> Mr J owns all 100 issued £1 shares in J Limited. Mr J is the sole company director and is the person responsible for making all the company's profits because of his knowledge, expertise and hard work. On starting up the company, Mr J allowed his mother to subscribe £40 for 40% of the shares but *shortly afterwards* she gifted them to her grandchildren. The circumstances are such that the decision to issue 40 shares at par is a bounteous arrangement (as were the shares in *Jones v Garnett*).

This is essentially a case of:
(1) A gift from Mr J to the grandmother; and
(2) A gift from the grandmother to the grandchildren.
The Manual's tax analysis is as follows:

> The true settlor here is Mr J *rather than the children's grandmother.*

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38 Page 791 at B.

39 The conclusion that the mother was a settlor "did not lead, necessarily, to the further conclusion that [the daughter] was not also a settlor". See p.791 at B.

40 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.

> Section 629 therefore applies and attributes the dividends received by the children to Mr J for tax purposes.

The words in italics suggest that HMRC accept the views set out above.

## 69.5 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.*[41]

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 B wishes to benefit the beneficiaries by the payment, but because A has asked B to, as a favour to A, then applying this principle, A is the (indirect) settlor.

## 69.6 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:

41 *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 liferents and the English rule against perpetuities the exercise of a power of appointment must be written into the instrument creating the power. Earl Fitzwilliam is, therefore, to be treated as the settlor so far as concerns the trust purposes contained in the appointment made by his trustees under step 3, but he cannot reasonably be regarded as having provided property directly or indirectly for the purpose of or in connection with the settlement made by Lady Hastings under step 5.
>
> The words "for the purpose of or in connection with" connote that there must *at least be a conscious association of the provider of the funds* with the settlement in question. It is clearly not sufficient that the settled funds should historically have been derived from the provider of them. If it were otherwise anyone who gave funds unconditionally to another which that other later settled would fall to be treated as the settlor or as a settlor of the funds. It is clear that in the present situation there cannot possibly have been any conscious association of Earl Fitzwilliam with Lady Hastings' settlement.

*(Fitzwilliam v IRC* 67 TC at 732, emphasis added)

It seems therefore that if:

(1) a trust ("trust A") exists and A is its settlor;
(2) there is an arrangement under which:
    (a) the trustees of trust A appoint trust property to B;
    (b) B gives the property to a separate trust ("trust B");

B will be the settlor of trust B, and A will not be a settlor, unless the creation of trust B is envisaged by A at the time that trust A is made.

The "conscious association" test is an understandable and generally helpful paraphrase of the statutory words (though of course it does not solve much as the question may arise as to what is a "conscious association". Further, Lord Keith said there must *at least* be a conscious association, suggesting that it is a necessary, but may not be a sufficient, condition). The application of the conscious association test in the context of an appointment followed by a gift really is surprising, but the House of Lords have spoken. The matter is for most practical purposes ended – unless and until the House of Lords speak again. For implications for tax planning, see 69.33 (Planning to create settlement with foreign domiciled settlor).

## 69.7 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 55.1 (Transfers between trusts – Introduction).

### 69.7.1 *Transfer from trust A to new trust created by trustees*

Suppose:

(1) Trustees of a trust made by A ("Trust A") have power to transfer to a new trust.

(2) The trustees transfer the trust fund to new trustees to hold on the terms of a newly created trust, Trust B. All the funds of Trust B are derived from Trust A.

Who is the settlor (in the general sense) of Trust B? The trustees of Trust A cannot be the "settlor" as they have merely exercised a fiduciary power. So either A is the settlor or there is no settlor.[42] The answer is that A is the settlor of Trust B. In *Eilbeck v Rawling* 54 TC 101:

(1) a Gibraltar settlement ("Trust A") made by "Settlor A" held £600,000;

(2) a Jersey settlement ("Trust B") made by "Settlor B" held £100;

(3) £315,000 was transferred from Trust A to Trust B by exercise of the trustees' powers.

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42 If at the time of the creation of Trust A, the transfer to Trust B is already in contemplation, then A is the settlor of Trust B. It is here assumed that the transfer was not in contemplation at the time of the creation of Trust A.

Buckley LJ said at p.161:

> The donee of a special power of appointment is charged with the exercise of a personal discretion which he cannot delegate. When he exercises that discretion in making an appointment, he acts as the delegate of the settlor. What the donee does in exercise of a special power of appointment is done vicariously by the settlor. It is also settled law of long standing that, for the purposes of the rule against perpetuities, when a special power is exercised, the limitations created under it are to be written into the instrument which created the power. This association of the interests arising under an appointment in the exercise of a special power with the settlement conferring that power is not, in my opinion, confined to the rule against perpetuities. If one asks who was the settlor of the £315,000 appointed by the appointment of 27 March 1975, the only possible answer is [Settlor A] the settlor of the £600,000 comprised in the Gibraltar settlement [Trust A]. The taxpayer's brother [Settlor B] did not settle[43] the £315,000; he settled only £100. The Gibraltar trustee [the trustees of Trust A] did not settle the £315,000; it was not the Gibraltar trustee's to settle, and making the appointment the Gibraltar trustee was only exercising a fiduciary power conferred on him by the Gibraltar settlor [Settlor A], whose delegate he was as donee of the power. The exercise of the power had, in my opinion, precisely the same effect as if the Gibraltar trustee had appointed the £315,000 in favour of the Jersey trustee to be held upon trusts identical with the trusts of the Jersey settlement [Trust B] but set out in extenso in the appointment without reference to the Jersey settlement. If the appointment had taken that form, there could, I think, be no doubt that the trusts so appointed would be trusts taking effect under the Gibraltar settlement.

The House of Lords approved this reasoning on appeal.[44]

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43 Buckley is using the word "settle" as a paraphrase of the statutory word "provide".

44 It may be objected that this is not consistent with *Fitzwilliam*: see 69.6 (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 their 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

HMRC agree. The CG Manual provides:

> **33241 Settlor** [November 2009]
> Where trustees exercise a special power of appointment, or power of advancement, in such a way as to create a new settlement, see CG33800+, the settlor of the new settlement is the person who was the settlor of the old one. See, for example, *Pilkington v IRC*, 40 TC 416, p.442[45] and *Chinn v Collins*, 54 TC 311, p.351H.

The same point is made again at 34802.

It is considered that the same applies to a transfer for less than full consideration made in exercise of trustees dispositive powers, eg an interest-free loan from trust A to trust B.

### 69.7.2 *Transfer from trust A to existing trust made by B*

Suppose:

(1) A transfers property ("A's fund") to a trust ("trust A"). The trustees have the standard power to transfer property to another trust.

(2) B transfers property ("B's fund") to a separate trust ("trust B").

(3) The trustees of trust A transfer A's fund to trust B.

Trust B now has two settlors: A has provided A's fund indirectly, and B has provided B's fund directly.

### 69.7.3 *IT and CGT rule*

Section 470 ITA provides:[46]

> **Transfers between settlements**
> (1) Section 471 applies in relation to a transfer of property[47] from the

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excluded property, as one could not say that "the settlor" was domiciled in the UK at the time that the settlement was made! That can hardly be right.

If (which is doubtful) further authority is needed, see *Trennary v West* [2005] STC 214 at [49].

45 [Author's note] See 69.12.2 (Power of advancement).

46 The CGT equivalent is s.68B TCGA.

47 The expression "transfer of property" is defined in s.470(3) ITA:

"(3) In this section 'transfer of property' means—

(a) a disposal of property by the trustees of settlement 1, and

trustees of one settlement ("settlement 1") to the trustees of another settlement ("settlement 2") if the transfer—
(a) is not for full consideration,
(b) is not by way of a bargain made at arm's length, and
(c) is not excluded by subsection (2).

Section 470(2) ITA sets out three exceptions:

A transfer of property is excluded for the purposes of subsection (1) if—
(a) it occurs only because of the assignment by a beneficiary under settlement 1 of an interest in that settlement to the trustees of settlement 2,
(b) it occurs only because of the exercise of a general power of appointment, or
(c) section 473(4) applies in relation to it.[48]

In short, s.741 applies on a transfer between trusts by exercise of a trustee's power.

This takes us to s.471 ITA:

**Identification of settlor following transfer covered by section 470**
(1) If there is a transfer of property in relation to which this section 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—

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(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."

48 For this exception see (IT and CGT – IoVs from 6 April 2006).

(a) was provided for the purposes of settlement 1, or
(b) was derived from property so provided,
the property acquired by the trustees of settlement 2 on the disposal is treated from the time of the disposal as having been provided for the purposes of settlement 2.
(5) If as a result of subsection (4), property ("the transferred property") is treated as having been provided for the purposes of settlement 2—
(a) the person who provided the disposed property, or the property from which it was derived, for the purposes of settlement 1 is treated as having provided the transferred property for the purposes of settlement 2, and
(b) if more than one person provided the disposed property, or the property from which it was derived, for the purposes of settlement 1, each of them is treated as having provided a proportionate part of the transferred property for the purposes of settlement 2.

This applies for IT and CGT purposes. But it is considered that this only codifies the general law position, so there is no difference here between IT/CGT and IHT. HMRC agree. The CG Manual provides:

**33247 Settlor: from 6 April 2006: Transfer between settlements** [November 2009]
This section is concerned with the situation where the trustees of Settlement 1 ["S1"] transfer property to the trustees of Settlement 2 ["S2"], including cases where property is created by Settlement 1 on behalf of Settlement 2, such as the grant of a lease by the trustees of Settlement 1 to the trustees of Settlement 2.
Unless the transfer is for full consideration, or by way of a bargain at arm's length Section 68B TCGA applies. The reason for having these two alternatives is to allow for the possibility that Settlement 1 and Settlement 2 are connected persons (so that any transaction between them is not at arm's length by virtue of Section 18 TCGA 1992), and Settlement 1 sells an asset to Settlement 2 for its full market value. In such a case we do not want section 18 to cause section 68B to apply.
It is not unusual for trustees to appoint or advance assets to a newly created trust. See for example *Hart v Briscoe* 52 TC 53. Courts have said, see for example *Chinn v Collins* 54 TC 311, that the trustees in such a situation are perfecting the settlor's original gift in settlement. Therefore in such a case section 68B has the effect that it is the original settlor of Settlement 1 who is the settlor of Settlement 2. The property is treated as having been provided for the purposes of Settlement 2.
However there are three specific cases which are excluded.

> [1] A beneficiary, B, of Settlement 1 may transfer to Settlement 2 his interest in Settlement 1. In this case it is B who is the settlor (or an additional settlor) of Settlement 2.
> [2] Under the terms of Settlement 1 D may have a general power of appointment. If so D is the settlor (or additional settlor) of Settlement 2.
> [3] If section 68C(6) applies (see CG 33248).
> It is not considered that section 68B effected any change in the law.

## 69.8 Disclaimer

TSEM states at 1840:

> The person disclaiming is not a "settlor" within [the settlement-arrangement definition] (TSEM4120). Subsequent trusts that result from the disclaimer retain their original settlor.

A disclaimer, if possible, may be preferable to a surrender or assignment. The distinction between a disclaimer and a surrender/assignment is therefore important. This raises questions of trust law which cannot be fully discussed here, but for a broad outline see TSEM para 1840 [January 2008]:

> A person uses a true disclaimer to refuse a gift due under a trust. Effectively the person steps aside. This allows subsequent provisions of the trust to take effect.
> A disclaimer can relate to
> - capital
> - income
> - both.
>
> A disclaimer has retrospective effect. It applies from the date that the entitlement arose. There may be a lapse of time between the entitlement arising and the disclaimer. This is not conclusive evidence that the deed cannot be a true disclaimer. ...
> The person making a disclaimer may still benefit from another part of the trust income or capital. This is irrelevant. If that person seeks to impose new trusts, the deed is not a disclaimer. It is an assignment (TSEM1845).

It sometimes happens that a will creates a trust but a spouse or child has forced heirship rights (in Scotland known as legitim and elsewhere, legitime) which if exercised would override the trust. A disclaimer of those rights does not make the spouse or child a settlor. This is consistent with the policy of s.142 IHTA which provides that the disclaimer is (in short) not subject to IHT. The same would apply in England to a person who chose not to exercise rights under the Inheritance (Provision for Family and Dependants) Act 1975.

## 69.9 Assignment or surrender of equitable interest

A person who assigns an equitable interest under Trust A to Trust B is the settlor of Trust B but does not of course become the settlor of Trust A.

If a person surrenders an equitable interest under Trust A there is no "Trust B". In that case, that person is the settlor for the settlement-arrangement definition[49] so far as they have provided the income, but they are not a settlor of Trust A for the IHT definition, the CGT s.86 definition, or the standard IT/CGT definition. Similarly if a person assigns an equitable interest to another individual.

HMRC agree: CG Manual 33242 provides:

> **Settlor: Up to 5 April 2006** [November 2009]
> Normally the same person was 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 could not have affected the identity of the settlor for CGT purposes.

The CG Manual also provides:

> **34801. Meaning of settlor** [August 2007]
> In general if HMRC Trusts Head Office Bootle or Edinburgh, or their predecessors Financial Intermediaries and Claims Office or Claims Branch have advised or ruled that a person is the settlor for Part XV ICTA 1988 or Part 5 Chapter 5 ITTOIA2005 purposes then the same person should be regarded as the settlor for the purposes of these provisions. In exceptional cases, eg the assignment of a life interest, a person may have settled a right to income under an existing settlement without thereby creating a new settlement for CGT purposes. Although the Income Tax Settlements Legislation may apply as regards that income, that person is not thereby a settlor of the main settlement.

49 *IRC v Buchanan* 37 TC 362.

The position is similar to a variation of trust by beneficiaries; see below.

## 69.10 Variation or resettlement by beneficiaries

### 69.10.1 *Trust law background*

Beneficiaries who are adult and absolutely entitled to trust property[50] 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").[51]

The distinction between a variation and a resettlement is crucial, but careful drafting will normally achieve whichever is desired.

HMRC agree. The CG Manual provides:

> **Variations of trusts**
> **37880. By agreement**
> If all the beneficiaries of the trust are 18 or over and agree, they may bring it to an end and share out between themselves (and others) the trust property. (There is an exception to this rule in Scotland in that a person with an alimentary liferent cannot exercise consent in this way.) In these circumstances there is a deemed

50 If there are minor and unborn beneficiaries, a variation can similarly be made with the consent of the court under the VTA 1958.

51 See s.1(1) VTA 1958 which assumes that beneficiaries have power to vary a trust:

> "Where property...is held on trusts arising...under any will, settlement or other disposition, the court may if it thinks fit by order approve on behalf of [unborn or unascertained beneficiaries] any arrangement ... *varying* or revoking all or any of the trusts, or enlarging the powers of the trustees of managing or administering any of the property subject to the trusts. ..."

This assumes that the Court only approves on behalf of unborn or unascertained beneficiaries, and adult beneficiaries can make a variation without the approval of the Court. See *Re Holt* [1969] 1 Ch 100 at p.120:

> "Under an arrangement approved by the court [under the Variation of Trusts Act 1958] the trusts may be brought wholly to an end. On the other hand, they may be varied; and there is no limit, other than the discretion of the court and the agreement of the parties, to the variation which may be made. Any variation owes its authority not to anything in the initial settlement but to the statute and the consent of the adults coming, as it were, ab extra. *This certainly seems to be so in any case not within the Act where a variation or resettlement is made under the doctrine of Saunders v. Vautier by all the adults joining together*; and I cannot see any real difference in principle in a case where the court exercises its jurisdiction on behalf of the infants under the Act of 1958."

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. Instrument of variation of will or intestacy** [August 2007]

It is quite common for instruments of variation of wills or intestacies to be executed within two years of the testator's (or intestate's) death. In England & Wales the usual form of the instrument is a deed. The general guidance is at IHTM35011+ and guidance on CGT at CG31600+. If an instrument of variation creates a continuing trust which replaces absolute interests in the original will, and there is no statement of intent in the deed or before 1 August 2002 no election, under Section 62(7) TCGA 1992, or its predecessor Section 49(7) CGTA 1979, the person who gives up the absolute interest in favour of the trustees is to be regarded as the settlor for the purposes of the annual exempt amount and Section 77 TCGA 1992. His personal position is considered at CG32000+, assuming the variation is gratuitous.

This is obviously correct. The Manual then turns to our situation:

**37887.** [August 2007]
If, however, in a case where there is no such election or statement of intent, the will or intestacy provided for property to be held subject to trusts, and these trusts are varied or replaced by the deed of variation, then there are two questions to be answered.
a. Is there a new separate settlement?
b. If so, who is the settlor of that settlement?
If there are only minor variations clearly there is no new settlement and the deceased remains the settlor. Minor variations would include for instance changes in the administrative powers of the trustees, or the provision of an ultimate gift over, that is, a provision saying to whom the property is to pass if the trusts fail, or the appropriation of property to particular funds within the settlement. Otherwise it is necessary to determine whether there is a new settlement in accordance with the principles explained at CG37882, and see CG37889. If there is a new settlement then the identity of the settlor should be determined in accordance with CG37900. ...
**37889.** [August 2007]
One situation which is quite common is where there is a life interest trust for the spouse of the deceased. For Inheritance Tax reasons this is partly varied so that there is a discretionary trust up to the amount of the Inheritance Tax nil rate band. In such a case, where the spouse continues to be a beneficiary of the new discretionary trust, it would often be appropriate to regard this, except for the purposes of Inheritance Tax, as little more than a cosmetic arrangement, particularly if the broad intention is that the bulk of the income should be paid to the spouse. So this would be regarded for Capital Gains Tax purposes as a variation of the original will trust, and not as giving rise to a new separate settlement. The deceased remains the settlor.

Para 37889 is correct though not for the reason given (which does not bear any examination) but for the reason given in 69.9 (Assignment or surrender of equitable interest).

### 69.10.2 *Tax consequences of resettlement*

A resettlement (unlike a variation) involves a disposal for CGT, and may lose the benefit of IHT relief for transitional serial interests. It also changes the settlor. The CG Manual provides:

> **37900. Identity of settlor**
> Where there is a variation of a trust of the kind described in CG37880+ [variation by beneficiaries] it is necessary to identify the settlor. If the conclusion taken is that there are no new settlements then for CGT purposes the identity of the settlor is unaffected. However if in effect interests in income have passed from one person to another, the former may well be the settlor of an arrangement for Income Tax purposes.
> **37901. Identity of settlor** [August 2007]
> If however one or more new settlements have come into existence, then the settlors of those settlements are one or more of the parties to the variation. The question should be tackled on a practical basis by determining where each beneficiary's share has gone. ...
> **37903. Example** [August 2007]
> Under a settlement made by X, A and B are each entitled to half the income. On A's death his son P gets half absolutely. On B's death her daughter Q gets half absolutely. The values of their respective interests are, say:
>
> | | |
> |---|---|
> | A's life interest | £60,000 [30% total value] |
> | P's remainder | £40,000 [20% total value] |
> | B's life interest | £75,000 [37.5% total value] |
> | Q's remainder | £25,000 [12.5% total value] |
>
> Under the variation, which is considered to terminate the old settlement:
> A takes 30% of the property.
> 20% goes to a new accumulation and maintenance settlement for P's children.
> B takes 25% of the property.
> The rest [25%] is held for Q for life with remainder to Q's son R.
> P should be regarded as the settlor, for the purpose of the annual exempt amount, of the accumulation and maintenance settlement, because this is how his share has been dealt with.
> B and Q equally should be regarded as the settlors of the other settlement. ...

## 69.11 Variation under Variation of Trusts Act 1958

Where a court approves a variation of trust on behalf of a minor beneficiary, under the VTA, it is considered that the minor beneficiary does not become a settlor. The reason is that the court in giving its approval does not merely act on behalf of the minor: the court has a wider role.[52] The position is analogous to trustees exercising a power of advancement.[53] But HMRC do not agree. CG Manual para 37902 provides:

> **Minor as settlor** [August 2007]
> It is considered that where a court has given consent on behalf of a minor, that minor can be a settlor. The authority lies in *Yates v Starkey*, 32 TC 38, where it was held that a person could be a settlor under compulsion, and *Mills v IRC*, 49 TC 367, where it was held that a minor with very little involvement in the transactions could be the settlor because she provided the property.

Neither of these cases justifies the HMRC view.

## 69.12 Exercise of power of appointment or advancement

### 69.12.1 *Special power of appointment*

The exercise of a special power of appointment does not make the appointor a settlor.[54]

### 69.12.2 *Power of advancement*

Where trustees have a power of advancement (that is, a power to apply trust property for the benefit of a beneficiary) they may use that power to

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52 *Re Steed* [1960] 1 Ch 407; *Re Remnant* [1970] Ch 560. Further consideration is needed if foreign trust laws apply.

53 This view is consistent with the fact that where a Court approves a variation on behalf of an unborn beneficiary, that beneficiary clearly does not become a settlor.

54 This is self-evident, but if authority is needed, see the quotations set out in 69.7.1 (Transfer from trust A to new trust created by trustees).

transfer trust property to a new trust.[55] The consent of that beneficiary is not needed and therefore that beneficiary is not the settlor of the new trusts.

*Pilkington v IRC* concerned a proposal to transfer property to a new settlement by exercise of a power of advancement in favour of a Miss Penelope. Lord Radcliffe said:

> When one asks what person can be regarded as the settlor of Miss Penelope's proposed settlement, I do not see how it is possible to say that she is herself or that the trustees are. She is the passive recipient of the benefit extracted for her from the original trusts; the trustees are merely exercising a fiduciary power in arranging for the desired limitations. It is not their property that constitutes the funds of Miss Penelope's settlement: it is the property subject to trusts by the will of the testator and passed over into the new settlement through the instrumentality of a power which by Statute is made appendant to those trusts.[56]

HMRC agree: see CG 33241 set out in 69.7 (Transfer from trust A to trust B by exercise of trustees' power).

### 69.12.3 *General power of appointment*

A general power of appointment (whether testamentary or not) may be used:
(1) in a manner which creates a new settlement, or
(2) in a manner which merely varies an existing settlement.[57]
In case (1) the appointor is the settlor of the new settlement. In case (2) it is considered that the appointor is not in principle the settlor, but is in the same position as a person who consents to the exercise of a power.

## 69.13 Consent to exercise of power

A trust sometimes provides that the trustees can only exercise a power of appointment with the consent of a particular beneficiary (typically the life

55 See Kessler & Sartin, *Drafting Trusts and Will Trusts* (10th ed., 2010) para 11.11 (Power of advancement used to create new trusts).
56 *Pilkington v IRC* 40 TC 416 at p.442.
57 The position is analogous to 69.10 (Variation or resettlement by beneficiaries).

tenant). If the power of consent is wholly personal (ie proprietary),[58] 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, for the purposes of the settlement-arrangement definition. The consentor has provided income for the purpose of the settlement-arrangement because they have effectively given up their right to the income by their consent.[59]

(2) For similar reasons a gratuitous consent to an appointment which terminates the consentor's contingent interest in trust capital probably makes the consentor the settlor, for the purposes of standard IT/CGT and IHT[60] definitions from the time that the contingency is satisfied.

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58 On this terminology and powers of consent generally see Kessler & Sartin, *Drafting Trusts and Will Trusts* (10th ed., 2010) para 7.33 (Nature of powers of consent).

59 The position is analogous to a person who assigns or surrenders their life interest. The analogy is not exact. In one case the arrangement consists of the assignment alone. In the other case the arrangement consists of the consent and the exercise of the trustees' power of appointment. So in a sense there is an arrangement with two settlors: (i) the consentor and (ii) the (actual) settlor of the classic settlement who conferred the power of appointment on the trustees. But HMRC (or the actual settlor) may plausibly argue that the consentor (not the actual settlor) is taxable under the Settlement Provisions in these circumstances. They may take support from *Braybrooke v Att-Gen* 9 HLC 149 at p.165, accessible on *www.commonlii.org*. (A case on the Succession Duty Act 1853 whose provisions are analogous to the settlement provisions. Since Succession Duty was only abolished in 1949, the drafter of the original settlement provisions doubtless had it in mind.) The ground of the decision in *Braybrooke* was:

> "that, although the estate of the son arose under a joint power of appointment made by his father and himself, and although therefore the father was in a sense one of the settlors, yet he was not a settlor from whom the interest or any part of the interest of the son, in his character of successor, was derived. And the decision shews that, in order to ascertain who is the settlor 'from whom the interest of the successor is derived,' we must inquire, not who are the parties by whose conveyance the estate has been created, but who is the conveying party out of whose estate the interest in question has been derived." See *Att-Gen. v Charlton* (1877) 2 Ex. D. 398 at p.417.

60 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.

The consentor has provided capital for the purposes of the settlement because they have effectively given up their right to the capital by virtue of their 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.[61]

 In these cases the consentor has not provided any property by their consent.

(4) The giving of a consent is probably not a disposal for CGT[62] 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.[63]

(5) The giving of the consent is probably not a "disposal" for the purposes of the gift with reservation rule[64] and indeed it is likely that the power of consent is a "settlement power" and so not property for IHT: see s.272 IHTA.

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61 This is fairly clear from first principles, but some support can be found in two cases. In *Braybrooke* (see above fn) a tenant in tail exercised his power to dispose of the lands entailed, with the consent of the protector. The protector was not the creator of the disposition: "It cannot be argued that a person whose consent is apparently necessary to a disposition, makes that disposition." In *Mills v IRC* the father's consent was apparently thought necessary for Hayley Mills to enter into the arrangements: see 49 TC 367 at p.403. This did not prevent Hayley being a settlor.

62 Under general principles or by virtue of s.24 TCGA (extinction of an asset constituting a disposal).

63 It will matter if the usual CGT exemption on the disposal of an equitable interest does not apply (eg offshore trusts). It could matter if the conditions of TCGA Sch. 4A are satisfied, but that would be unusual.

64 See *Baird v Baird* [1990] 2 AC 548 at 557 [the exercise of a power of appointment] "disposes of no property of the appointor". HMRC agreed. The old CTO Advanced Instruction Manual E.91 provided:

> "Nor should you regard the giving of a consent by a limited owner to the exercise of the power of advancement as the making of a disposition."

This passage does not seem to be in the current IHT Manual. This is one of a number of important statements (deliberately?) culled in the transition from the old to the new Manual. There is no reason to think that HMRC have changed their view.

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).

## 69.14 Provision of property for company held by trust

HMRC take the view that provision of property to a company wholly owned by a trust is in principle provision of property for the purpose of the trust, and so makes the provider a settlor. SP 5/92 provides:

> 16 The condition in TCGA Sch 5 para 9(3)[65] may be satisfied where property or income is provided to a company in which the trustees are participators.[66]

This is supported by *obiter dicta* in *Crossland v Hawkins* 39 TC at p.506 followed by Goulding J in *IRC v Mills* 49 TC at p.337. It is correct for the standard IT/CGT definition, the settlement-arrangement definition and the IHT definition.

However, for the CGT s.86 definition, the question is not whether a person has provided property for the purpose of the settlement. The question is whether a person has provided *settled* property. So long as the property provided remains property of the company, not property of the trust, this condition is not satisfied.[67]

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65 The condition is that property is provided directly or indirectly for the purposes of the settlement; see 69.3.5 (CGT s.86 definition of settlor).

66 The SP continues with an exception:

> "Where, however, the transaction is carried out with the sole object of leaving funds within the company for the company's purposes and it can be shown that any indirect benefit to the trust is merely incidental to that object, the transaction is disregarded for the purposes of para 9(3).
>
> 17 Examples of transactions which may be so disregarded are—
> – where another shareholder waives an entitlement to all or part of a dividend; or
> – where a director restricts withdrawals of remuneration voted,
> in order to assist the company's cash flow, and no payments are made, directly or indirectly, to the trustees as a result of this. All relevant factors will be considered in determining whether it is appropriate to apply this practice in a particular case."

67 This view, expressed in earlier editions of this work, is now supported by *Coombes v HMRC* [2008] STC 2984.

### 69.14.1 *Transactions with wholly owned companies*

SP 5/92 para 18 provides:

> In general, transactions between trustees and companies which they, directly or indirectly, wholly own, or between such companies, are outside the scope of TCGA 1992 Sch 5 para 9(3).[68]

This is right. There can be no element of bounty so a wholly owned company cannot "provide" property to its owner, just as shareholders cannot "provide" property to their company.

## 69.15 Provision of services

### 69.15.1 *Services envisaged when settlement made*

In two cases:
(1) a third party created a trust which held a company; and
(2) well-known actors (Jack Hawkins, Hayley Mills) provided services to the company at a substantial undervalue. The company made profits and paid dividends to the trustees.

In both cases there was clearly a settlement; the question was who was the settlor. It was held that the actor was the settlor.[69]

Viscount Dilhorne in *IRC v Mills* 49 TC at 408 considered two situations:
(1) Employees of a company held by trustees contribute by their labour to the profits of the company, and so increase the company's dividends and the income of the settlement.
(2) A stockbroker who gives well founded advice to trustees of a settlement increases the value and income of the settlement.

One might have said that these were not settlors because they provide no

68 The SP sets out a commonsense definition of "wholly owned" and continues with a qualification:
> "This approach may not, however, be taken where, on the facts of a particular case, it appears that the transaction has been entered into solely or mainly for the purposes of obtaining a UK tax advantage."

69 *Crossland v Hawkins* 37 TC 493 approved *Jones v Garnett* 78 TC 1; *IRC v Mills* 49 TC 367. More accurately, the actor was one of the settlors but the contribution by the person who created the trust was ignored as insignificant.

bounty but what if they do act with gratuitous intent? Viscount Dilhorne did not rely on the bounty point:

> The difference between those cases, on the one hand, and *Crossland v Hawkins* and this case [*Mills*], on the other, is that in *Crossland v Hawkins* and in this case funds which ordinarily would have been received by Mr. Hawkins and by Miss Mills for their acting were diverted to companies which were channels for their transmission to trustees. It is not the provision of services but of funds which comes within the section.

The distinction is not between provision of services and provision of funds, because the actors did provide services; the key feature is the provision of services which yields funds *which would otherwise be received by the provider*. It is considered that the test should be whether one can identify funds which:

(1) would (in the absence of the settlement) have been received by the individual, but
(2) were diverted to the trust.

The settlement provisions do not work unless one can *identify* the funds which are provided by the settlor. In Viscount Dilhorne's examples of employees and stockbrokers, this condition is not met.

Suppose:

(1) an individual has an opportunity of purchasing land, or shares in a private company;
(2) they allow the trust to take up the offer by advising the trust and not pursuing the opportunity themselves;
(3) had the trust not taken up the offer they would have done so.

In this case the individual is a settlor if one can distinguish the return from the trust's investment from the profit from the advice. A clear case being where the trust only invested a nominal amount in the project. But if the trust provides substantial funds for the development, one cannot identify any money as coming specifically from the adviser. One should not apportion the profits between the adviser's contribution (advice) and the settlement's contribution (finance). It is impractical to do so as there is no sufficiently clear answer to how the apportionment should be made. If that is right, the *Mills* and *Hawkins* line of cases is effectively restricted to "one-man companies" with no substantial capital (as was the case in both *Mills* and *Hawkins*). Tax Bulletin 64 Example 9 suggests that

HMRC agree. The example (slightly rephrased) is as follows:

> Mr. J owns 60 of the 100 issued £1 shares in J Limited. Mr. J is the sole company director *and* is the person responsible for making *all* the company's profits because of his knowledge, expertise and hard work. The remaining 40 shares are held by the children of Mr. J and were originally owned by their grandmother who had subscribed for them at par when the company was set up but shortly afterwards had gifted them to her grandchildren. Dividends are paid.

(Emphasis added.) HMRC say:

> [S.629 ITTOIA] applies and attributes the dividends received by the children to Mr. J for tax purposes. Since Mr. J
> [1] is the person *responsible for making the company's profits* and
> [2] decides on the level of dividends paid,[70]
> 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 their 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 they had the resources) to make the same investments as those they recommended to the trustees. This is a clear case.

Suppose a property developer who is well disposed to the trust gives free property market advice to trustees, and the trustees invest in land 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 them.

Suppose a director of a company held on trust seems reasonably well remunerated but HMRC argue that their remuneration is insufficient.

70 It is hard to see the relevance of [2].

Even if HMRC are right, the individual is not the settlor, because one cannot identify funds which would have been received by the director.

*Mills* and *Hawkins* were cases where it was intended from the outset that the settlor should provide services at an undervalue. In those cases the settlor contracted to provide services. In *Jones v Garnett*, it was likewise anticipated from the outset that Mr. Jones would provide his services at an undervalue. Here there was no contract, but that made no difference:

> It was the *expectation* of such events and the hope of profit which, together with the absence of any risk attached to the children's ownership of the shares, gives the "element of bounty" to the arrangement constituted by the allotment. What subsequently actually happened was not part of the arrangement.[71]

69.15.2 *Services not envisaged when settlement made*

What is the position if:

(1) a company is up and running and well established;

(2) an individual ("T") *subsequently* provides services at an undervalue (to benefit shareholders).

The question may arise in three circumstances:

(1) shares may be held by a spouse or minor children;

(2) shares may be held by a trust:

  (a) of which some other person is the settlor;

  (b) of which T is the settlor.

In case (1) there is (or may be) no settlement-arrangement before T begins to provide T's services. The question is whether a settlement-arrangement comes into existence.

In case (2) there is a settlement already. The question in 2(a) is whether T becomes the settlor. In case 2(b) T is already the settlor. The question is whether they provide further property (which might taint the settlement).[72] Of course, all the questions are related and they come down to the same question: does T gratuitously provide property for the

71 *Jones v Garnett* 78 TC 1 at [22]. Likewise Lord Walker at [50]: "A plan which existed when the structure was established."

72 See 69.3.9 (Tainting).

purposes of the settlement?[73] It is suggested that the answer is, strictly, yes, if one can identify the funds that T has provided: see above. But it appears that HMRC do not take the point. In *Jones v Garnett*, Lord Neuberger envisages a case (1) situation (share held by Mr and Mrs Jones but no settlement-arrangement):

> On that basis, I find it also very hard to see why Mr Jones's decision each year not to take anything like a full salary, thereby increasing substantially the dividend payable to his wife, does not involve an element of bounty. Neither [Counsel for HMRC] (no doubt reflecting the Revenue's policy) nor [Counsel for the taxpayer] (as it would involve his clients losing on this issue) was prepared to adopt this approach. Although it appears to me to be logically attractive, it would be inconvenient in practice, in that it would be difficult to administer, and it might well produce unfair, even arbitrary, results.[74]

### 69.15.3 *Services provided for full consideration*

In *Mills* in the Court of Appeal, Buckley LJ noted other circumstances why a person who provides services to a trust or company may not be providing property:

(1) A person does not provide funds for a settlement if:
  (a) they are entirely ignorant of the settlement (which would generally be the case for employees of a company held by a trust), or
  (b) they do not have the view of advancing the interests of the trust.

(2) A person does not provide funds for a settlement if they do so for reward in the ordinary course of their professional business.

No-one would suggest that these persons providing their services to the company or trust should be regarded as settlors and the only question is why not? It is suggested that the correct reason is because there is no element of bounty.

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73 See *Jones v Garnett* 78 TC 1 at [83]:

> "... the definition of settlement in [s.620 ITTOIA] and of the settlor in [s.620 ITTOIA] are closely connected, and it appears to me to be perfectly proper to rely upon observations as to what can be taken into account when considering who is a settlor, when deciding whether there is a settlement."

74 See *Jones v Garnett* 78 TC 1 at [89].

### 69.15.4 *What is the arrangement?*

In *Jones v Garnett* Mr. Jones worked for a company held equally by himself and his wife. Lord Hoffmann gave "settlement-arrangement" a somewhat limited meaning:

> [HMRC's] second argument is that the transfer of the share [to Mrs Jones] was not the whole of the arrangement, which included the provision of services by Mr Jones, the dividend policy and so forth. Again, I think that would be inconsistent with the argument by which the revenue have, in my opinion, succeeded on the first point. The transfer of the share was in my opinion the essence of the arrangement. The expectation of other future events [i.e. provision of services by Mr Jones] gave that transfer the necessary element of bounty but the events themselves did not form part of the arrangement.[75]

## 69.16 Interest-free or back-to-back loan

A person who lends interest-free (or on favourable terms) is in principle[76] a settlor. HMRC agree. SP 5/92 para 22 provides:

> A loan made, directly or indirectly to a relevant settlement after 19 March 1991 on non-commercial terms, eg at a low or nil rate of interest is regarded as a provision of funds for the purposes of TCGA 1992 Sch 5 para 9(3). This is the case whether the loan is for a fixed period or repayable on demand.[77]

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75 78 TC 1 at [29]. Lord Walker said the same at [54] stressing the absence of a contract of employment.

76 It is assumed that the loan is made with gratuitous intent. The position is different if the loan (though on favourable terms) is made without any gratuitous intent, which is conceivable, for instance, in the case of a loan by a life tenant.

77 As to whether an interest-free loan makes the trust a settlor-interested trust, see 24.3.2 ("Settlor-interested" for IT purposes).
SP 5/92 para 19-21 deal with the CGT implications of loans to trusts before 19 March 1991. This is not now important but is set out here for completeness:

> "19 A fixed-period loan made, directly or indirectly, to a relevant settlement prior to 19 March 1991 on non-commercial terms, eg at a low or nil rate of interest is, generally, regarded as a provision of property in pursuance of a liability incurred before 19 March 1991, provided the loan remains outstanding on the same terms. As such, it falls within the terms of TCGA 1992 Sch 5 para 9(3)(b) and the first condition set out in para 9(3) is not met.

Likewise Tax Bulletin 8 provides:

> Our view is that a person making a loan to the trustees on better than commercial terms is ... a settlor and transferor and within the provisions of [Chapter 5 Part 5 ITTOIA] or [s.727 ITA].

The same applies to a back-to-back loan. In *IRC v Wachtel*:
(1) the trustees borrowed from a bank, and
(2) an individual guaranteed the trustee loan and deposited funds equal to the trustee borrowing with the bank. The trustees paid only 1% interest on their loan.

The individual was rightly held to be a settlor.[78]

While a person who lends interest-free is in principle a settlor, what is the property provided, and when is it provided? It is considered that the property provided is the money lent, and property derived from that. It is provided at the time that the interest free loan is made. If the money lent is spent on expenses, there is no property derived from the loan and the lender ceases to be a settlor.

Suppose:
(1) A settlor while abroad lends money to a trust with mixed resident trustees. The loan is interest-free and repayable on demand.
(2) The settlor later comes to the UK and deliberately leaves the loan outstanding.[79]

HMRC may contend that the settlor has provided property by deliberately leaving the loan outstanding but it is tentatively suggested that this is not

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> 20 There would, however, be a direct or indirect provision of property for the purposes of the settlement where a fixed-period loan falls to be repaid after 18 March 1991 but repayment is not made and so becomes a repayable on demand loan.
>
> 21 An extra-statutory concession D41 ... sets out the position in the case of non-commercial, repayable on demand, loans for the purposes of applying TCGA 1992 Sch 5 para 9(3)."

78 46 TC 543 at p.555.

79 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 69.14 (Provision of property for company held by trust).

the case: what is the "property" which the settlor has provided? It is not the interest foregone, as that does not exist. Thus the trust continues to be non-resident.

## 69.17 Indemnities

SP 5/92 provides:

> 34 An indemnity given by the new trustees to retiring trustees is not considered as the provision of funds for the purposes of the settlement under TCGA 1992 Sch 5 para 9(3).

This is right because there is no element of bounty. (Also the benefit of the indemnity is held by the *former* trustees so it is not property comprised in the settlement.)

> Other types of indemnity are considered in light of the facts of a particular case.

The standard form indemnity given by a beneficiary who receives trust capital is not the provision of funds, it is made in consideration of the trustees not exercising their trustee lien.

## 69.18 Guarantees

SP 5/92 continues:

> 35 The giving of a guarantee is regarded as an indirect provision of funds under the terms of TCGA 1992 Sch 5 para 9(3).[80]

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80 SP 5/92 goes on to deal with the CGT implications of guarantees to trusts before 19 March 1991. This is not now important but is set out here for completeness:
"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."

## 69.19 Repayment of loan made by trustees

SP 5/92 para 23 provides:

> The repayment of any loan made, directly or indirectly, to any person by the trustees is not generally regarded as the provision of funds for the purposes of the settlement under TCGA 1992 Sch 5 para 9(3). This does not, however, apply where
> [1] more is repaid than is due under the original terms of the loan or,
> [2] in the case of loans made after 19 March 1991, where the interest charged under the terms of the loan exceeds a commercial rate.

This is clearly correct (apart from point [2] but in practice that is not likely to arise). There is no element of bounty.

## 69.20 Sale or share issue at undervalue

A sale to a trust at a conscious undervalue is the provision of property and the seller is a settlor. Likewise a person is a settlor if they hold all the shares in a company and consents to the company issuing new shares to a trust at a conscious undervalue.[81] The TSE Manual correctly states at 4120 [January 2008]:

> ***Example 1***
> X is the director and owns all the 150 issued ordinary £1 shares of X Ltd. X Ltd issues 100 new ordinary £1 shares which are acquired for £100 by the X Family Trust. The trust has been established for the benefit of X's family by his father, X Senior, who created the trust by settling cash of £100. Shortly after the issue of the new shares, a dividend of £100 per share is declared and paid and the trust receives dividends of £10,000. X controlled the arrangement for the issue of the shares at par followed by the dividend. X is therefore the true settlor of the settlement from which income of £10,000 arose. The original settlement of £100 by X Senior is usually disregarded on de minimis grounds.

A sale at market value is not the provision of property. HMRC agree. the

81 This proposition is self evident but if authority is needed, see *Crossland v Hawkins* 39 TC 493 at pp.506–507.

CG Manual provides:

> **34891. Multiple settlors**
> Where property is acquired as a result of an arms length transaction the third party is not to be regarded as providing property for the purposes of the settlement, thereby becoming a settlor. Instead the property is regarded as representing the cash previously held.

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.[82]

If values are uncertain the solution may be a market value adjustment clause. SP 5/92 provides:

> 13 Solely for the purposes of TCGA 1992 Sch 5 para 9(3)(a), a provision in the document governing the transaction for an appropriate adjustment to the consideration where the value agreed by the Revenue differs from the original consideration arrived at by an independent valuer and specified in the sale document is, in general, regarded as falling within the terms of the above definition of an arm's length transaction. The arm's length value of the transaction is to be determined in accordance with the principles set out in para 12 above. This will usually correspond to the value for capital gains tax purposes except, for example, where TCGA 1992 s 19 would apply.
> 14 It would also be necessary for the terms of the contract to provide for compensating interest at a commercial rate to be paid in either direction once the arm's length value is determined. For this purpose, the official rate of interest for ICTA 1988 s 160 purposes will usually be regarded as equivalent to a commercial rate of interest, although a different rate may be accepted as so equivalent if the circumstances of a particular case warrant this treatment.
> 15 This practice is, however, subject to the consideration passing on sale being realistically based, ie on a third party valuation by a qualified valuer, all the other terms of the transaction being at arm's length and the compensating interest being timeously paid. The position in a particular case depends on all the facts and circumstances.

82 This is consistent with the principles that a settlement-arrangement must have an element of bounty: see 69.2.3 (Settlement-arrangement definition of "settlement"), and that arm's length sales confer no "benefit": see 27.4.1 (Arm's length transaction).

## 69.21 Failure to exercise right of reimbursement

SP 5/92 para 24 provides:

> [1] Failure, by or on behalf of any relevant person, to exercise statutory rights to reimbursement e.g. under [s.646 ITTOIA], may be regarded as the provision of funds for the purposes of the settlement under TCGA 1992 Sch 5 para 9(3).[83]

Point [1] only applies to a failure to exercise rights which is both deliberate and gratuitous (ie with an element of bounty). This is the reason for the exceptional case which para 24 then addresses:

> [2] The settlement could remain outside the terms of para 9(3) where the exercise of the right to reimbursement is unsuccessful, provided it could be shown that there had been a genuine attempt to enforce rights to reimbursement.

The exception is stingily worded (here as in several other points, SP 5/92 gives the impression that it was intended to make life as difficult as possible for offshore trusts). It is not necessary to show "a genuine attempt to enforce rights to reimbursement". It is sufficient to show that such rights are not enforceable, or that a decision not to obtain reimbursement is a commercial one or that enforcement would not be cost-effective.

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83 For completeness, Tax Bulletin 8 correctly qualifies this:

> "Para 24 of the Statement of Practice [5/92] points out that failure to exercise statutory rights to reimbursement against non-resident trustees may be regarded as the provision of funds for the purposes of the settlement under para 9(3) of Schedule 5, TCGA 1992. This will not, however, apply in respect of a settlor's non-exercise of statutory rights to reimbursement out of the trust income account where the settlor has a life interest in all the assets of the trust. In such circumstances, failure to exercise the right to reimbursement would, effectively, not add funds to the trust since all income would, in any ease, either be paid to the settlor under the terms of the trust deed or be used to meet expenses chargeable against income.
> But even in such cases the settlor may have rights to reimbursement out of the trust capital account, eg in relation to accrued income charges, which if not exercised will be regarded as the provision of funds."

For other issues relating to reimbursement, see 27.4.10 (Reimbursement of tax under statutory indemnity) and 27.21 (Relevant income used to pay expenses)

## 69.22 Payment of administrative expenses

SP 5/92 specifies two cases where payment of capital expenses out of a life tenant's income does not make the life tenant a settlor:

> 29 An expense on capital account paid out of trust income is not treated as a provision of income by a beneficiary for the purposes of TCGA 1992 Sch 5 para 9(3) provided that either—
> [1] the trust deed permits payment of capital expenses from income and the beneficiary is entitled only to net income after such payments;[84] or
> [2] the trustees borrow money from the income account which is subsequently restored, along with interest over the period of the loan. The appropriate rate of interest is considered to be that which a Court of Equity would order on the replacement of trust income.[85]

The question, more analytically, is whether the life tenant has provided intentional and gratuitous benefit to the trust. Clearly, in the two cases mentioned, the life tenant does not do this and so does not become a settlor.

Where a trust has no income, someone (typically a beneficiary) may voluntarily pay the expenses. In this case there may also be no gratuitous element. It may be in the beneficiary's interest to make the payment. Subject to that, the SP tacitly suggests that the intentional and gratuitous

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84 For completeness, Tax Bulletin 8 expands on this:
"Para 29 of the Statement of Practice concerns, inter alia, trust deeds which permit capital expenses to be paid out of the income account. Neither the existence nor the exercise of this power would cause the trust to lose an interest in possession status for IHT purposes."

85 For completeness, Tax Bulletin 8 expands on this. The bulletin sets out para 29[2] and continues:
"The appropriate rate of interest is considered to be equal to the rate payable on the Basic Account administered by the Court Office of the Supreme Courts of Justice. Such interest will constitute taxable income in the hands of the income beneficiary (either when it is credited in the case of a life tenant, or when it is paid or applied for the benefit of a discretionary beneficiary). It may also be treated as 'relevant income' for [s.731 ITA] purposes.
Income beneficiaries will only be liable on the net amount of income available after deduction of any income which has been applied to meet expenses on capital account. Only when the income account is made good will that income become taxable on the beneficiary."

payment of trustees' expenses *does* make the payor a settlor. But this is not correct. First, in some cases, the payment of expenses may be a provision of services to the trust rather than the provision of property.[86] Secondly, if a non-settlor pays trustees expenses, or pays a sum to the trustees which are immediately consumed in payment of expenses "no property of which S is the settlor" is comprised in the settlement, so the payor of expenses is not the settlor.[87]

HMRC agree. The STEP/CIOT questions[88] consider the IHT problems that arise when:

(1) a person (after 2006) adds property to an estate IP trust and
(2) the property is spent on trust expenses.

> **Question 37(2)**
> ... if an addition of cash was made which was then spent by the trustees and HMRC regard this addition as within the relevant property regime (eg an addition to pay expenses or improve properties), how would the proportion of the settled property subject to the new rules be calculated? Would a valuation be needed of the property before and after the improvement?
> **HMRC Answer**
> If a payment of cash was made and then spent immediately on, say, a tax liability or another administration expense, then that short period will be the extent of its time as "relevant property" and there will be no question of having to consider what proportion of the existing settled property represents it going forward.
> If a payment was made towards the improvement of a property, then this would appear to require "with" and "without" valuations when there is a chargeable event.[89]

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86 See 69.15 (Provision of services).

87 See 69.3.6 (Person ceasing to be settlor).

88 Accessible at http://www.step.org/pdf/3October2008versionSch20FA2006letter.pdf

89 The question goes on to ask: In HMRC's view, do all subsequent post Budget additions need to be kept physically segregated? HMRC say no, which is just as well as money spent can hardly be regarded as segregated:
"It is clearly up to trustees to decide whether to keep post-Budget additions separate from the rest of the trust fund. We think that it may be sensible to do so—or, at least, to keep good records of additions. (The trustees of discretionary trusts already need to do this, of course, in order for the 10-year anniversary value of each addition to be identified correctly in light of the relief in s 66(2) IHTA for property that has not been 'relevant property' for a full 10-year period)."

*Note added 6 August 2008: HMRC have indicated that they are actively reconsidering this response with a view to producing further guidance shortly.*[90]

## 69.23 Trust retains life tenant's income

SP 5/92 para 33 provides:

> A life tenant is not regarded as having provided income or property for the purposes of the settlement merely because there is an administrative delay in paying out the income that has vested in that beneficiary. If, however, the beneficiary directs the trustees to retain this income on the terms of the settlement, this is regarded as a provision of funds within TCGA 1992 Sch 5 para 9(3).

This is fairly obvious.

## 69.24 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[91] 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

90 No such guidance has been produced, presumably the issues have been filed as too difficult.

91 The actual evidence recorded that she was "not very interested", which is not the same. The case should have been decided on the simple factual basis that Hayley Mills *did* intend to provide funds for the purpose of the settlement, even if she did not trouble to think very much about it. The judge made this point at p.378:

> "The case was put on a factual assumption that Hayley Mills did not subjectively intend to provide funds. This was factually incorrect, and not even conceivable, because it was completely inconsistent with the view that the contract she signed was valid. If Hayley had not thought about it at all, the contract which she signed would be void under the rule *non est factum*."

> 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.[92] 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 singular) and sometimes purposes (in the plural) but there is no distinction.[93]

## 69.25 Purpose: advisers and agents of settlor[94]

It is considered that in ascertaining purpose one may have regard not only to the mind of the settlor, but also the mind of those acting for him or her. Agency principles may be applied. See *Crossland v Hawkins* 39 TC 439 at p.508:

> The mere fact that he did not concern himself with some of the 'steps' in the legal machinery involved does not make it any the less his arrangement within the section. A man does not avoid the incidence of section 397 [now s.629 ITTOIA (income paid to unmarried minor

92 Dilhorne, who took a third in law, was "not in the highest flight of English lawyers" (DNB).

93 "The statute seems to me to use the word 'purpose' and 'purposes' indiscriminately"; *Crossland v Hawkins* 39 TC 493 at p.507.

94 See 29.15 (Purpose: advisors and agents of transferor).

> children of settlor)] by merely being absent from and leaving to his solicitors and accountants certain parts of the legal machinery if he is aware of the proposals for an 'arrangement' or a settlement and actively forwards them by personally carrying out and assisting in the vital parts in which his performance and co-operation are necessary. Nor can he avoid liability by merely giving his solicitors carte blanche to effect some scheme for the benefit of his family and refusing to concern himself with its precise form.

On this analysis many apparent difficulties fall away.

In *Mills*, the father acted on behalf of the daughter.[95] 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*[96] 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.

## 69.26 Settlement made by court for person lacking capacity

The court has power to make a settlement for a person lacking capacity "on his behalf". It is considered that the person lacking capacity is the settlor.[97] 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.[98]

## 69.27 Settlement made by compromise of claim of minor or person lacking capacity

Parties to litigation may make a settlement under a compromise on behalf

95 See 49 TC 367 at pp.382 and 385.

96 See 69.4 (Gift from A to B followed by gift to trust by B).

97 Sections 16, 18(h) Mental Capacity Act 2005. The tax position is the same for settlements made under the Mental Health Act 1983.

98 Court of Protection Practice Note, 15 November 1996, para 4.

of a claimant who is a minor or person lacking capacity.[99] 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.[100]

This assumes that the minor/person lacking capacity 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.[101]

But HMRC accept in practice that there is no settlor.[102] It would follow that the trust fund is excluded property, eg if it is an AUT, an OEIC, or not UK situate.

## 69.28 Trust under Criminal Injuries Compensation Scheme

An award under the Criminal Injuries Compensation Scheme may be transferred to a trust.[103] The applicant under the Criminal Injuries Compensation Scheme is not the settlor of such a trust.[104] That is

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99 See Kessler & Sartin, *Drafting Trusts & Will Trusts*, (10th ed., 2010) Chapter 26 (Trusts of damages).

100 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.

101 *Zim Properties v Proctor* 58 TC 371.

102 Private correspondence.

103 Para 50 Criminal Injuries Compensation Scheme 2001.

104 The drafter of Part 2 Chapter 4 FA 2005 assumed this, though one needs to dig a little into the provisions to see why this is so:
(1) CICS trusts are within the provisions: s. 35 FA 2005.
(2) Settlor-interested trusts are outside the scope of the provisions: see s.25(3) and 30 FA 2005. (In relation to CGT this was clearer before s. 77 TCGA was

consistent with the position under the VTA. However, HMRC have apparently expressed the view that the claimant is the settlor, and in practice this view may well favour the taxpayer (as s.624 ITTOIA reduces the IT charge if the settlor is not a higher rate taxpayer).

## 69.29 Trust made in divorce settlement

In *Harvey v Sivyer* 58 TC 569 a separated husband made payments to his minor children under a deed of separation. The payments were not voluntary; they were pursuant to an obligation to maintain the children and contained no element of bounty.[105] The taxpayer argued that for this reason that there was no "settlement" within the settlement-arrangement definition. The argument was rejected and the taxpayer was held to be the settlor. The judge tentatively reconciled his decision with the bounty requirement because "the natural relationship between parent and young child was one of such deep affection and concern that there must always be an element of bounty by the parent, even when the provision is on the face of things made under compulsion".[106] This is romantic nonsense, as any family lawyer will attest. The better way to justify the decision is to note that the bounty requirement is not statutory, and not to be applied unthinkingly. The Court of Appeal noted in an earlier case, "if the legislature had set a 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".[107] So this is simply an exception to the bounty requirement. On this analysis, *Harvey v Sivyer* was correctly decided, though not for the right reasons.

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repealed in 2008).

(3) The claimant under the CICS would always be a beneficiary, so if he was the settlor the trust would be settlor-interested.

So the drafter must have assumed that the claimant was not the settlor, or the provisions made no sense.

105 58 TC 569 at p.572.

106 58 TC 569 at p.577.

107 *Yates v Starkey* 32 TC 38 at p.53.

## 69.30 Trust made by instrument of variation

### 69.30.1 *The usual situation*

Suppose:

(1) B inherits property absolutely from the estate of a deceased, D.

(2) B varies the will so as to create a settlement of that property; and s.142 IHTA and s.62 TCGA apply.

B is clearly the settlor in the general sense: see 69.4 (Gift from A to B followed by gift to trust by B).

### 69.30.2 *Settlor for IHT*

For inheritance tax purposes, the effect of s.142 IHTA is probably to override the general sense; the settlor is D and not B. HMRC agree. (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.

### 69.30.3 *Settlor for IT: variation before 6 April 2006*

B is the settlor for IT purposes in the case of variations made before 6 April 2006.

### 69.30.4 *Settlor for CGT: variation before 6 April 2006*

The identity of the settlor for CGT is an unresolved question.[108] 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-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

108 See "*Marshall v Kerr* Revisited", *Taxation*, 3 May 2001 (Christopher Sokol QC).

is now) s.62(9) TCGA: this subsection was not in force in the tax years relevant to *Marshall v Kerr*.

To distinguish between administration and non-administration cases is highly anomalous, so this view of s.62(9) TCGA brings welcome consistency into the law. It also brings CGT into line with IHT.

It appears to be the HMRC view that the beneficiary is the settlor even in cases (2) and (3). CG Manual 37888 [August 2007] provides:

> The Revenue had always considered that Section 62(7) was concerned with computational matters only, and had no effect on the question whether a new settlement had come into existence or the identity of the settlor. The majority of the House of Lords, in Marshall v Kerr, 67TC56, preferred slightly different reasoning in holding that a residuary legatee, who had executed an instrument of variation so that her 50 per cent share of the estate was settled, was the settlor for the purposes of Section 87 TCGA 1992 (charge on beneficiaries of non-resident settlements). It may be noted that the case was concerned with the pre-1978 version of the relevant legislation and it is considered that the Revenue's arguments in that case are stronger under the later legislation.
>
> Where the instrument was executed before 6 April 2006 this decision should be applied for the purposes of Section 77 TCGA 1992 & Section 86 TCGA 1992 (charge on settlors of certain settlements) and TCGA 1992/SCH1 (annual exempt amount for trustees).
>
> Where the instrument was executed on or after 6 April 2006 and notice is given under Section 62(7) Section 68C TCGA 1992 applies with these consequences.
>
> - Where under the will or intestacy property was to pass absolutely to an individual, and a variation is executed settling that property (or property deriving from that property), then the person to whom the property would have passed is the settlor with regard to that property.
> - Where under the will or intestacy property was to be settled, but the variation is such that a new settlement is created (see CG37887) then the deceased is the settlor.
> - Where under the will or intestacy property was to be settled, but the variation is minor, then the deceased would be the settlor without the new legislation in FA 2006 and therefore this case is not provided for

specifically.[109]

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.

69.30.5 *IT and CGT – IoVs from 6 April 2006*

Section 472 ITA provides:[110]

> (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,[111]

109 Likewise TSEM 1815 [January 2008]:
"The settlor of a trust created by a deed is not the deceased, unless it's a disclaimer (TSEM1840). It is the person who was entitled to the gift that has now gone into trust. The gift can be capital or income or both. The case of *Marshall v Kerr* (67 TC 56) is relevant. There may be more than one settlor."

110 The CGT equivalent is s.68C TCGA.

111 Section 472 provides:
"(4) For the purposes of subsection (3)—
(a) 'legatee' includes a person taking property—
(i) under a testamentary disposition or on an intestacy or partial intestacy, whether beneficially or as trustee, or
(ii) under a donatio mortis causa, and
(b) a person who is a legatee as a result of para (a)(ii) is treated as acquiring the property when the donor dies.
(5) For the purposes of subsection (4)(a) property taken under a testamentary disposition or on an intestacy or partial intestacy includes any property appropriated by the personal representatives in or towards satisfaction of—

(b) a person who immediately before the variation would have been so entitled if that person had not been an infant or otherwise lacking legal capacity,
(c) a person who, but for the variation, would have become so entitled, and
(d) a person who, but for the variation, would have become so entitled if that person had not been an infant or otherwise lacking legal capacity.

Section 472 (and its CGT equivalent, s.68C TCGA) applies in the usual situation, where a beneficiary absolutely entitled to property under a will varies the will so as to create a settlement. Section 68C TCGA enacts the HMRC view that the beneficiary is the settlor for CGT. Section 472 confirms (which no-one ever doubted) that the beneficiary is the settlor for IT.

This applies not just for the standard IT/CGT definition, but for all purposes of IT and CGT. Although the drafter adds the words except "where the context otherwise requires", I cannot think of a case where the context would "otherwise require"; and I expect the drafter has copied 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

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(a) a pecuniary legacy, or
(b) any other interest or share in the property devolving under the disposition or intestacy."

(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.[112] 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.

### 69.30.6 *Commentary*

What is the reason for s.473? Perhaps because it can be hard to identify settlors on variations of settlements. Perhaps because, if the will actually settled the property, there is little need or scope for tax planning by IOVs. In practice s.473 is not important. It appears to be dead letter tax law (not the only dead letter tax law enacted 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

112 See 69.10 (Variation or resettlement by beneficiaries).

object of the IOV rules, which is to allow beneficiaries to avoid the tax unfairnesses of badly drafted wills.

## 69.31 Pension trusts and employee trusts

### 69.31.1 *Is a pension trust or employee trust a settlement?*

Employers generally create employee trusts and pension trusts for wholly commercial reasons. There is normally no element of bounty on the part of the employer. Nor is there any element of bounty on the part of the employee, who is not in a position to negotiate or reject the arrangements. Such a trust is here called "**a commercial trust**".

A commercial trust is a settlement under the classic settlement definition. However, a commercial trust is not a settlement under the settlement-arrangement definition.[113]

HMRC agree. CG Manual 14596 provides:

> **Pension funds**
> ... It is considered that for the purposes of Income Tax[114] 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.

### 69.31.2 *Who is the settlor of a commercial trust?*

Since a commercial trust is not a settlement-arrangement, the question of who is the settlor does not arise when the settlement-arrangement definition of settlement is applicable. However the question arises as to who is the settlor of the commercial trust where the classic definition of settlement is applicable.

The answer depends on which definition of settlor applies. Let us look first at the standard IT/CGT definition and the IHT definition of settlor.

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113 Because of the bounty requirement; see 69.2.3 (Settlement-arrangement definition of "settlement").

114 The author means, for the purposes of the settlement-arrangement definition of "settlement."

Under these definitions "settlor" includes (1) the person who provides property and (2) the person who makes the settlement. It is considered that the position is as follows:

(1) "Providing" property requires an element of bounty, and no-one can be said to "provide" property to a commercial trust.
(2) To "make" (or perhaps to "enter into") a settlement does not require an element of bounty.

HMRC agree. The CG manual provides:

> **33245. Settlor: from 6 April 2006: Basic principles** [November 2009]
> ...Basically under Section 68A(1) to (3) [TCGA] a person is a settlor if:
> [1] he made or entered into the settlement. This describes the person who has had the deed drawn up on his behalf. The property may come from elsewhere; or the transfer of property to the settlement may be without 'bounty'(see next bullet),
> [2] he has provided property for the purposes of the settlement. On the basis of *IRC v Leiner* 41 TC 589 these words are regarded as applying only where there is 'bounty'. See CG35021 on 'bounty',
> [3] the property is settled as a result of his will or intestacy.

The employer normally "makes" a commercial trust (normally the employer is a party to the trust deed and the deed is drawn on his behalf) and so the employer is a settlor under the standard IT/CGT definition and the IHT definition. HMRC agree. CG Manual provides:

> **33240 Settlor: Up to 5 April 2006** [November 2009][115]
> ... There is no judicial guidance on the precise meaning of "made" and "entered into" although they have been present in the Income Tax legislation for many years. They would appear to be descriptive of anyone who can reasonably be described as settlor in accordance with the relevant legislation but also anyone who has created a settlement as a formality or put property into a settlement other than for full consideration....
> Because a person who has 'made' or 'entered into' a settlement is within

115 This passage is considering Sch 1 TCGA before the 2006 amendments. At that time the Sch 1 applied a classic definition of settlement (so an employee trust was a settlement), and it applied the settlement-arrangement definition of settlor (so someone who made or entered into a settlement was a settlor). The point made here therefore applies to the standard IT/CGT and IHT definitions of settlor which contain similar wording.

> 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+. ...
> **33580. Trusts for employees [June 2003]**
> Except where specific rules provide otherwise, trusts set up for the benefit of employees are subject to the normal rules relating to settled property. For the purposes of determining the annual exempt amount the settlor is the person who made or entered into the settlement, generally the employer. ... In addition any individual or company which adds property to the settlement is also a settlor. ...

The CGT s.86 definition of "settlor" is different and does *not* include the person who makes or enters into a settlement. So the employer is not a settlor for the purposes of s.86. HMRC appear to agree. This can be inferred from comments in the CG Manual on s.77 TCGA. That section was repealed in 2008 but the comments are relevant because the definition of settlor for s.77 was (in short) the same as for s.86 TCGA. The CG Manual provides:

> **34804 Corporate Settlors** [August 2007]:
> 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.

More analytically, a commercial settlement was a "settlement" for the purposes of s.77 (which applied the classic definition, not the settlement-arrangement definition). However s.77 did not apply because the company was not within the s.77 definition of settlor. The CG Manual provides:

> **33580. Trusts for employees** [June 2003]
> ... CG35020+ shows that in many circumstances the employer is not the settlor for TCGA 1992 Section 77.

Similarly:

> **35020. Settlor trusts: Share option schemes: Trusts for employees**
> There is nothing in Section 77 itself to prevent it being applied to a

company.[116] 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. In the latter case it can also be argued that the employees themselves are also settlors.

The Revenue Booklet entitled 'The tax treatment of Top-Up Pension Schemes', Para 2.7.5, states:

> 'The 'benefit to settlor' rules in [s.624] and [TCGA 1992, Sections 77 – 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.'

**35021. Settlor trusts: Share option schemes: Trusts for employees**

The legal basis of this is that a person is a settlor under Section 79 to the extent that that person has provided property for the purposes of the settlement. The courts have indicated in dealing with similarly worded Income Tax legislation that this means that is necessary for the settlor to have provided 'bounty', and that a commercial transaction does not normally contain bounty. Therefore if a settlement can fairly be regarded as part of an employer's normal commercial arrangements for the remuneration of his employees, neither the employer nor the employees should be regarded as settlors.

**35022. Settlor trusts: Share option schemes: Trusts for employees**

The absence of approval for a share option scheme or a top-up pension scheme does not prevent it from being 'normal'. Cases should only be challenged if the benefits are provided for a very small number of employees, particularly directors and/or shareholders.

**35023. Settlor trusts: Other commercial arrangements**

In exceptional circumstances trusts may be set up for commercial reasons other than to benefit employees. In general Section 77 should not be applied to genuine commercial arrangements, where the main beneficiaries are members of the public, and it is not intended that funds should revert to the person setting up the trust. On the other hand it is possible that the main beneficiary is the settlor, in which case the application of Section 77 should be contended for.

### 69.31.3 *Could employees be settlors of employee trust?*

CG Manual para 35020 states in relation to unapproved pension schemes:

116 This sentence is debatable but the issue is now of historic interest only.

> ... it can also be argued that the employees themselves are also settlors.

Similarly, the comment that employers and employees are not settlors is said in the passage set out above to apply only to "normal commercial arrangements".

Why are employees not settlors in normal cases? There may be two reasons:

(1) The employee may not have provided anything as they normally gave up no rights when the employer made the transfer to the trust. The trust is created at the discretion of the employer and these employees play no part in it.
(2) Common form employee trusts benefit a wide class of beneficiaries, so one may not be able to identify any particular part of the trust fund as provided by any particular employee (even if it is the case that a class of employees have jointly provided the trust property). That would preclude any charge to tax on any employee.

Employees may be settlors where these factors are both absent.

The TSE Manual provides:

> **TSEM5355 - Trusts for particular purposes: employment - related trusts - summary for FURBS/EFRBS - non-resident trustees** [Jan 2011]
> **...The Settlements Legislation**
> **Information** The Settlements legislation in Chapter 5 Part 5 ITTOIA will not apply if the scheme is operating on normal commercial lines as part of an employment package. But in certain circumstances you may consider whether the Settlements legislation applies to charge the FURBS/EFRBS trust's income and gains on a director.
> **Action** The Settlements legislation provisions can apply if the trust is apparently not genuinely to provide retirement benefits and/or the beneficiary of the trust has directly or indirectly provided funds for the settlement (see TSEM4120). Apply the following guidelines when examining trust returns and accounts and liaise with the tax office for the company and the employment income tax office, or submit to HMRC Trusts & Estates Technical Edinburgh, as necessary. .
> The Settlements legislation will not apply where only the employer makes contributions - unless the contributions are
> made by a close company which the member controls and
> unrealistically large by normal commercial standards.
> For example, if there is only one director who is also the sole shareholder of the employing company, and substantial contributions are

> made into the FURBS/EFRBS, you may consider whether the Settlements legislation applies to treat the director/shareholder as the settlor. If you think this may be the case, you must liaise with the tax office for the company. They will consider whether to deny a deduction for the contributions.
> The Settlements legislation will not apply if the member makes contributions and these are reasonable compared with the member's salary. However, if the member makes any contributions, refer the case to the Divisional Technical Adviser.
> If you consider the Settlements legislation may apply, submit your papers to HMRC Trusts & Estates Technical Edinburgh

### 69.31.4 *Trust of pension scheme death benefits*

The IHT Manual provides:

> **17125. The identity of the settlor**
> The settlor in relation to a discretionary trust created over death benefits (IHTM17030) when the member first joined the scheme is the member themselves.
> The settlor is considered to be the member even in the case of a non contributory scheme. The reason for this is that pension benefits and rights are the product of sums paid into the pension fund by the employer as deferred or delayed remuneration for the employee's current work (see *Parry v Cleaver* [1970] AC 1 and *The Halcyon Skies* [1976] 2 WLR 514).

This is obviously correct if the member has a general power of appointment over the death benefit and creates the trust by exercise of that power.

It is not clear if HMRC mean to say that the member is the settlor in other cases but if they do their view is very doubtful. The two non-tax cases cited by the IHT manual do not shed much light on the issue. If the member was not the settlor of the pension trust before the transfer to the death benefit trust, how can they become the settlor? The transfer from a pension trust to the trust of the death benefit does not alter the identity of the settlor.[117]

117 See 69.7 (Transfer from trust A to trust B by exercise of trustees' power).

## 69.32 Trust made by company: are shareholders settlors?

The position here is again made more complicated by the differences between the definitions of settlor.

### 69.32.1 *Trust made by company: s.86 definition of settlor*

The s.86 definition of settlor is unique in that it makes express provision to treat shareholders and other participators as settlors where a company is a settlor.

Para 8(4) sch 5 TCGA provides:

> For the purposes of this paragraph—
> (a) where property is provided by a qualifying company controlled by one person alone at the time it is provided, that person shall be taken to provide it;
> (b) where property is provided by a qualifying company controlled by 2 or more persons (taking each one separately) at the time it is provided, those persons shall be taken to provide the property and each one shall be taken to provide an equal share of it;
> (c) where property is provided by a qualifying company controlled by 2 or more persons (taking them together) at the time it is provided, the persons who are participators in the company at the time it is provided shall be taken to provide it and each one shall be taken to provide so much of it as is attributed to him on the basis of a just apportionment;
> but where a person would be taken to provide less than one-twentieth of any property by virtue of paragraph (c) above and apart from this provision, he shall not be taken to provide any of it by virtue of that paragraph.

Para 8(5) sch 5 TCGA defines "qualifying company":

> For the purposes of sub-paragraph (4) above a qualifying company is a close company or a company which would be a close company if it were resident in the UK.

The definition of control is a slightly cut back version of the ultra-wide definition. Para 8(8) sch 5 TCGA provides:

> For the purposes of this paragraph the question whether a company is controlled by a person or persons shall be construed in accordance with sections 450 and 451 of CTA 2010; but in deciding that question for those purposes no rights or powers of (or attributed to) an associate or associates of a person shall be attributed to him under section 451(4) to (6) of CTA 2010 if he is not a participator[118] in the company.

Why does the s.86 definition have this provision which is not found in any other definition of settlor? The answer may be that it is there specifically because the s.86 definition is narrower than the others, as discussed above, lacking the rule that someone who makes a settlement is a settlor.

If para 8 applies (so that a participator is "taken to provide" the trust property) it is considered that the company should be taken not to provide the property, ie, it is not the settlor.

### 69.32.2 *Trust made by company: other definitions of settlor*

Where a company makes a settlement, the individual controlling shareholder(s) will be settlor(s) if they can be said to provide property indirectly.[119] In relation to companies with only one or two shareholders, this may well be the case if there is an element of bounty, though it depends on the facts. The CG Manual para 34804 [August 2007] provides:

> Companies frequently create settlements. These are generally settlements for employees, see CG35020, or other commercial arrangements, see CG35023. Such settlements are usually excluded from Section 77 TCGA 1992 because of the bounty test. Exceptionally it may be appropriate to argue that TCGA Section 77 applies to the particular settlement. *Although there is no specific provision comparable to TCGA Schedule 5 Para 8(4), nevertheless it may be appropriate in such a case to consider whether the property entering the settlement has been provided indirectly by the shareholders, both for the purposes of TCGA Section 77 and for the purposes of Section 619 ITTOIA [the settlement-arrangement definition].*
> (Emphasis added)

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118 Para 8(9) sch 5 TCGA provides the common form definition of participator: "In this paragraph 'participator' has the meaning given by section 454 of CTA 2010."

119 Contrast 26.3.2 (Transfer procured by individual).

## 69.33 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 H's wife W (not UK domiciled); and

(2) W gives it to a trust.

Who is the settlor: H or W or both?

The success of schemes involving a transfer to a foreign domiciliary who creates a settlement depends on how the transaction is carried out. Does W have a genuine and wholly independent role?[120] 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[121] 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.[122] But it is different if B is acting at the behest of the settlor.[123]

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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120 See 69.4 (Gift from A to B followed by gift to trust by B).

121 W may also need tax advice, but what matters here is that W has independent advice on the property law aspects of the gift.

122 See 69.6 (Appointment from old trust to B followed by gift to new trust by B).

123 See 69.5 (Trust created by B at request of A).

CHAPTER SEVENTY

# SITUS OF ASSETS FOR IHT

## 70.1 Concepts of situs

Situs[1] of assets is relevant for many tax and some non-tax purposes, of which the most important are IHT excluded property and the CGT remittance basis.[2]

Situs (like domicile) is in origin a concept of private international law (or conflict of law) which has been adopted for tax purposes. The rules are laid down by the common law. The common law rules apply for tax, except so far as modified by specific rules in tax legislation.

IHT situs is almost entirely based on the common law rules. These are discussed in this chapter. Some IHT double tax treaties override the usual IHT situs rules.[3]

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, though in a few cases the common law/IHT principles still apply for CGT. Situs for CGT is discussed in the next chapter.

The rules which determine the location of a source of income for income

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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". Section 59 Stamp Act 1891 (repealed) used the term "locally situate". The concept in each case is the same. "Situs" has become adopted into legal English usage and should not be written in italics.

2 Other tax issues where situs may arise include (1) the ITA remittance basis and (2) foreign IHT and CGT credit relief. In most cases the issue is whether or not the asset is situated in the UK, and if outside the UK it does not matter where. However in cases of foreign IHT and CGT credit relief, it may be necessary to identify the state where assets are situated.

3 See 60.5 (Treaty situs).

tax purposes are different from situs.[4] For instance, dividends from UK situate shares may be foreign source income and vice versa; interest from a foreign situate debt may be UK source income and vice versa. Situs only occasionally matters for IT, but where it does, the common law rules discussed in this chapter will apply.

Strictly one should not refer to situs in the abstract, but to situs for a specific purpose (CGT, IHT, or whatever) but context may supply the reference, and in this situs means situs as determined by the common law rules which apply for IHT purposes.

### 70.1.1 *Commentary*

The situs of land and chattels seems obvious (but occasionally the law does not adopt the obvious solution). For intangible assets (shares, debts, etc.), the law must choose connecting factors to link the asset to a jurisdiction. There is a large choice of possible connecting factors, and the selection of the determining factor must sometimes be arbitrary.[5] 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

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4 See 16.4 (Why does location of source matter?).

5 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.

Similarly, in *New York Life Insurance v Public Trustee* [1924] 2 Ch 101 at p.119 the situs rules were described as "legal fictions". It is of course true that an asset with no corporeal existence, such as a debt or other chose in action, has no material position in the material world. Nevertheless a better analysis is to say that "situs" (of a chose in action) is a metaphorical term describing an abstract concept. The situs of a chose in action is not "fictional", but perfectly "real" (or at least as real as concepts such as "residence" or "domicile" or indeed "chose in action") though the concept may be described as "technical" or (if one prefers a pejorative term) "artificial". Lawyers are entitled to use ordinary words in special senses and to call a situs (of a chose in action) a "fiction" is inapt and misleading. See J.H. Baker, *The Law's Two Bodies* (2001), Lecture 2 ("Legal Fictions"); Neil MacCormick, *Institutions of Law* (2007), p.136.

that the role of situs in private international law has decreased, and very few of the common law rules apply to CGT.

Amendment of the IHT rules is however difficult because of the problem of double inheritance taxation. To the extent that different states adopt the same common law situs rules, they effectively prevent double taxation which otherwise arises if state A regards an asset as situate in state A for IHT purposes and state B regards the same asset as situate in state B. That was perhaps why in 1974 CTT (now IHT) adopted the common law situs rules and not the CGT statutory situs rules. The disparities between CGT and IHT situs are not accidental.[6]

Two reforms would improve the position:

(1) Treat all assets other than UK land and securities as non-UK situate for the purposes of excluded property rules. That would be a simplification and it is most unlikely that the IHT charge on such assets of foreign domiciliaries brings in any significant tax. The abolition of stamp duty on UK situate property (other than securities) is a precedent.

(2) A counterside would be to introduce a charge on UK private residences held via non-resident close companies.[7] Rules analogous to the relevant property 10 year and exit charges would not work. Rules treating the shares of property companies as if they were UK situate are not practical. The rough and ready but workable solution is an entry charge on acquisition by such a company, avoidable by an election that the company should be regarded as transparent for IHT. The precedents are the 1.5% SDRT entry charge and the election out of the POA charge. The SDLT regime would provide the administrative structure for enforcement. Double taxation aspects would need consideration but would not be insoluble.

## 70.2 Every asset has one situs

Under the common law rules, every asset is situate in one jurisdiction[8] and

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6 It could of course arise that state A regards an asset as situate in state A for CGT purposes and state B regards the same asset as situate in state B; however that is less likely to cause problems in practice, because (among other reasons) a DTA following the OECD model convention will normally determine which state imposes CGT.

7 To be EU compliant the same rules would have to apply to UK resident close companies, but in practice such companies do not usually acquire a UK residence.

8 *English Scottish and Australian Bank v IRC* [1932] AC 238.

only in one jurisdiction. In *R v Williams* [1942] AC 541 at p.559 the Privy Council said:

> Property, whether movable or immovable, can ...[9] have only one local situation.[10]

This rule is self evidently necessary since the purpose of situs rules in private international law is to resolve conflicts of jurisdiction, and one purpose in tax is to avoid double taxation. It is also implicit in the word situs: the physical fact that a physical object (above the level of quantum physics) can be situate in only one place. I stress this as some old cases considered assets could be dual situate. They no longer represent the law.

## 70.3 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

9 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.

10 Likewise *Laidlay v Lord Advocate* (1890) 15 App Cas 468 at p.483: "locality cannot be both England and India—the choice has to be made between the two".

> 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?

## 70.4 Situs of registered shares

### 70.4.1 *Place-of-register rule*[11]

The IHT Manual provides:

> **27121 Usual location**
> For the purposes of Inheritance Tax an inscribed[12] and registered security[13] (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*.[14]...
> 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 call this "**the place-of-register rule**".[15] 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

11 See Robert Venables QC, "The Situs of Registered Shares", PTPR Vol 9 p.115.

12 Author's footnote: "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".

13 Author's footnote: "Securities" here includes shares as well as debt securities.

14 (1857) 2 H & N 339 accessible on *www.kessler.co.uk*. This was approved in *AG v Winans (No. 2)* [1910] AC 27.

15 A "register" is only a record of stockholders and their assignees: see *Ramsay v IRC* 54 TC 101 at p.133.

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 and 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 whatsoever should be given to these dicta. The IHT Manual tactfully ignores this case. Thus the majority of the Court of Appeal have accidentally introduced into the law if not an uncertainty at least an inconsistency which needs to be explained away. But there it is.

### 70.4.2 *Overseas branch register*

Multiple registers raise a problem for a place-of-register rule. If there is only one register applicable to the shares in question, that is where the shares can be dealt with. The IHT Manual provides:

> **27122 Branch registers**
> If a company has more than one register, and any changes must be recorded on one of the registers, the relevant securities are situate in the place where that register is required by law to be kept – not in the place of the head office of the company.

This requires an examination of company law to identify which of the two registers is applicable. The IHT Manual summarises the company law background:

> **27124 Overseas branch registers of UK companies**
> Under UK law a share cannot, at one and the same time, be registered on more than one register.
> The rule applies even as regards overseas branch registers (these are branch registers of members resident in the country to which the register relates). Under [s.132 CA 2006], a company that maintains an overseas branch register has to keep a duplicate thereof at the place where its principal register is kept.
> And "no transaction with respect to any shares registered in an overseas branch register shall, during continuance of the registration, be registered in any other register" – see [s.133 CA 2006].
> Shares on the overseas branch register of a UK company are therefore situated, for Inheritance Tax purposes, in the country where the register

> is kept.
> Under [s.129 CA 2006] a company may maintain an overseas branch register. The countries and territories in which overseas branch registers may be kept are specified in [s.129 CA 2006]. [S.129 CA 2006] enable[s] the provisions as to overseas branch registers to be extended by Order in Council to countries within the jurisdiction, or under the protection, of the Crown.

This view is confirmed by s.133(3) CA 2006:

> An instrument of transfer of a share registered in an overseas branch register—
> (a) is regarded as a transfer of property situated outside the UK.

### 70.4.3 *Transfer office*

Another solution may be that the company has only one register and merely a "transfer office" elsewhere:

> **27125 - Duplicate or multiple registers of non-UK companies** [October 2007]
> Some overseas company laws allow a shareholder to use duplicate (or multiple) share registers to record the transfer of their securities.
> The South African Companies Act, for example, authorises South African companies to maintain branch registers in any foreign country. Shares can be transferred on any register, but no transfer of shares passing on death can be registered in the UK until any death duty claimed by South Africa on the shares has been paid.
> Remember that some registers merely record information about transfer of securities without providing the legal basis for the transfer. These registers do not affect the locality of the security (IHTM27071)
> Details of transfer arrangements given in the Stock Exchange Year-Book[16] do not always make the position clear and, if necessary, you must ask the taxpayer to explain.

16 Author's note: The Stock Exchange Official Year Book has long ceased publication; it was first published in 1876 and the most recent edition I have been able to trace was 1994.

### 70.4.4 *Two effective registers*

If that fails one must look for another territorial connection:

> **27125 - Duplicate or multiple registers of non-UK companies** [October 2007]
> Where there are many registers the register upon which the shares would normally be dealt with in the ordinary course of business is the register that determines the locality of the security – see *Treasurer of Ontario v Aberdein* [1947] AC 24.

But which is the register which would normally be used? The Manual explains:

> If the share certificates are here, one of the alternative registers is here, and transfers can be effected here the shares will normally be regarded as legally situate here (*Re Clark, McKechnie v Clark* [1904] Ch 294).

*R v Williams* [1942] AC 541 is another example: the location of a (signed and endorsed) share certificate acting as a tie-breaker between two competing jurisdictions (each with a share register).[17] The Manual continues:

> This is only an assumption and as such can be rebutted by the particular circumstances of the case (see *Standard Chartered Bank Ltd v IRC* [1978] 1 WLR 1160). But if tax is offered on shares in a foreign company with transfer facilities in the UK, you can assume that the register here is the one on which the shares would normally be dealt with in the ordinary course of business.

### 70.4.5 *Company without "register" (in true sense)*

The IHT Manual provides:

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17 IHT Manual para 27150 [October 2007]:
"If the company has more than one register on which the holding could be effectively transferred, and the share certificates are found at the material time at a place where a register is located, the holding is for Inheritance Tax purposes situated at that place – see *R v Williams* [1942] AC 541. Cases where none of the effective registers is located where the certificates are found must be referred to TG or your Team Leader, in Scotland."

**27123 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).

### 70.4.6 *Register of share transfers*

The IHT Manual provides:

**27127 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.

### 70.4.7 *Miscellaneous*

The IHT Manual provides:

**27128 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.

## 70.5 Registered debt securities

The rules for debt securities[18] 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.

18 I use the term "debt securities" to mean securities which are not shares.

### 70.5.1 *Place-of-register rule v specialty rule*

Shares are not "specialties" so the specialty rule cannot apply to them.[19] 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 Bonds and debentures under seal**
> Debentures if under seal, are specialty debts, locally situated where the document is found. So, also, are debts due from the Crown, or under a statute, whether under seal or under hand, and even when they are secured by registered bonds.

Thus for debentures the specialty rule overrides the place-of-register rule. For HMRC views as to which securities are "specialties", see 70.13.3 (Situs of specialty).

## 70.6 Securities of international organisations

For convenience this section deals with CGT situs as well as IHT situs, as the rules are the same.

### 70.6.1 *Designated organisations*

Section 126 FA 1984 provides power to designate:

> (1) Where—
> (a) the UK or any of the Communities is a member of an international organisation; and
> (b) the agreement under which it became a member provides for exemption from tax in relation to the organisation, of the kind for which provision is made by this section;
> the Treasury may, by order made by statutory instrument, designate that organisation for the purposes of this section....
> (4) The Treasury may, by order made by statutory instrument, designate any of the Communities or the European Investment Bank for the purposes of this section, and references in subsections (2) and (3) above to an organisation designated for the purposes of this section include

19 See 70.13 (Specialty obligation).

references to a body so designated by virtue of this subsection.

Section 126(2)(3) set out the consequences of designation:

(2) Where an organisation has been so designated, the provisions mentioned in subsection (3) below shall, with the exception of any which may be excluded by the designation order, apply in relation to that organisation.
(3) The provisions are—
(b) any security issued by the organisation shall be taken, for the purposes of capital transfer tax to be situated outside the UK;

The IHT Manual provides:

**27141List of non-UK situs organisations** [October 2007]
Unless in bearer form and situated physically in the UK[20] 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:
[a] the International Monetary Fund: The Bretton Woods Agreement Order in Council, 1946 ((SR & O) 1946 No 36)
[b] the International Bank for Reconstruction and Development[21]: The Bretton Woods Agreement, as above
[c] the International Finance Corporation: The International Finance Corporation Order, 1955 (SI 1955 No 1954)
[d] 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 or your Team Leader (Scotland).

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)

20 I do not understand the basis for this exception, but in practice the point may never arise.
21 [Author's footnote] More commonly known as the World Bank.

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.

## Section 265 TCGA provides:

(1) Where—
(a) the UK or any of the Communities is a member of an international organisation; and
(b) the agreement under which it became a member provides for exemption from tax, in relation to the organisation, of the kind for which provision is made by this section;
the Treasury may by order designate that organisation for the purposes of this section.
(2) The Treasury may by order designate any of the Communities or the European Investment Bank for the purposes of this section.
(3) Where an organisation has been designated for the purposes of this section, then any security issued by the organisation shall be taken, for the purposes of this Act, to be situated outside the UK.

## The CG Manual provides:

**12440 Types of asset (2): Shares and securities etc** [November 2009]
*Securities of International/European Organisations*
Special rules are provided for dealing with securities issued by certain designated international organisations.
Section 265 TCGA 1992 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 Capital Gains Tax to be located outside the UK. The list of organisations that have been designated under this provision is as follows.
- International Bank for Reconstruction and Development
- Asian Development Bank
- African Development Bank
- The European Economic Community
- The European Investment Bank
- The European Bank for Reconstruction and Development
- The European Coal and Steel Community
- The European Atomic Energy Community

### 70.6.2 *Inter-American Development Bank and OECD support fund*

Section 131 FA 1976 provides:

> (1) The following provisions of this section shall have effect on the UK's becoming a member of the Inter-American Development Bank ("the Bank").
> (2) A security issued by the Inter-American Development Bank shall be taken for the purposes of capital transfer tax … to be situated outside the UK.

Section 266 TCGA provides a corresponding CGT exemption:

> A security issued by the Inter-American Development Bank shall be taken for the purposes of this Act to be situated outside the UK.

Section 4 OECD Support Fund Act 1975 provides:

> (1) A person not resident in the UK shall not be liable to income tax in respect of income from any security issued by the support fund established by the Agreement if he would not be liable but for the fact that—
> (a) the security or income is issued, made payable or paid in the UK or in sterling; or
> (b) the support fund maintains an office or other place of business in the UK;
> and such a security shall be taken for the purposes of capital transfer tax and capital gains tax to be situated outside the UK.

## 70.7 Bearer documents

The place-of-register rule cannot apply to bearer shares as there is no register of shareholders.

### 70.7.1 *Bearer shares*

The general principle is that the shares are situate where they can be legally transferred: see 70.3 (Situs of shares: general principle). Applying this rule it is clear that bearer shares are situate where the certificate is held.

### 70.7.2 *Bearer debt securities*

The leading case is *Att Gen v Bouwens*.[22] This concerned foreign bearer bonds which were marketable in England and it was not necessary to do any act outside England in order to transfer them. Lord Abinger said at p.192:

> No ordinary[23] 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.

The situs of bearer debt securities is where the document is to be found. Dicey agrees.[24] HMRC also agree. The IHT Manual provides:

> **27076 Bearer securities**[25]
> A security which is represented by a document of title, the property in which passes by delivery, is locally situated, for Inheritance Tax purposes, in the place where that document is found at the material time. *Att Gen v Bouwens*,[26] *Winans v Att Gen* [1910] AC 27.

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22 (1838) 4 M & W 171 accessible *www.commonlii.org*. This was approved in *Att Gen v Winans (No. 2)* [1910] AC 27.

23 Situs governed the jurisdiction of the Ordinary (an ecclesiastical office). The jurisdiction passed to the Court of Probate in 1857, and to the Chancery Division in 1875, but nothing turns on that.

24 *The Conflict of Laws* (14th ed, 2006), para 22-044. But for a dissenting view, see 70.11 (Letter of allotment of shares).

25 This passage applies to both shares and debt securities.

26 (1838) 4 M & W 171 accessible *www.kessler.co.uk*.

### 70.7.3 *Eurobonds*

HMRC have commented specifically on the situs of Eurobonds in a passage which I mention for completeness but which adds nothing to the general principles:

> 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.[27]

## 70.8 Intermediaries and depositories

### 70.8.1 *The securities law background*

In order to determine situs of an asset one must of course identify the asset and its legal nature. The Law Commission explain:

> 2.7 ...immobilisation entails depositing securities in paper form with a depository linked to a settlement system so that they are held indirectly. Where a new issue of securities is immobilised from the outset, the entire issue will be typically constituted by a single 'global' or 'jumbo' certificate which remains in the vaults of the depository.[28] The

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27 [1994] PCB 139. For completeness, the passage concludes:
"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."
A eurobond within s.124 (now repealed) had to be a bearer security, so this does not take matters much further.

28 Footnote original: Interests in the global note may be exchangeable for definitive certificates, so that the investor can acquire a direct relationship with the issuer. Usually, however, the global note is intended to be permanently immobilised and cannot be split into definitive certificates other than in extreme circumstances, such

depository (or its nominee) becomes the owner of the securities either by registering the securities in its name with the issuer (in the case of registered securities) or by physical possession of the global certificate (in the case of bearer securities).

2.8 Participants in the settlement system keep interests in the immobilised securities by holding an account with the securities depository. These account holders are able to transfer and pledge their interests in the securities through book entries on the depository's books rather than by re-registration or by delivery of the underlying securities. Following the computerisation of settlement systems in the late twentieth century, the depository's 'books' that record ownership are now electronic records....

2.11 Recording investors' interests in securities as electronic bytes of information enables these interests to be transferred with ease from one account holder to another simply by a credit and debit in the computerised accounts of an intermediary. As long as the legal system recognises this as a valid transfer of an interest in securities, traditional formalities associated with the transfer of underlying securities (for example, the execution of stock transfer forms and the issuance of new certificates) can be avoided. Greater transferability of securities enhances liquidity and consequently their value.

**Pooled Accounts**

2.17 ... Where an intermediary holds fungible securities for more than one investor it will typically pool these securities in a single client account. To do so, the intermediary opens an account with the issuer or intermediary above it in its own name and records in its own books each individual investor's allocation in the pooled account. In most legal systems, the only reference to an investor's specific allocation is made in its intermediary's accounts and not in the accounts of any higher-tier intermediary or in the register of the issuer...

**Central Securities Depositories in indirect holding systems**

2.19 The efficiencies generated by intermediation led the Group of Thirty to recommend in 1989 that each domestic market should establish a central securities depository (CSD) to hold both physical and dematerialised securities in the relevant market. Immobilisation of securities is therefore centralised in a single depository (or through a nominee of the CSD). An indirect holding system based on the immobilisation of securities in a domestic CSD is the most common

as the failure of a bond trustee to act on the instructions of the investors upon a default.

model in advanced countries[29] and there are about thirty systems operating in this manner in Europe alone. As we explain below, the UK does not operate a centralised depository for domestic securities in this way.

National CSDs do not usually raise issues for situs as the situs of the register of the CSD is usually the same as the situs of the underlying assets. However the issue does arise for international CSDs and other intermediaries.

2.20 In addition to national CSDs, Euroclear in Brussels and Clearstream in Luxembourg operate as international central securities depositories (ICSDs). ICSDs were originally established to manage clearing and settlement of Eurobonds for which there was no supporting market infrastructure. Since their creation over thirty years ago, the business of ICSDs has expanded to also cover most domestic and internationally traded securities. Euroclear and Clearstream maintain links to CSD counterparts in all the significant domestic financial markets, facilitating cross-border securities trading, clearing and settlement...[30]

The Law Commission then turn to the legal analysis. This is complicated by the variety of jurisdictions which may be involved. I concentrate on Belgium and Luxembourg as they are the homes of Euroclear and Clearstream. The Law Commission say:

**LEGAL ANALYSIS OF INTERMEDIATED SECURITIES**

2.24 Intermediation has had a substantial effect in transforming the legal nature of investor's rights in securities. In the UK and elsewhere, the traditional analysis of an investor's rights arising from its direct relationship with an issuer and based on its physical possession of securities or by an entry in the issuer's register no longer reflects the reality of the market place....

2.31 Belgium[31] and Luxembourg[32] are each home to major ICSDs

29 Footnote original: In America, the Depository Trust and Clearing Corporation has custody, through its nominee Cede & Co, of between 60% to 80% of all publicly traded securities in the US. In 1999, this amounted to securities worth $23 trillion.

30 Law Com., *The UNIDROIT Convention on Substantive Rules regarding Intermediated Securities Further Updated Advice to HM Treasury* (May 2008).

31 Footnote original: Belgian Royal Decree No. 62, as co-ordinated by Royal Decree of 27 January 2004.

32 Footnote original: Luxembourg Law of 1 August 2001 on the circulation of securities and other fungible instruments, Articles 6.7 and 15.

(Euroclear and Clearstream respectively) and both have recently clarified their respective securities laws. Investors that hold securities through an intermediary in an omnibus account are treated as having a co-ownership right in the pool of fungible securities, exercisable only against the intermediary. Should the intermediary fall insolvent, the investor is given a right of revendication, that is to say, a claim for the return of property enforceable against the intermediary and its creditors...

**Direct enforcement versus indirect enforcement**

2.35 In all common law jurisdictions (such as the UK and the US) and a number of civil law countries (for example Belgium and Luxembourg), an investor that holds through an intermediary is unable to exercise the rights it may have in the underlying securities directly against the issuer of those securities.[33] The investor can only enjoy the fruits of its investment by enforcing its rights against its intermediary. Furthermore, the investor will be generally prohibited from making a claim against securities held in the account of a higher tier intermediary but must rely on the contractual and fiduciary obligations of its own intermediary to pursue such claims....

2.49 The effect of commingling securities in a pooled account is generally to preclude the continuing existence of direct property rights of individual owners in the specific securities held prior to commingling...

LEGAL PROTECTION BASED ON CO-OWNERSHIP

2.51 In a number of EU Member States, account holders are given proprietary rights (or the equivalent protection) by treating their interests in a commingled account as co-ownership (or co-proprietary) interests in a fungible pool.

2.52 In Belgium[34] and Luxembourg,[35] statute converts what would otherwise be a mere contractual claim against the intermediary into an intangible co-ownership right in a pool of fungible book-entry securities held by the intermediary.[36]

A note on terminology. It is apparent from the above that the terms "depository" and "intermediary" may be used synonymously. I prefer the word **"intermediary"** as an asset may be held through a number of

33 Footnote original: Unless the issuer permits otherwise by contract or provisions in a deed poll or trust deed.

34 Footnote original: Belgium Royal Decree No 62, Article 2.

35 Footonte original: [Luxembourg] Securities Act 2001, Article 7.

36 Law Com. *The UNIDROIT Convention on Substantive Rules regarding Intermediated Securities Further Updated Advice to HM Treasury* (May 2008).

intermediaries and "depository" only seems apt for the first of the chain.

I use the word **"investor"** to describe the ultimate holder of the securities through one or more intermediaries. I refer to the investors assets as **"intermediated securities"** but without prejudging the issue of whether those assets are properly described as securities in the normal sense of that rather vague word. I refer to the asset held by the ultimate depository as **"the underlying security."**

### 70.8.2 *Situs*

There are no relevant statutory provisions, so the common law rules apply for IHT.

The relevant principle is that an asset is situate where it can be dealt with. An intermediated security is dealt with (ie transferred) in the jurisdiction of the intermediary. That is the jurisdiction where litigation over the transfer of the intermediated security would normally take place. So that is the situs of the intermediated security; the situs of the underlying asset is irrelevant.

It might be argued that since a simple bare trust or nomineeship is transparent for IHT situs[37] the situs of the investor's asset, the intermediated security, must be that of the underlying security. It is in principle correct the underlying security is held on trust, though of course that does depend on the documentation and law involved. However that trust not a simple bare trust since it allows pooling and change of title is effected by registration; in fact it is not properly described as a bare trust in the strictest sense of that expression.

Dicey agrees:

> ... the general principle is that the *situs* of a chose in action is where it is recoverable or may be enforced. ... Furthermore, there is an analogy between immobilised securities and registered securities (which are normally regarded as situated where the register is located). Accordingly, the *situs* of immobilised securities should be regarded as the place where the depository is established and where it keeps the database in which the entitlements of the depositors are recorded.[38]

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37 See 70.25 (Interest under bare trust or nomineeship).

38 14th ed para 22-043. This view is enthusiastically supported by Benjamin, *Interests in Securities* (2000), Chap 7. See too an interesting posting to the Trusts Discussion Forum V2 # 74 (Peter Cushen).

This is also supported by Canadian authority:

> The place where the central securities depository control account is located could [and should] be considered the situs of "dematerialized" securities. In a multi-tiered holding system, the account would be situated at the financial investment intermediary on whose books the interest of the debtor appears. This is the place where the record that determines title is to be found.[39]

The Law Commission agree:

> 21.6 The concentration of the investor's interests into one account *with a single situs* can also greatly simplify conflicts of laws issues. This is of particular benefit to lenders wishing to take security over a portfolio of securities. Provided that the choice of law rules applied to the different intermediated securities are clear, the lender need only concern itself with the perfection requirements of the jurisdiction in which the account is located rather than the requirements of each of the jurisdictions applicable to the various underlying securities.[40]

Thus there is a substantial difference between the situs of the intermediated security (the asset held by the investor) and the situs of the underlying securities. However such differences are not surprising since, as the Law Commission say, "Intermediation has had a substantial effect in transforming the legal nature of investor's rights in securities." Investors may ignore the difference between intermediated securities and underlying securities, but if so they may be surprised on the insolvency of an intermediary, as actually happened in the case of Lehman Brothers.

### 70.8.3 *HMRC view*

HMRC take a different view. The IHT Manual provides:

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39 *Re Bloom* [2004] BCSC 70, 27 BCLR (4th) 176, accessible *www.canlii.org*.

40 Law Com. *The UNIDROIT Convention on Substantive Rules regarding Intermediated Securities Further Updated Advice to HM Treasury* (May 2008). *http://www.justice.gov.uk/lawcommission/docs/intermediated_securities_advice_May2008.pdf*

> **27077 Eurobonds and American depository receipts**
> The situs of securities dealt with through computerised clearing systems (e.g. Euroclear; CEDEL [which became Clearstream in 2002]) is regarded as determined by the terms of issue of the particular security.
> ...

That is, HMRC regard clearing systems as transparent for situs; what matters is the situs of the underlying security. Another HMRC statement makes the same point:

> ... where a financial institution or other intermediary has purchased Eurobonds or similar fungibles through Euroclear or Cedel [now Clearstream] 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.[41]

The CG Manual discusses the issue under the heading "depository receipts". The Manual first discusses the securities law background and practice:

> **50240 Depository receipts** [April 2010]
> 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

41 [1994] PCB 139.

> 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.

A depository receipt is a form of intermediated security. The CG Manual continues:

> **50241 Depository receipts: Tax analysis** [April 2010]
> For capital gains purposes[42] the holder of the DR has two separate chargeable assets, namely
> [1] a beneficial interest in the underlying shares, and
> [2] the DR (being the document evidencing title, and comprising a number of rights as against the depository).

It is in principle[43] correct that the holder of a DR has a beneficial interest in the underlying shares and rights against the depository. It does not follow that these should be regarded as two separate assets. A DR should be regarded as a matter of general law as one asset and not two. Admittedly a DR confers a bundle of different rights, but that is also true of a share, a unit in a unit trust, an equitable interest, and most other types of property which are nevertheless regarded as single items of property and not as two or more distinct items. However, it does not matter as the Manual goes on to effectively ignore its two-asset analysis. In the view of the Manual, the only asset which matters is the beneficial interest in the underlying share:

> A disposal of shares in DR form is therefore in strictness a disposal of two separate assets. In general, however, the value of a DR may be expected to track closely that of the underlying shares. So the

42 Author's note: whether the holder of a DR has one or two assets is a question of general property law; it is not strictly correct to ask if a person has two assets "for CGT purposes". But nothing turns on that.

43 Though this strictly depends on the relevant law and documentation.

> 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.

Conversion to and from DR form is neutral for CGT:

> **50241. Depository receipts: Tax analysis** [April 2010]
> ... 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.

This conclusion is not controversial, whatever the jurisprudential nature of a DR.

The CG Manual then turns to consider situs:

> **50243. Tax analysis – situation of assets** [April 2010]
> 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.

There is a certain common sense in the HMRC view that situs is determined by the situs of the underlying asset. However, situs is not a matter of common sense, and that view cannot stand against the authorities set out above. So as a statement of the common law situs rules, this is not correct. (The CG Manual passage is correct for CGT purposes as specific CGT provisions reverse the common law rule; I consider that elsewhere.)[44]

It must be frustrating for HMRC to see a significant part of the economy

44 See 71.9 (Intermediaries and depositories).

taken out of the scope of IHT by means of clearing systems and depository receipts. Though in practice the loss of tax will be nil or next to nil, for well advised foreign domiciliaries will not hold UK situate investments, above the nil rate band, and for non-residents, IHT on such assets is largely uncollectable. Indeed the current law could aid the UK economy by encouraging UK investment, or at least it could do so if HMRC acknowledged it.

## 70.9 CREST

The Law Commission explain the securities law background:

> 2.21 Investment securities constituted under English, Scots and Northern Irish law can take either certificated or dematerialised ('uncertificated') form. CREST is the main securities settlement system in the UK and settles securities in uncertificated form. Unlike system operators in most national settlement systems, CREST does not hold domestically issued securities[45] as a central securities depository for account holders. CREST has no proprietary rights in the securities and is not treated as 'holding' these securities from the issuer on behalf of its participants. Rather, the CREST member is treated as holding directly from the issuer. This CREST member alone is entitled to exercise voting, dividend and other rights attaching to the shares and may do so directly against the issuer.
> 2.22 Instead, it is the register operated by CREST which, in the case of UK securities, is actually constituted by statute[46] as the sole legal record of entitlement to the securities. Although the issuer will maintain a regularly reconciled record of what is held in CREST for corporate events purposes, it is the CREST register that confers legal title and which determines the person or entity named in the register as the shareholder for company law purposes.

Thus holding a security through CREST (rather than in certified form)

45 Footnote original: That is, in the UK, Republic of Ireland, Isle of Man, Guernsey and Jersey.

46 Footnote original: For UK companies it is the entry in the CREST register that confers legal title on the owner: Uncertificated Securities Regulations 2001, SI 2001 No 3755 reg 24. For Irish, Manx, Guernsey and Jersey securities, the pre-2001 system still operates. Settlement is through CREST but legal title is transferred when the entry is made in the issuer's register.

does not make any difference as to situs.

## 70.10 Share certificate endorsed in blank

The IHT Manual explains the background law and practice as follows:

> **27150 Share certificates endorsed in blank** [October 2007]
> Certificates of many American and Canadian railroads and of certain other companies have a printed form of transfer and/or power of attorney endorsed, which enables the certificates, when the form is signed by the registered holder of the shares, to be transferred by delivery.
> It is common practice for such certificates to be "endorsed in blank", i.e. for the endorsement to be signed by the registered owner as transferor, the name of the transferee being left blank.
> Dividends are paid by the company to the registered owner, and if these shares have in fact changed hands by delivery, the beneficial owner for the time being recovers his dividends from the registered owner.
> Usually the shares are registered in the name of a recognised broker, bank, discount house, etc, known in England as a "good Marking Name" or, in America, as a "Street Name". This helps to make sure that the purchaser receives their dividends with minimum of trouble and risk.
> A list of good Marking Names recognised by the London Stock Exchange is printed in the Stock Exchange Official Year Book.[47]
> 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.

I doubt if this is still current practice, but set out the HMRC comments for completeness:

> The local situation of shares for Inheritance Tax purposes is determined as followings:
> [a] If the registered owner is a good Marking Name, the shares are situated where the register is kept, not where the certificates are found. ...[48]

47 Author's note: The Stock Exchange Official Year Book has long ceased publication; it was first published in 1876 and the most recent edition I have been able to trace was 1994.

48 Omitted text set out at 70.4.2 (Overseas branch register).

> [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.[49]

The HMRC view is that one ignores the fact a share transfer form has been endorsed in blank. This is right, because the endorsed certificate does not alter the place where registered shares are dealt with as between shareholder and company: see 70.3 (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.

## 70.11 Letter of allotment of shares

A letter of allotment confers the right to an issue of shares. The letter is normally transferable by delivery, just like a bearer security. One would have thought that the bearer security rule would apply. However, in *Young v Phillips* 58 TC 232 a letter of allotment in respect of a company

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49 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.

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 *Att Gen v Bouwens* set out above[50] 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 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,

50 See 70.7 (Bearer documents).

> 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.[51] 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:

> **12440 Types of asset (2): Shares and securities etc** [November 2009]
> *Letters of allotment*
> Letters of allotment should be treated as located in the country where the company issuing the letters is registered. In the case of Young v Phillips 58 TC 232 bonus shares were issued in respect of registered shares located in the UK. The issue was made in letter of allotment form. The letters were then taken to the Channel Islands and disposed of there. It was held that the letters of allotment were located in the UK because they evidenced rights which were properly enforceable only in the UK.

Thus in the HMRC view *Young v Phillips* is relevant to letters of allotment only, it has no relevance to the situs of bearer debt securities or shares which are governed by cases of much higher authority. It is suggested that

51 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 *www.kessler.co.uk*. Contrast the sophisticated definition of "asset for which there is a liquid market" in ICAEW Tech 7/03 para 19 (Guidance on the determination of realised profits and losses in the context of distributions under the CA 1985).

the reasoning should be restricted to short life assets (such as the letters of allotment in that case which, it was stressed, had a life of only two months).

Even letters of allotment may be situate where the letter is situate, if there is a "market" there.

## 70.12 Simple contract debt

The basic principles are well established:

> As to the locality of many descriptions of effects, household and moveable goods, for instance, there never could be any dispute; but to prevent conflicting jurisdictions between different ordinaries, with respect to choses in action and titles to property, it was established as law, that judgment debts were assets, for the purposes of jurisdiction, where the judgment is recorded; leases, where the land lies; specialty debts, where the instrument happens to be; and simple contract debts, where the debtor resides ...[52]

The IHT Manual provides:

> **27091 Debts: contractual**
> In English law, a **simple**[53] **contract** debt is situated where the debtor resides: *Att Gen v Bouwens*;[54] *English, Scottish and Australian Bank Ltd v IRC* [1932] AC 238.

I call this **"the place-of-debtor rule"**. It can be traced back to Elizabethan times.[55]

A winding-up order against the debtor does not affect the situs of the debt,[56] but judgment against the debtor (turning the debt into a judgment debt) does do so.[57]

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52 *Att Gen v Bouwens* (1838) 4 M & W 171 accessible *www.commonlii.org*.

53 [Author's note] A "simple" contract is one which is not a specialty. Different rules apply to judgment debts and bank accounts: see below.

54 (1838) 4 M & W 171 accessible on *www.kessler.co.uk*.

55 *English Scottish & Australian Bank v IRC* [1932] AC 238 at p.248.

56 *Wight v Eckhardt* [2004] 1 AC 147. In practice this issue will not usually arise.

57 See 70.16 (Judgment debt).

### 70.12.1 *Meaning of "residence" and dual resident debtor*

In order to apply the place of debtor rule one needs to determine where the debtor resides. For this purpose the test of residence for a company is not the usual test (management and control) but where the company carries on business:

> Now, when you are dealing with a corporation, you are dealing again with a legal notion, and you have to examine the question where the debt can be said to be situate. It appears to me plain that a corporation according to our law is deemed to reside for the purposes of suit in the place where it carries on business in its own name ...[58]

The *rule* has a certain logic, for situs of a simple debt is (or at least, in the past broadly was) decided by reference to jurisdiction, and jurisdiction over a company depends (or at least, in the past broadly depended) on its place of business and not its tax-residence.[59]

The *terminology* used in the rule is inapt, and it would be better if some other word were used, rather than using (or rather, misusing) the word "residence" in this non-standard meaning. But the terminology having arisen for historic reasons, there is not much to be done about it. It does not matter too much as long as one remembers that "residence" here has this non-standard meaning, in relation to companies. In practice it is rare for there to be any difference between tax-residence and residence under this test.

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 is, where the debt was payable.

### 70.12.2 *Place-of-debtor rule v. jurisdiction where debt enforced*

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.

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58 *New York Life Insurance v Public Trustee* [1924] 2 Ch 101 at p.120 followed *Kwok Chi Leung Karl v CED* [1988] STC 728 at p.733.

59 See Dicey *Conflict of Laws* (14th ed., 2006), para 14-059 and 30-007.

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.[60] However the background law (that is, conflict of law or private international law) has moved on considerably since *New York Life Insurance* was decided in 1924. It is now largely governed by international conventions, under which it is only very approximately correct to say that residence of the debtor is the test of jurisdiction, even though in many cases the end result is the same.[61] This raises a difficulty where the debtor resides in one jurisdiction but the debt is enforceable in another. Do we continue to apply the historic residence tests, or do we say the debt is situate where it is enforceable, ignoring the place that the debtor resides? *Raiffeisen Zentralbank v Five Star Trading* [2001] QB 825 notes the difficulty:

> [36] In the case of intangible property, English law has, for various purposes (e.g. inheritance), traditionally allocated to it a situs at the place of the debtor's residence. This is on the basis that the debtor is there directly subject to the coercive power of the courts to enforce the obligation. The location of a right of action in this or any way is, however, evidently artificial. Parenthetically, I add that "coercive power" would itself appear to be an unstable international concept, capable of widely differing interpretation ...
> [37] Modern conditions underline the artificiality of selecting supposed control at the debtor's residence as an appropriate basis for characterisation or choice of the relevant law to determine questions regarding the validity or effect as against the debtor of an assignment. Jurisdiction may be grounded on consent and various other bases apart from residence. Obligations are commonly enforced today not against the person, but against assets. Debtors often trade or hold some or even

60 *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.

61 The background private international law is discussed in slightly more detail in connection with the location of the source of interest, where HMRC suggest similar issues arise: see 17.4.5 (Impact of modern private international law). A full discussion of the background law would need a book to itself (which is another good reason for not using jurisdiction for the purposes of tax law).

> 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.

It is considered that although jurisdiction was the historic reason for adopting the place-of-debtor rule, now the rule has been chosen, one should continue to look to residence, regardless of where the debt would be enforced. So a debt is situate where the debtor resides even though enforceable elsewhere, eg under an exclusive jurisdiction clause. Although the historic reason for the place-of-debtor rule no longer holds much if any validity, the rule is as good as any other. Well-established precedents are not overturned merely because their historic reason has become unsound. So it is considered that the law is settled.

## 70.13 Specialty obligation

### 70.13.1 *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.[62] A life policy, contract for deferred annuity, capital redemption policy and the like are specialties if made by deed. Shares are not specialties.[63]
(3) The term also includes a debt incurred under a statute, whether or not it is a debt under a deed.[64]
(4) Certain debts are by statute given the nature of a specialty debt.[65]

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62 In *Aiken v Steward Wrightson Agency* [1995] 1 WLR 1281 the term was applied to a contract by deed to provide services (and an action for breach of that contract was held to be an action "upon a specialty" so as to qualify for a 12-year limitation period).

63 *R v Williams* [1942] AC 541.

64 *Royal Trust Co v AG for Alberta* [1930] AC 144.

65 eg 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."

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".[66] No particular form is necessary to be a "specialty" beyond the formalities of a deed.

As a shorthand, a deed was formerly 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.

### 70.13.2 *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 the concept of deeds is a specialty if it is executed in accordance with the local law requirements of a deed. In the Isle of Man, for instance, a seal was never required except for corporations, though for a document to be a deed the parties must intend it to be a deed.[67]

A document governed by a foreign law which does not recognise the concept of deeds will be a specialty if it is executed in accordance with the English law requirements of a deed.[68]

### 70.13.3 *Situs of specialty*

The IHT Manual provides:

> **27091 Contractual**
> A specialty debt is situated where the instrument happens to be.

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66 The Law Commission took this view in Working Paper No. 85 (1985) and Report No. 253, para 2.12.44.

67 *Aall Trust & Banking Corporation v Samuel McCormick* 2 OFLR 85, Butterworths Offshore Service Cases, Vol 2, p.479.

68 *Alliance Bank of Simla v Carey* (1880) 5 CPD 429.

I call this "**the specialty rule**".[69] This rule (like the place-of-debtor rule) can be traced back to Elizabethan times.[70] So a debt due from a UK resident can be made non-UK situate for IHT by drafting the debt as a specialty and keeping the document offshore. Conversely a debt, policies, and other specialities can be made UK situate for IHT by bringing the deed here.

The specialty rule requires one to ascertain whether a debt is a specialty, and the IHT Manual offers a little guidance:

> **27079 Bonds and debentures under seal**
> Debentures if under seal, are specialty debts, locally situated where the document is found. So, also, are debts due from the Crown, or under a statute, whether under seal or under hand, and even when they are secured by registered bonds.
> Most UK government securities (e.g. Treasury Loan, Exchequer Stock, War Loan) are registered, so that their locality is determined by the place of registration. However, some bonds issued by the UK government (containing an express obligation to pay) are governed by the general rule that a debt due from the Crown is a specialty debt, situated where the document evidencing the obligation is physically 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)**

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69 *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.

70 *English Scottish & Australian Bank v IRC* [1932] AC 238 at p.248.

Perhaps the withheld text states how HMRC check that bonds are not omitted from IHT account. The Manual continues:

> **27091 Contractual**
> ... 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 70.4 (Situs of registered shares).

### 70.13.4 *Scottish specialty*

The IHT Manual continues:

> **27092 Debts in Scotland**
> In Scotland, the rule that a debt is situated where the debtor resides applies alike to specialty (IHTM27078) debts and to those due on simple contract. For Inheritance Tax purposes debts due from persons resident in Scotland are regarded as locally situated there. If any difficulty arises in applying this rule, refer the case to TG (IHTM01081).
> Any case where a Scottish instrument under seal is outside the UK and the locality of the asset determines whether or not an allowance under s.159 IHTA is admissible must also be referred to TG for consideration.
> This direction relates to specialty debts generally. It covers, for example,
> [1] mortgages under seal,
> [2] policies under seal, and
> [3] covenant debts, and
> [4] also applies to debts due from the Crown, or due under a statute.

I find the comments relating to Scotland somewhat surprising and would be grateful to any reader who could direct me to relevant Scots authority.

### 70.13.5 *Reason for the specialty rule and future developments*

What is the reason for the specialty 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[71]: 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;[72] and, unlike such debts, were enforceable against the real estate.[73] They were said to be "of a higher nature" than debts by contract. It is, therefore, not surprising that specialty debts by deed were treated from an early date as bona notabilia [i.e. assets situate] where the deeds were found at the time of the death, unlike ordinary debts which were said "to follow the person of debtor".

In this reasoning the conclusion does not follow from the premises, and in any case the premises have long ceased to be valid in English law. The rhetorical language (not for the first time) conceals a weakness in the reasoning. One might conclude that the specialty rule has no good reason but *Commissioner of Stamps v Hope* [1891] AC 476 offers a better 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,

71 This rule was abolished by the Civil Procedure Act 1833.

72 This rule was abolished by the Administration of Estates Act 1869.

73 This rule was abolished by the Administration of Estates Act 1833.

60(1).

The reason for the rule is not that the specialty has a "species of corporeal existence".[74] 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.

The Supreme Court could sweep these dusty cobwebs away. But in tax cases the point should not often arise as HMRC should not 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 their specialties outside the UK. So the courts are not likely to have to examine the issue (though it could arise in non-tax litigation or in Scotland or the Privy Council). The courts have shown themselves prepared to amend long established common law rules, such as the rule that there is no recovery for payments made under a mistake of law. But they have 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. Moreover, situs is a question of international law and it is "of great importance that some fixed common principles should guide the Courts in every country on international questions. In questions of international law we should not depart from any settled decisions, nor lay down any doctrine inconsistent with them."[75] So it is considered that the rule will remain even if challenged in the Supreme Court. It should be abolished (if at all) by Parliament.[76]

## 70.14 Debt secured on land

### 70.14.1 *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).

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74 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.

75 *Udny v Udny* 1 Sc.&Div. 441 at p.452.

76 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.

Let us look at the matter as one of principle. Is the rule that situs depends on location of the land a sensible or workable rule? It is not, for the following reasons:

(1) One debt may be charged on land in two different countries. A secured debt confers a bundle of different rights, including:
    (a) right to sue on the covenant;
    (b) right to sell if the debt is unpaid;
    (c) right to foreclose if the debt is unpaid.
    However, this bundle is a single asset. It cannot be situate in both countries.
(2) The rule becomes absurd if a large debt happens to be secured on an asset of small value. Would one say a £100m debt is situate in Jersey if it is secured on a property there worth £100,000? But obviously one cannot have a rule where the situs depends on relative values of the debt and the security which may fluctuate enormously from time to time.
(3) It has never been suggested that a debt charged on (say) shares is situate where the shares are situate but there is no good reason to distinguish between shares and land.

The only sensible rule therefore is to apply the specialty rule and ignore the fact that the debt is secured.

The case law is complicated. The law got off on the right footing with *Commissioner of Stamps v Hope* [1891] AC 476. Here the debt was a specialty secured on land in New South Wales. The deed was held in Victoria. The question was situs for the purpose of probate duty and the Privy Council held that the debt was situate in Victoria.

Only three years later the Privy Council muddied the waters in *Walsh v The Queen* [1894] AC 144. Here there were a variety of debts, some secured on property in and out of Queensland. It was held that the debt should be regarded as being in Queensland up to the value of the property there. The best explanation of this case is that it did not concern the common law situs rule. The case turned on the specific statute (the Queensland Dividend Duty Act 1890) which (by implication) operated an entirely different situs rule. This explains why the earlier case of *Commissioner of Stamps v Hope* was not referred to in the judgment of the Privy Council.

*Payne v R* [1902] AC 552 concerned a specialty debt charged on land in Victoria. The deed was in New South Wales. The Privy Council held at p.560 (without citing authority or any discussion) that a mortgage debt was a specialty debt in New South Wales and a simple contract debt in Victoria. That is obviously wrong. They also held the asset was situate in Victoria *and* New South Wales, which (although followed in *Henty v The Queen* [1896] AC 567) is not now the law.[77] 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.

A comment of the Special Commissioner in *Hafton Properties v McHugh* also supports this view.[78]

Dicey notes that a mortgage debt is normally a specialty and continues:[79]

> [1] A mortgage of land confers an interest in land and will be held situate where the land is situate,[80]
> [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.[81] …
> [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.[82]

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77 See 70.2 (Every asset has one situs).

78 "... the debt was a mortgage debt. Such a debt is regarded for private international law purposes (at any rate) as a speciality debt, the situs of which is to be found where the mortgage deed is to be found;" 59 TC 420 at p.426.

79 Dicey, *Conflict of Laws*,(14th ed, 2006), para 22-035.

80 [Dicey's footnote] *Re Hoyles* [1911] 1 Ch 179.

81 [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.

82 [Dicey's footnote] *Re Hoyles* [1911] 1 Ch 179; *Dicey* para 22–012; c.f. Falconbridge, *Selected Essays on the Conflict of Laws*, (2nd ed. 1954) pp.573–580 for an acute discussion of the problem raised in this paragraph.

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[83] suggests that the HMRC view is (like mine) that the specialty prevails, not the location of the land.

### 70.14.2 *Simple debt charged on land*

In the case of a simple debt charged on land (not made by deed) the choice lies between:

(1) The location of the land.

(2) The simple debt rule (situs is residence of debtor).

The arguments of principle suggest that the simple debt rule prevails. This conclusion is also supported by the passage from *Raiffeisen* cited in 70.12 (Simple contract debt). This conclusion is consistent with the position for specialty debts secured on land.

## 70.15 Debt under letter of credit

The IHT Manual provides:

> **27091 Contractual**
> 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).

83 70.13.3 (Situs of specialty); note the references to mortgages in the quotation from the IHT Manual.

## 70.16 Judgment debt

A judgment debt is situate where the judgment is recorded.[84] Obtaining judgment may therefore have the effect of changing situs, for better or worse.

## 70.17 Bank account

The IHT Manual provides:

> **27093 Debts: Bank accounts** [October 2007]
> A bank account is a debt, and under general law is situated at the branch of the bank where the account is kept: *R v Lovitt* [1912] AC 212.[85]
> This general law rule may be modified for IHT purposes by a Double Taxation Convention ...

This is not a special rule for bank accounts: it is an application of the general rule that, in the case of a company carrying business in two places, a simple debt is situate where payable; see 70.12.1 (Meaning of "residence" and dual resident debtor).

UK bank accounts may qualify for IHT relief.[86] Guidance on what constitutes a branch of a bank can be found in the discussion of branch and PE.[87]

## 70.18 Building society account

A standard form building society account is not a debt, it is an interest in the society, so corporation situs rules rather than debt rules should be applied.

The IHT Manual provides:

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84 *AG v Bouwens* (1838) 4 M & W 171 accessible on *www.commonlii.org*.
85 In the Law Reports the name of this case is: *The King v Lovitt.*
86 See 53.17 (Non-residents foreign currency bank accounts).
87 See 74.2 (Meaning of permanent establishment); 74.11 (Meaning of "branch or agency").

**27151[Bank or][88] 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.

## 70.19 Insurance policy

For the purpose of common law situs rules a policy is treated in the same way as a debt, so the place-of-debtor and specialty rules apply.[89] The IHT Manual correctly provides:

**27101 Policy monies: general rule**
When the policy is under hand the policy monies are situated where the debtor (company) is resident (generally the head office of the company)
...
**27102 Payment made at place other than Head Office**
Where under the terms of the policy, payment is to be made at some place other than the residence of the head office the monies are deemed to be situated at the place of payment (*New York Life Insurance Co v Public Trustee* [1924] 2 Ch 101).
**27103 Policy issued at branch office**
If[90] a policy is issued by, or through, a branch office of a UK company, outside the UK, and no reference is made in the terms of the policy as to the place where the policy monies are to be paid.
Policy monies are to be treated as situated in the country of the branch office provided that the whole course of business in relation to the policy had been transacted in that country.
The "whole course of business" connotes the happening of all the following events in the country of the branch office:
- that the policy is issued to a resident in that country from the branch in that country

88 The reference to a "bank" in the heading seems to be erroneous since the text only relates to building societies.
89 *New York Life Assurance Co v Public Trustee* [1924] 2 Ch 101.
90 The text has gone wrong here: The previous Manual read: "A further type of case is one in which the policy *etc*"; and that is clearly the meaning. Probably the first two paragraphs are intended to form one sentence.

> - that 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.

### 70.19.1 *Policy made by deed*

The IHT Manual correctly provides:

> **27104 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:

> 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 30.12 (IHT on policy held by foreign domiciliary).

## 70.20 Land

The IHT Manual provides:

> **27074 Land and interest in land** [October 2007]
> Immovable property is situated where it is actually located, but you must note that in the case of some types of interest either in land or relating to land, different legal systems may take opposing views as to whether they constitute movable or immovable property.
> These differences are resolved (under Private International Law, and also by specific provision in Double Taxation Conventions where these apply) by the adoption of the view taken by the law of the country in which the land itself is situated: *Johnstone v Baker* (1817) 4 Madd 474; *Macdonald v Macdonald* [1932] SLT (HL) 381.
> Land is usually classed as immovable property, and so is generally governed by the law of the country in which the immovables are situated. This issue of devolution may be especially significant here when ascertaining the exemption of foreign property that may or may not pass to a surviving spouse or civil partner (IHTM11032).

## 70.21 Chattels

The rule is what one would expect. The IHT Manual provides:

> **27075 Chattels**
> Chattels are situated where they happen to be at the relevant time.[91]

It is suggested that this applies even where:
(1) a chattel is moved out of the UK;
(2) the chattel is transferred to another person or trust;
(3) the chattel is returned to the UK.
The temporary removal of the asset at the time of the disposal cannot be ignored, for tax purposes, even if the time spent out of the UK is short.

## 70.22 Ships and aircraft

The IHT Manual provides:

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91 The text is found twice: IHT Manual paras 21047 and 27075. For a concession on works of art see 53.18 (Works of art).

> **27073 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.

See now *Dornoch v Westminster International* [2009] EWHC 889.

## 70.23 Goodwill and intellectual property

Goodwill is situate where the trade or profession is carried on (see *IRC v Muller* [1901] AC 217).

For intellectual property, see *Forster's Australia Ltd v CIT* 302 ITR 289 (AAR) 10 ITLR 939.

Because of IHT business property relief, these issues will not often arise.

## 70.24 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.

## 70.25 Interest under bare trust or nomineeship[92]

The interest of a beneficial owner in property held by a nominee or bare trustee is situate where the underlying asset is situate: a nomineeship or bare trust is transparent for situs. In *Re Clore, IRC v Stype Investments* land in England (the Guy's estate was held by a Jersey nominee(Stype Investments):

> Immediately after the conveyance of the Guy's estate to Stype

92 For present purposes the terms "bare trust" and "nomineeship" are used synonomously.

> Investments and the execution of the declaration of trust which acknowledged that the Guy's estate would "continue to remain in the beneficial ownership of Sir Charles," the Guy's estate belonged in equity to Sir Charles in fee simple and his interest constituted property situate in England. Stype Investments was entitled to be paid any outgoings or charges in respect of the estate, but this entitlement did not affect the nature, quality or situation of the interest of Sir Charles in the estate.[93]

For unit trusts see 35.5 (Situs of unit) and 70.8 (Intermediaries and depositories).

## 70.26 Equitable interest under a substantive[94] trust

The situs of an equitable interest under a substantive trust is not often relevant for IHT, but it may matter, eg 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.[95]

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

93 [1982] STC 625 at p.633-4.

94 By "substantive" I mean a trust other than a bare trust (nomineeship) or unit trust.

95 For a contrary view see Harris, *The Hague Trusts Convention*, (2002), Chapter 9 (Situs of equitable interests).

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.

## 70.27 Unadministered estate of deceased person

The IHT Manual provides:

> **27072 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,[96] 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, ie 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[97]
> 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)

## 70.28 Situs of partnership share

The situs of a partnership share may not matter for IHT, because of BPR,

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96 Author's Note: Further consideration will be required for jurisdictions other than England and Wales, especially civil law jurisdictions.

97 See s.91 IHTA.

but the issue will sometimes arise.

An interest in a partnership is an asset (a chose in action) distinct from the assets of the partnership. It has its own situs distinct from the situs of the partnership assets. HMRC agree. The HMRC website POA guidance provides at Appendix 1:

> For IHT purposes ... we do not regard the partnership interest as transparent.

There are several factors that the court might have used to determine situs. In practice the situs of an interest in a general[98] partnership is the place where the partnership business is carried on.[99] This is not necessarily the place where the partners reside: there is no concept here of carrying on business by tacit oversight.[100] The same applies to a limited partnership.

### 70.28.1 *Situs of LLP*

A LLP is a body corporate and its situs for private international law will be determined by using the rules applying to companies. For IHT purposes, however, s.267A IHTA provides:

> 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

98 That is, a partnership which is not a limited liability partnership.

99 See *Laidlay v Lord Advocate* (1890) 15 App Cas 482, followed *Commissioner of Stamp Duty v Salting* [1907] AC 449. Since *Laidlay* is a Scottish case, the law of England and Scotland on this point must be taken to be the same. In a case where it is not clear where the partnership business is carried on, it would be logical to adopt the partnership residence test of control and management. Further consideration would be needed if the partnership is not governed by UK law.

100 See 13.3 (Trading income of UK resident).

(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 a LLP in the same position as a conventional partnership. An obscure passage in the IHT Manual para 25094[101] [October 2007] suggests that HMRC may not have reached this view, but it seems clear enough.

## 70.29 Situs of pension and death benefits

Death in service benefits payable in respect of service under the Crown, local authorities or overseas governments are generally payable at discretion and so not liable to IHT. However the situs does matter in the exceptional case where the benefit is an asset in the estate of the deceased.

Section 153(2) IHTA provides:

(2) For the purposes of this Act—
(a) a pension paid under the authority of a scheme made under section 2 of the Overseas Pensions Act 1973 which
  [i] is constituted by the Pensions (India, Pakistan and Burma) Act 1955 or
  [ii] is certified by the Secretary of State for the purposes of this section to correspond to the said Act of 1955
  shall be treated as if it had been paid by the Government of India or the Government of Pakistan (according as the arrangements in pursuance of which the pension was first paid under the said Act of 1955 were made with the one or the other Government);
(b) a pension paid out of any fund established in the UK by the Government of any country which, at the time when the fund was

101 Para 25094 provides:
**Limited liability partnerships** [October 2007]
... 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."

established, was, or formed part of, a colony, protectorate, protected state or UK trust territory shall, if the fund was established for the sole purpose of providing pensions, whether contributory or not, payable in respect of service under the Government be treated as if it had been paid by the Government by which the fund was established;

(c) a pension paid out of the Central African Pension Fund established by section 24 of the Federation of Rhodesia and Nyasaland (Dissolution) Order in Council 1963 shall be treated as if it had been paid by the Government of a territory outside the UK; and

(d) so much of any pension paid to or in respect of any person under—

(i) the scheme which by virtue of subsection (3) of section 2 of the Overseas Pensions Act 1973 is constituted under that section by section 2 or subsection (2) of section 4 of the Overseas Service Act 1958 or

(ii) such other scheme made under section 2 of the Overseas Pensions Act 1973 as is certified by the Secretary of State for the purposes of the Taxes Act to correspond to section 2 or subsection (2) of section 4 of the Overseas Service Act 1958

as is certified by the Secretary of State to be attributable to service under the Government of an overseas territory shall be treated as if it had been paid by the Government of that territory.

(3) ... for the purposes of subsection (2) above—

(a) “pension” includes a gratuity and any sum payable on or in respect of death, and a return of contributions with or without interest thereon or any other addition thereto;

(b) “UK trust territory” means a territory administered by the Government of the UK under the trusteeship system of the United Nations;

(c) “overseas territory” means any country or territory outside the UK;

(d) references to the Government of any such country or territory as is mentioned in paragraph (b) or (d) of that subsection include a Government constituted for two or more such countries or territories and any authority established for the purpose of providing or administering services which are common to, or relate to matters of common interest to, two or more such countries or territories.

(4) If, by reason of Her Majesty's Government in the UK having assumed responsibility for a pension, allowance or gratuity within the meaning of section 1 of the Overseas Pensions Act 1973 payments in respect of it are made under that section, this section shall apply in relation to the pension, allowance or gratuity, exclusive of so much (if any) of it as is paid by virtue of the application to it of any provisions of the Pensions

> (Increase) Act 1971 or any enactment repealed by that Act, as if it continued to be paid by the Government or other body or fund which had responsibility for it before that responsibility was assumed by Her Majesty's Government in the UK.

The important effect of this is that the pension (defined to include a death benefit) is not UK situate if it is treated as payable by a foreign government. The IHT Manual provides:

> **17132 Crown, local authorities and overseas governments** [October 2007]
> ... The following table is therefore for general guidance only and is not intended to be exhaustive.
> *Overseas Service :* Sums payable on death to personal representatives by way of return of subscriptions under the regulations of
> • the Indian Military Widows and Orphans Fund;
> • the Superior Services (India) Family Pension Fund
> • the Indian Military Service Family Pensions Fund; and
> • the Indian Civil Service family pension fund
> Lump sum payable on death to personal representatives under a scheme constituted under the Pensions (India, Pakistan and Burma) Act 1955 or a corresponding scheme (a foreign asset by virtue of Section 153(2)(a)
> *Whether payment included in estate:* Yes if the deceased died domiciled (IHTM13000) in the UK (excluded property under Section 6(1) IHTA 1984 if not so domiciled)
> Benefits payable to personal representatives as of right on death of a Colonial Government servant (a foreign asset by virtue of Section 153(2)(b))
> *Whether payment included in estate:* Yes if the deceased died domiciled in the UK (excluded property under Section 6(1) IHTA 1984 if not so domiciled)
> Benefits payable under s 1 Overseas Pensions Act 1973 other than 'statutory increases' thereof (a foreign asset by virtue of Section 153(4) and Section 153(2)(b))
> *Whether payment included in estate:* Yes if the deceased died domiciled in the UK (excluded property under s 6(1) if not so domiciled)
> Benefits payable out of the Central African Pension Fund (a foreign asset by virtue of Section 153(2)(c))
> *Whether payment included in estate:* Yes if the deceased died domiciled in the UK (excluded property under s 6(1) if not so domiciled)
> Lump sum payable on death to personal representatives as of right under scheme constituted under the Overseas service Act 1958, or a

corresponding scheme (a foreign asset by virtue of Section 153(2)(d))
*Whether payment included in estate:* Yes if the deceased died domiciled in the UK (excluded property under s 6(1) if not so domiciled)...

CHAPTER SEVENTY ONE

# SITUS OF ASSETS FOR CGT

## 71.1 Situs of assets for CGT – Introduction

This chapter deals with situs of assets for CGT. Strictly one should not refer to situs in the abstract, but to situs for a specific purpose (CGT , IHT, or whatever) but in practice where the context is clear it is sufficient to refer to situs, and in this chapter references to situs means situs for CGT purposes.

For a general introduction to situs, see 70.1 (Concepts of situs). For situs of partnership assets, see 36.6 (Transparency of partnership for CGT). See too 35.5.2 (Situs of unit for CGT); 70.6 (Securities of international organisations).

## 71.2 Meaning of "shares" and "debentures"

The CGT situs rules make specific provision for shares and debentures, so it is necessary to consider the meaning of these terms.

The meaning of debenture is particularly important, because there is an significant distinction for CGT situs between:

(1) debts which are not debentures, whose situs is generally the residence of the creditor;[1]

(2) debts which are debentures, whose situs is:
    (a) UK if issued by UK incorporated company, or
    (b) if registered and issued by a non-UK incorporated company, the place of the register.

There are two statutory provisions which relate to the definitions but they are of very limited scope. It is convenient to mention them first to clear them out of the way.

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1 See 71.10 (Debt situs rule).

### 71.2.1 *Company with no share capital*

Section 275(2)(a) TCGA provides:

> In subsection (1) above—
> (a) in paras (d), (da) and (e), the references to shares or debentures, in relation to a company that has no share capital, include any interests in the company possessed by members of the company, ...

In UK company law the only type of company with no share capital is a company limited by guarantee. There are also foreign entities which are classified as companies for tax purposes which have no share capital, but I cannot think of any to which s.275(2)(a) is likely to be significant.

So far as it concerns *shares* the rule makes sense up to a point. In short, the rule is that "shares" includes the interest of members of a guarantee company. The only puzzle is why the rule is needed. In practice the situs of interests in guarantee companies will rarely if ever arise. A provision of this kind is quite common in tax.[2] The rule was enacted in other areas to prevent avoidance and perhaps the drafter put it in here without much thought as to whether it was actually needed.

I do not understand why the statutory provision refers to *debentures* and suspect the drafter may be under a misapprehension here. A debenture is a right against the company, not an interest in the company. Whether the company has a share capital is (in the absence of the definition) highly relevant in deciding whether an asset is a "share" but it is wholly irrelevant in deciding whether an asset is a "debenture". I would be grateful to any reader who could offer an explanation. In practice it does no harm.

### 71.2.2 *Securities issued by non-company*

Section 275(2)(b) TCGA provides:

> in paras (d) and (e), the references to debentures, in relation to a person other than a company, include securities.

This assumes that (in the absence of this definition) securities issued by

2 There are too many to list; see for instance s.135(4)(5) TCGA.

a non-company would not be, or may not be, debentures. I think that is doubtful. The term "debenture" is normally used in the context of companies, but the concept is not restricted to companies.[3]

Section 275(1)(d) refers to debentures issued by a government authority.[4] Treasury gilts, though "securities" are not normally called "debentures" so perhaps the provision is useful to avoid doubt..

Similarly, other non-companies, such as trusts or individuals, can in theory create "securities" and if such assets might not be regarded as "debentures" then this provision could be needed (though in practice this does not happen).

While unnecessary, this provision does no harm.

### 71.2.3 *Change from "securities" to "debentures" in 2005*

Before 2005 the legislation referred to "securities" where it now has the word "debentures." HMRC explained the reason for the change:

> The scope of the existing rules in s 275 which apply in relation to securities will be extended so that they apply in relation to debentures - this means, for example, that ... all registered debentures (rather than just those which are securities) of a company which is not incorporated in the UK will be treated as being situated where they are registered ...[5]

HMRC were concerned that there might be a debenture which was not a security. I think that is doubtful. I would have thought that any debenture must necessarily be a security.[6]

The reform raises the question of whether an asset could be a security but not a debenture; if there were such an asset the effect of the 2005 reform was to take it outside the scope of the statutory situs rules, which was not intended! The better view is that any registered debt security is a

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3 See Gower and Davies, *Principles of Modern Company Law* (7th ed 2003), p.806: "The word "debenture" is not restricted to securities of companies or bodies corporate. Clubs not infrequently issue debentures and the name may even be applied to bonds issued by an individual; eg to those issued by the Tichborne Claimant..." This passage is not in the current edition but the point is sound.

4 See 71.4 (Municipal and government securities).

5 BN 36, 16 March 2005.

6 See s.738 CA 2006: "In the Companies Acts "debenture" includes debenture stock, bonds and any other securities of a company..."

debenture so this problem does not arise.

If that is correct, the substitution of "debentures" for "securities" in 2005 was misconceived, but it did no harm.

### 71.2.4 *Meaning of "debenture"*

In the absence of applicable statutory guidance, the word "debentures" should be given its normal meaning. It is a wide and somewhat vague term:

> If we begin by asking what the word "debenture" means, apart from any definition, the reply must be that it has no precise meaning. Chitty J. observed in the case of *Levy v. Abercorris Slate and Slab Co.*,[7] that the word "means a document which either creates a debt or acknowledges it, and any document which fulfills either of these conditions is a debenture." ... Sir Nathaniel Lindley had previously stated simply, "What the correct meaning of 'debenture' is I do not know": *British India Steam Navigation Co. v. IRC*.[8] In *Lemon v. Austin Friars Investment Trust*[9], the same ignorance was professed in the Court of Appeal. Warrington LJ in particular, after observing that it had been said "by a wiser man than himself" that it was impossible to give an exhaustive definition of the word "debenture," went on to remark that he did not propose to incur the reproach of venturing where wise men fear to tread. The textbooks are agreed at least in this that no accurate definition of the word can be found.[10]

Company law draws a distinction between an ordinary debenture and debenture stock:

> Debenture stock is merely borrowed capital consolidated into one mass for the sake of convenience. Instead of each lender having a separate bond or mortgage, he has a certificate entitling him to a certain sum, being a portion of one large loan; and generally debenture stock differs from a debenture in form rather than in substance.[11]

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7 (1887) 37 Ch D 260.

8 (1881) 7 QBD 165.

9 [1926] 1 Ch 1.

10 *Knightsbridge Estates Trust v Byrne* [1940] 1 AC 613 at p.621.

11 *Re Herring* [1908] 2 Ch 493 at p.497.

No-one doubts that debenture stock is within the general meaning of "debentures".

In the following discussion, I use the word **"securities"** to mean either shares or debentures.

## 71.3 Co-owned assets

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.[12]

"Interest" is normally a wide term, but s.275C(4) defines it narrowly:

> 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).

Thus we are concerned here with co-ownership interests, or shares of assets. Section 275C applies to co-owned assets of all kinds but the most important cases are co-owned securities.

Section 275C goes on to lay down two rules which govern situs of co-ownership interests:

> (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.

I refer to these as **"the co-ownership situs rules"**.

At first sight it is hard to see the point of these rules. If an asset is situate in a jurisdiction, one would expect a share in the asset to be situate in the same place and a statutory provision to that effect seems unnecessary.

However, s.275 stipulates the situs of shares, debentures, debts, etc and

12 Paragraph (b) is otiose since the matter is fully covered by (a); but it does not matter.

it might be argued that a person who owns a co-ownership interest in a share, debenture, debt, etc does not own a share, debenture, debt, etc; so it might be argued that these statutory situs rules do not apply to co-ownership interests. Hence s.275C(2) has a role to play.

Section 275C(3) is needed where situs depends on the residence of the owner and the asset is co-owned. For instance, if a debt or a ship is jointly owned by two persons, one UK resident and one non-resident, the interest of the UK resident is regarded as UK situate and the interest of the non-resident is regarded as non-UK situate.

## 71.4 Municipal and government securities

Section 275(1)(d) TCGA provides:

> shares or debentures[13] 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:

> **12440 Location of assets: Shares and securities** [November 2009]
> [The Manual sets out s.275(1)(c) and continues:] This applies to shares and securities issued by such bodies whether they are in registered form or in bearer form.

## 71.5 Securities of UK incorporated company

Section 275(1)(da) TCGA provides:

> Subject to para (d) above, shares in or debentures of a company incorporated in any part of the UK are situated in the UK.

This rule prevents CGT remittance basis planning for UK incorporated companies by use of bearer shares and foreign share registers. That was common practice before 2005. The spur to the 2005 reform was probably *Chandrasekaran v Deloitte & Touche* [2004] EWHC 1378 which discussed and raised the awareness of this planning.

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13 For the meaning of “debentures” see 71.2.2 (Securities issued by non-company).

## 71.6 Registered securities: non-UK company

Section 275(1)(e) TCGA provides:

> subject to paras (d) and (da) above, registered shares or debentures are situated where they are registered and, if registered in more than one register, where the principal register is situated.

This applies to shares and debentures of foreign incorporated companies but not UK incorporated companies. It (more or less) restates the common law rules.[14]

The CG Manual provides:

> **12440 Types of asset (2): Shares and securities etc** [November 2009]
> *Shares and securities*
> ...Registered shares and securities[15] other than those dealt with in the previous two paragraphs 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 1992. Which register is the principal register is a question of fact.

## 71.7 Bearer shares

Bearer shares of non-UK incorporated companies are governed by the common law rule.[16] They are situate where the document is situate.

## 71.8 Bearer debentures: non-UK company

What is the position for bearer debentures? Unless one of the statutory situs rules applies, the common law rule will apply and the debenture will be situate where the document is situate. Two statutory rules need consideration: the debt situs rule and the UK-law rule.

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14 See 70.4 (Situs of registered shares).

15 Following the 2005 reforms, the reference to securities should strictly read "debentures" as that is now the statutory term. But it makes no difference.

16 See 70.7 (Bearer documents).

### 71.8.1 *Does debt situs rule apply to bearer debentures?*

Section 275(1)(c) TCGA (the debt situs rule) 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.[17]

Debenture stock is not a debt[18] so the debt situs rule does not apply to debenture stock.[19]

An ordinary debenture (not debenture stock) is a debt in the normal sense of the word. At first sight it seems that the debt situs rule applies, so a bearer debenture is situate where the creditor is resident. If that were right the situs of the document of a bearer debenture would never determine situs. However it is considered that the context of s.275, the reference to a debt in the debt situs rule means a simple debt and not a debenture. The debt situs rule does not apply to any debentures.

HMRC agree. The CG Manual provides:

> **CG12440 Types of asset (2): Shares and securities etc** [November 2009]
> *Shares and securities*
> ... The Companies Acts allow companies to issue 'share warrants to bearer' or 'stock warrants to bearer' provided the company's Articles of Association allow it. These are commonly called bearer shares and 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.
> The location of bearer securities issued by any body other than

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17 See 71.10 (Ordinary debt)

18 For the meaning of "debenture stock" see 71.2.4 (Meaning of "debenture"). A person who holds debenture stock is not a creditor: *Re Dunderland Iron Ore* [1909] 1 Ch 446. So the asset is not a "debt".

19 Against this, it might be argued that the co-ownership situs rule applies so the situs of the debenture stock is the situs of the underlying debenture. But it is considered that (1) the co-ownership situs rule does not apply in this case and (2) even if it does, the situs of the underlying debenture is not governed by the debt situs rule as the underlying debenture is not a debt for the purposes of that rule.

- a municipal or governmental authority or
- any body created by such an authority, or
- a company incorporated in the UK

is not covered by a specific capital gains rule. Therefore it has to be decided in accordance with general law, see CG12420-CG12421. 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.

### 71.8.2 *Does UK-law rule apply to bearer securities?*

A debenture is an intangible asset and if it is "subject to UK law" (as widely defined) then in principle it appears that the UK-law rule applies, and the debenture will be UK situate.[20]

The CG Manual does not refer to the UK-law rule. One might argue that the reference to an intangible asset in s.275A means intangible assets other than debentures, in which case a debenture of a foreign incorporated company is not UK situate even if it is subject to UK law. This appears to be the HMRC view since the manual passage above says that the location of bearer securities "is not covered by a specific capital gains rule".

### 71.8.3 *Planning implications*

Remittance basis taxpayers will generally avoid investing in debentures which are UK situate for CGT purposes. Non-UK incorporated companies who issue debentures and want their investors to include remittance basis taxpayers will in principle wish to ensure that their debentures should not be UK situate for CGT purposes.

To achieve this:

(1) The debenture could be registered and the register kept outside the UK; in that case the position is clear.
(2) The debenture could be a bearer instrument and
    (a) kept outside the UK and
    (b) not "subject to UK law" (as defined) though that may not be necessary.

20 See 71.13.2 (The UK-law rule).

### 71.8.4 *Commentary*

The combination of statutory and common law rules for securities of non-UK incorporated companies is intricate and sometimes impractical. It has never been thought through. It is suggested that the rule should be that *all* securities are situate in the place of incorporation of the company. That would be logical, and a simplification, with no loss of tax.

## 71.9 Intermediaries and depositories

The starting point is to understand the securities law background and the common law situs rules; see 70.8 (Intermediaries and depositories) where I conclude (contrary to the HMRC view) that the situs of intermediated securities[21] under the common law situs rule is that of the intermediary on whose books the interest of the investor appears. This is the place where the record that determines title is to be found. The situs of the underlying security does not matter.

In the absence of a statutory provision, the same rule will apply for CGT. Six statutory provisions need consideration: the co-ownership situs rules, s.60 TCGA, the UK-law rule, and three rules dealing with securities in s.275(1)(d)(da)(e).

### 71.9.1 *Intermediated securities of non-UK companies*

The reader will recall that s.275(1)(e) TCGA provides:

> subject to paras (d) [government securities] and (da) [UK incorporated companies] 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.[22]

In this paragraph I assume we are not concerned with government securities or UK incorporated companies within paras (d) or (da).

I first consider debentures and then shares.

As far as debentures are concerned, there are two questions:

21 For the terminology - "intermediated securities" "depository" "intermediary" "investor" "the underlying security" - see 70.8 (Intermediaries and depositories).

22 See 71.6 (Registered securities: non-UK company).

(1) are intermediated debentures (the interests held by investors) properly described as "debentures" within the meaning of 275(1)(e)?
(2) if so are intermediated debentures "registered" debentures?

Since debenture stock count as "debentures"[23] it seems reasonably clear that the intermediated debentures are properly described as "debentures".

Intermediated debentures are registered in the sense that the investors interests are recorded on the intermediary's register.[24] At first sight one might think that the register referred to in s.275(1)(d) must be a register kept by the company which issued the debentures. However a company does not have to keep a register of its debenture holders (unlike a shareholder register). The distinguishing feature of a register is that it determines or provides evidence of ownership.[25] So it is considered that intermediated debentures are "registered" on the intermediary's register. It follows that:

(1) If the underlying debenture is not registered, the intermediary's register is the only register, and the investors interests are situate where the intermediary's register is situated.
(2) If the underlying debenture is registered, there are two registers:
    (a) The company's register of the underlying debenture (which will record the intermediary as the registered holder).
    (b) The intermediary's register of the intermediated debenture (which will record the investor as the registered holder).

It is considered that the company's register does not come into the picture, since the asset which the investor owns is the intermediated debenture and not the underlying debenture. But even if that is not correct, the intermediary's register should be regarded as the principal register so that is the one which governs situs.

For these reasons, an intermediated debenture of a non-UK incorporated company is situate where the intermediary keeps its register.

In practice it does not often matter whether the situs of an intermediated debenture (of a non-UK incorporated company) is in the place of the

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23 See 71.2.4 (Meaning of "debenture").

24 Benjamin, "Interests in Securities" (2000) para 2.91: "Interests in securities [Intermediated securities] may properly be characterised as a form of registered securities, even where the underlying securities are in bearer form."

25 The intermediary's register is not open to inspection, unlike a register under s.744 Companies Act 2006, but open access is not an essential feature of a register, and there is no reason to expect foreign law to apply English company rule principles.

intermediary's register or the situs of the underlying debenture. Either way, the asset will not usually be UK situate. But it could matter, for instance, if the debenture is a bearer debenture and the document is in the UK. In such a case it is sensible to look to the intermediary's register rather than to the place of the document of the underlying debenture, since an investor could not be expected to know where the document of the underlying debenture is situated.

The same applies when the underlying security is shares in a non-UK incorporated company, rather than debentures.

### 71.9.2 *Securities of UK incorporated companies*

It is considered that intermediated securities of UK incorporated companies are properly described as shares or debentures and so fall within the rules in s.275(1)(d) TCGA. If that is correct, the registered securities rule in 275(1)(e) does not apply: it does not matter whether the securities are regarded as registered. Intermediated securities of UK incorporated companies are UK situate.

### 71.9.3 *Municipal and government securities*

For the same reason, intermediated securities of government or municipal authorities are situated in the authority concerned: s.275(1)(d) TCGA.

### 71.9.4 *Another view*

In the case of co-ownership interests the co-ownership situs rules[26] provide:

> (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.

Do investors hold interests in the underlying securities as co-owners

26 See 71.3 (Co-ownership interests).

(within the meaning of the co-ownership rule)? That depends on the terms of the agreement with the intermediary but it is likely to be the case.[27] If so, it appears at first sight that these rules override the common law situs rule, so the situs of the investor's interest for CGT is that of the underlying security.

Section 60(1) TCGA provides another route to the same destination:

> In relation to property held by a person
> [a] as nominee for another person, or
> [b] as trustee
> [i] for another person absolutely entitled[28] as against the trustee,
> [ii] or for any person who would be so entitled but for being an infant or other person under disability
> [iii] (or for 2 or more persons who are or would be jointly so entitled),
> this Act shall apply as if the property were vested in, and the acts of the nominee or trustee in relation to the property were the acts of, the person or persons for whom he is the nominee or trustee ....

Does the intermediary hold for the investors as bare trustee (within the s.60 sense of that expression)? That depends on the terms of the agreement with the intermediary but it is likely to be the case. If so, it appears at first sight that the effect of s.60 TCGA is to treat the investors as co-owners of the underlying security, so the situs of the investor's interest is that of the underlying security.

It is considered however that these deeming provisions do not alter the fact that the investor's intermediated securities are "registered" so that s.275(1)(e) continues to apply. This also overrides the UK-law rule[29] even if the underlying security was subject to UK law, or if the intermediary arrangement was subject to UK law.

### 71.9.5 *Conclusion*

The CG Manual passage set out in 70.8.3 (HMRC view) concluded that the situs of an intermediated security for CGT purposes is that of the underlying security rather than that of the intermediary's register. That is

27 See 70.8.1 (The securities law background).

28 Section 60(2) TCGA defines "absolutely entitled" but need not be set out here.

29 See 71.13 (Intangible assets).

correct for securities of UK incorporated companies. It is considered that situs of securities of non-UK companies depends on the place of the intermediary's register. That could be different from the situs of the underlying security, though circumstances in which the difference matters will be rare.

## 71.10 Debt situs rule

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.

I refer to this as **"the debt situs rule"**. This reverses the common law rule (under which a simple debt is situate where the *debtor* is situate).

A debt is UK situate if the creditor is dual-resident.

This provision overrides the UK-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) debentures;
(2) judgment debts;
(3) bank accounts.

The debt situs rule (if applicable) generally[30] disapplies the CGT remittance basis because a debt owned by a remittance basis taxpayer is deemed UK situate so the gain from the debt is taxed on an arising basis.

## 71.11 Judgment debt

Section 275(1)(k) TCGA provides:

> a judgment debt is situated where the judgment is recorded.

The CG Manual explains:

30 An exception is if the individual disposes of the debt while temporarily non-resident.

> **12430 Types of asset (1): Land, tangible property and debts** [November 2009]
> *Types of asset (1): Land, tangible property and debts [November 2009]*
> 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 1992.

Obtaining judgment may have the effect of changing situs.

71.11.1 *Commentary*

It is considered that there is no point in a separate rule for judgment debts, and s.275(1)(k) should be repealed. That would be a small but worthwhile simplification. The statutory rule is based on the common law rule, but that is no reason to retain it.

## 71.12 Bank account

A foreign currency bank account is normally a chargeable asset for CGT.[31] The question therefore arises as to the situs of the asset. Section 275(1)(l) TCGA provides:

> a debt which—
> (i) is owed by a bank, and
> (ii) is not in sterling, and
> (iii) is represented by a sum standing to the credit of an account in the bank of an individual who is not domiciled in the UK,
> is situated in the UK if and only if
> [a] that individual is resident in the UK and
> [b] the branch or other place of business of the bank at which the account is maintained is itself situated in the UK.

In short, for UK resident foreign domiciled individuals, the situs of a foreign currency account is the situs of the branch.

This restates the common law rule for bank accounts; it is needed because without this provision the situs of the account would be the residence of the creditor (ie the account holder).

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31 See 49.11 (Foreign currency bank account).

In cases where the conditions (i), (ii) and (iii) are not all satisfied, the usual CGT debt rule applies. The moral is that a foreign domiciled UK resident individual should keep foreign currency in non-UK bank accounts.

Section 275(1)(l) only applies to individuals bank accounts. However the situs of a bank account held by a trust or a company does usually matter for CGT.[32]

## 71.13 UK-law rule

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.

### 71.13.1 *Meaning of "intangible asset"*

Section 275A(2) TCGA provides a commonsense definition of "intangible asset":

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32 If it did matter, the usual CGT debt rule would apply so all accounts held by a non-resident trust or non-resident company would be non-UK situate, as situs would depend on residence of the account holder. This means that UK services relating to the account qualify for foreign services relief under s.809W ITA. That could be important for a bank account held by a non-resident close company, which is a relevant person, but in practice the point will rarely if ever arise as such a company would not normally use a UK account.

> 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.

### 71.13.2 *The UK-law rule*

Section 275A(3) TCGA provides:

> If asset A is subject to UK law (see section 275B(2)) at the time it is created, it shall be taken for the purposes of this Act to be situated in the UK at all times.

I refer to this as “**the UK-law rule**”.

The expression “subject to UK law” is widely defined in s.275B(2):

> For the purposes of section 275A, an intangible asset is subject to UK law at a particular time if any right or interest which comprises or forms part of the asset is, at that time,—
> (a) governed by, or otherwise subject to, or
> (b) enforceable under,
> the law of any part of the UK.

## 71.14 Futures and options

### 71.14.1 *Definitions of “future” and “option”*

Section 275B(3) TCGA provides:

> In section 275A—
> "future" has the meaning given by section 581 of CTA 2009, and
> "option" has the meaning given by section 580 of that Act.

So we turn to s.580 CTA 2009 for the definition of option:

> (1) In this Part "option" includes a warrant.
> (2) References in this Part to an option do not include a contract whose

terms—

(a) provide—

(i) 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

(ii) 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

(b) do not provide for the delivery of any property.

(3) Subsection (2) does not prevent an option whose underlying subject matter is currency from being an option.

Section 710 CTA 2009 defines a “warrant”:

In this Part [Part 7]

“warrant” means an instrument which entitles the holder to subscribe for—

(a) shares in a company, or

(b) assets representing a loan relationship of a company,

whether or not the shares or assets exist or are identifiable.

Section 581 CTA 2009 defines a “future”:

(1) In this Part "future" means 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,

but this is subject to subsection (3).

(2) For the purposes of subsection (1)(b), a price is agreed when the contract is made even if—

(a) the price 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, provision is made for a variation in the price to take account of any variation in quantity or quality on delivery.

(3) References in this Part to a future do not include a contract whose terms—

(a) provide—

(i) 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

(ii) 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

(b) do not provide for the delivery of any property.

(4) Subsection (3) does not prevent a future whose underlying subject matter is currency from being a future.

Sections 580(2),(3) and 581(3),(4) contain identical exclusions. This excludes futures and options, such as financial futures over the FTSE 100 index, which are settled 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, s.580(3) and 591(4), bringing currency options within the rules, make no sense.

### 71.14.2 *"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.

### 71.14.3 *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 conventions of plain English legal drafting, but its structure is so convoluted that one wonders whether the drafter was trying to make a point about it (or perhaps a joke).

Section 275A(4) TCGA provides:

Subsections (5) to (9) below have effect if asset A—

> (a) is a future or option (see section 275B(3)), and
> (b) is not subject to UK law at the time it is created.

The rule is in s.275A(6) TCGA:

> That rule is that where, in the case of any intangible asset,—
> (a) the asset is a future or option,[33]
> (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 [ie subject to UK law] at that time,
> the intangible asset mentioned in para (a) above [i.e. the future or option] is to be treated for the purposes of subsection (5) above and this subsection as being so subject at the time it is created.

This triggers s.275A(5) TCGA:

> If, as a result of the application of the rule in subsection (6) below in relation to asset A or any other asset or assets, asset A falls to be treated as being subject to UK law at the time it is created, it shall be taken for the purposes of this Act to be situated in the UK at all times.

Thus a foreign law future/option over a UK law underlying intangible asset is itself UK situate.
EN FB 2005 explains the point of s.275A(6)(c)(ii):

> These rules apply recursively. In any case where there is a "nested sequence" of futures or options in which the underlying subject matter of each contract in the sequence consists of or includes the next contract in the sequence, subsection (5) has effect to provide that the first contract is taken for TCGA purposes to be situated in the UK at all times if the [relevant] requirements ... are met in relation to any of the

33 This is otiose, since it repeats s.275A(4)(a); but it does not matter.

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 [ie UK situate] at any time,
>
> the intangible asset mentioned in para (a) above is to be treated for the purposes of subsection (7) above and this subsection as being so situated at that time.

Thus a foreign law option over a UK situate share or debenture is UK situate.

### 71.14.4 *Underlying subject matter unissued shares or debentures*

Section 275A(9) TCGA makes provision for the case where the underlying subject matter is unissued shares or debentures:

> 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.

## 71.15 Insurance policy

The situs of policies rarely matters for CGT, because of the relief for policies. UK policies will be UK situate under the UK-law rule and for others the common law rule will apply.[34]

## 71.16 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 Types of asset (1): Land, tangible property and debts** [November 2009]
>
> *Land and buildings (Section 275(1)(a) TCGA 1992)*
>
> 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.

## 71.17 Chattels

Section 275(1)(b) TCGA provides:

> subject to the following provisions of this subsection, the situation of rights or interests (otherwise than by way of security) in or over tangible movable property is that of the tangible movable property.

The CG Manual provides:

34 A policy is not a debt for the purposes of the CGT debt situs rule.

> **12430 Types of asset (1): Land, tangible property and debts** [November 2009]
> *Chattels (Section 275(1)(b) TCGA 1992)*
> 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.

For the position of temporarily exported chattels, see 70.21 (Chattels).

## 71.18 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:

> **12430. Types of asset (1): Land, tangible property and debts** [November 2009]
> *Ships and aircraft (Section 275(1)(f) TCGA 1992*)
> ... Contrary to the general rules of international law,[35] 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.

This generally[36] disapplies the CGT remittance basis since a ship/aircraft owned by a remittance basis taxpayer is deemed UK situate and the gain taxed on an arising basis. If the individual holds the ship/aircraft through a non-resident company the asset is treated as not UK situate which has

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35 The Manual's view (that under international law ships and aircraft are situate where registered) is erroneous: see 70.22 (Ships and aircraft).

36 An exception is if the individual disposes of the asset while temporarily non-resident.

two advantages:
(1) The s.13 remittance basis is available on a disposal by the company.
(2) Relief is available under s.809W ITA for services relating to the asset.

## 71.19 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:

> **12450 Types of asset (3): Intangible assets - goodwill, patents, trademarks etc** [January 2010]
> *Goodwill (Section 275(1)(g) TCGA 1992)*
> Goodwill which is an asset of a trade, profession or vocation is located where the trade, profession or vocation is carried on. 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.

## 71.20 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.[37]

For unit trusts see 35.5.2 (Situs of unit for CGT).

## 71.21 Equitable interest under a substantive trust

The situs of an equitable interest under a substantive trust only rarely matters for CGT because of the exemption for equitable interests. However it may matter, eg 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

37 See 70.25 (Interest under bare trust or nomineeship).

law; it may arguably apply to any trust with UK trustees. In other cases the common law rules will apply.

## 71.22 Intellectual property

Section 275(1)(h) TCGA provides:

> 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,

A different solution must be found for copyright, since such rights do not need registration. Section 275(1)(j) TCGA provides:

> 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" has a commonsense definition in s.275(3) TCGA:

> In subsection (1) above, in each of paras (h) and (j), "corresponding rights" means any rights under the law of a country or territory outside the UK that correspond or are similar to those within that paragraph.

This will not often concern remittance basis taxpayers. 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.

It seems at first sight that intellectual property is (uniquely) capable of being situate for CGT purposes in more than one jurisdiction. But it is considered that intellectual property exercisable in a number of jurisdictions should be regarded as a number of separate assets, one situate in each jurisdiction. The CG Manual provides:

> **12450 Types of asset (3): Intangible assets - goodwill, patents, trademarks etc** [January 2010]
> *Copyright, design rights, franchises etc (Section 275(1)(j) TCGA 1992)*
> • Copyright, design rights and franchises

- Any rights or licences to use
  – any copyright work
  – any design in which design rights subsist

are situated in the UK if they or any right derived from them are exercisable in the UK.

## 71.23 Unadministered estate of deceased person

If the estate is subject to UK law, it is UK situate for CGT. Other estates are governed by the common law rule.[38]

38 See 70.27 (Unadministered estate of deceased person).

CHAPTER SEVENTY TWO

# TAXATION OF FOREIGN ENTITIES

## 72.1 Introduction

UK tax law categorises entities (in short) as companies, partnerships or trusts.[1] With more or less difficulty (depending on the similarity of the law of the country concerned) it is necessary to shoehorn foreign entities into these categories; or more accurately, it is necessary to decide whether references to companies, trusts, partnerships, etc in any particular statutory provision include some particular foreign entity. Similarly, it is necessary to decide whether terms such as "share capital" or "interest in possession" are apt to include rights in or under foreign entities (or indeed whether individuals have any "right or interest" in a foreign entity at all).

*Memec v IRC* explains the general approach:

> 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.[2]

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1 And lastly, PRs but PRs are not discussed in this chapter.

2 71 TC 77 at p.92. Most OECD countries adopt the same approach:

> "11. In most [OECD] Member countries, as a matter of principle, tax laws apply on the basis of the legal relationship deriving from other branches of the law. Thus the tax laws of these countries, when referring to partnerships, will, absent special tax definitions, refer to those entities that constitute partnerships according to domestic civil or commercial law.
>
> 12. Difficulties often arise, however, where income is derived by an entity organised under the laws of another jurisdiction. In that case, the entity will have to be classified for purposes of the application of the tax laws of the country

Thus in order to say whether a reference to (say) a trust or trustee in any particular statutory provision include some particular foreign entity or person, one must ask some fundamental questions:

(1) What are the determinative characteristics of a trust or trustee (within the meaning of the section), a question of UK law; and
(2) Does the foreign entity or person have those characteristics, a question of the foreign law.

Similar issues arise in the application of DTAs to foreign (and UK) entities, for instance, whether an entity is a "person" for the purpose of a DTA. Similar issues arise in non-tax contexts.[3]

So far as the matter raises issues of foreign law I necessarily rely on secondary material. I would be interested in comments from readers with foreign law expertise if views expressed in this chapter need correction or

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where the income is derived, regardless of whether or not that classification is compatible with the civil or commercial law system of the jurisdiction from which the entity derives its legal status.

13. For example, if the tax system of a country recognises only individuals, companies and partnerships (but not trusts) as taxpayers and provides for a different tax treatment for these three types of taxpayers, that country will have to 'force' foreign entities in one or the other of these categories (with more or less difficulty depending on the similarity of the civil and commercial law of the countries concerned) for purposes of applying its tax system to domestic income derived by these foreign entities.

14. In doing so, the practice of most countries is to adopt the same approach as the one they apply in a purely domestic context. They will therefore apply their domestic tax classification to foreign entities on the basis of the foreign law's legal characteristics of the entity. In the previous example, the country, for the purposes of taxing the domestic income of a trust established under the law of a foreign jurisdiction, will typically examine the legal characteristics of the trust as they derive from the trust law of the foreign jurisdiction in order to determine whom it should tax and whether that person should be taxed as an individual, company or partnership, which are the only categories recognised under its tax law."

See OECD, "The Application of the OECD Model Tax Convention to Partnerships" (1999) accessible (at a small charge) from *www.oecd.org*; J Avery Jones "Characterisation of Other States' Partnerships for Income Tax", [2002] BTR 375 is essential reading in this area.

3 See for instance s.1208 Companies Act 2006: "partnership" means—
(a) a partnership within the Partnership Act 1890, or
(b) a limited partnership registered under the Limited Partnerships Act 1907,
or a firm or entity of a similar character formed under the law of a country or territory outside the UK".

expansion, and in particular if they disagree with HMRC official views.

A full discussion of the deeply intriguing issues raised in this chapter would require a book to itself.

HMRC published their views in Tax Bulletin 83 (also called RI 279) but the HMRC website now states that this statement is "superseded by INTM180000". Accordingly the quotes are taken from the International Manual.

### 72.1.1 *"Transparent" and "opaque"*

UK tax law categorises entities as transparent or opaque.[4] The International Manual explains this terminology:

> **180020 Considerations when using the List of Classifications of Foreign Entities for UK tax purposes** [November 2010]
> ... Entities are described [in the official list set out below] as either fiscally "transparent" or "opaque" solely for the purposes of deciding how a member is to be taxed on the income they derive from their interest in the entity. In the case of a "transparent" entity the member is regarded as being entitled to a share in the underlying income of the entity as it arises and is charged to tax in the UK on their share of the profits on that basis. But, in the case of an "opaque" entity the member generally is taxed only on the distributions made by the entity.

The terminology is also used for CGT (eg a partnership is transparent for CGT); and for IHT (eg a partnership is not transparent for IHT). Indeed, one should strictly not use the term "transparent" without specifying a tax, because an entity may be transparent for one tax and not for another, but the term is used most often with IT in mind.

Classification of an entity as transparent ought logically to entail that the entity is regarded as not entitled to the income/gains (since its members, or those who own or have an interest in the entity, are regarded as so entitled). For instance, a partnership is transparent and income accrues to the partners and not to the partnership. Perhaps illogically, this is not always the case. For instance, despite the undoubted fact that an IP trust is transparent, the trustees may still be taxable on the trust income;

4 A note on terminology. The term sometimes used is "fiscally transparent" (or "fiscally opaque") but that is synonymous with "transparent" (or "opaque").

likewise a settlor-interested trust within s.624. That rule favours HMRC (by offering an alternative person liable for the tax) but in the case of DT exemptions, it may favour the taxpayer (by offering an alternative route to DT relief).

Thus classification as transparent or opaque does not necessarily answer all the tax questions which may arise in relation to an entity; but it is normally enough.[5]

The International Manual continues:

> It should be noted that the expressions "transparent" and "opaque" are not interchangeable with "partnership" and "company" or "body corporate". For example, a fiscally transparent entity is not necessarily a partnership. Likewise an UK company is a "body corporate" and is opaque for the purposes of UK tax on income, but a fiscally opaque entity is not necessarily a "body corporate" or a "company" for UK tax purposes.

Although the expressions are not interchangeable, the issues overlap. A transparent entity is not necessarily a partnership[6] but a partnership is always transparent for IT and CGT.[7]

The International Manual explains HMRC's approach to categorising an entity as transparent or opaque:

> **180010. Factors to consider in classifying a foreign entity for UK tax purposes** [April 2009]
> ... When considering the classification of a foreign entity (i.e. whether it is either opaque or transparent) for UK tax purposes, due regard is given to the approach of the Court of Appeal in the case of *Memec plc v IRC* (71 TC 77) and the line of case law that precedes it. In particular, the following matters should be considered:

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5 The Tax Tribunal expressed doubts about the terminology in *Swift v HMRC* [2010] UKFTT 88 at [18]:
"The issue is whether the UK tax is 'computed by reference to the same profits or income' or whether he is taxable on the equivalent of a dividend. Asking whether SP LLC is transparent or opaque may be another way of asking the same question but we consider that it is preferable to apply the words of the Treaty."
It is considered that the labels transparent/opaque are nevertheless useful shorthand.

6 For instance, an IP trust is also transparent: see 23.1 (Taxation of Life Tenant).

7 See 36.3 (Transparency of partnership for IT); 36.6 (Transparency of partnership for CGT).

> (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?
>
> 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 these factors we look at the foreign commercial law under which the entity is formed and at the internal constitution of the entity. ... The conclusion that is reached is then used in considering the relevant piece of UK tax law.[8]

72.1.2 *Significance of classification in foreign law*

HMRC say in the International Manual passage cited above::

> How the entity is classified for tax purposes in any other country is not relevant.

If the foreign tax law is sufficiently similar to UK law, it is considered that the foreign law classification ought to be relevant, though not of course decisive; but in practice that condition is not often satisfied.

8 This passage is also set out in INT Manual 180010. I deal with the omitted sentence in the following paragraph.

## 72.2 Definition of "IHT-settlement"

It was noted above that UK tax law categorises entities as companies, partnerships and trusts. "Partnership" is in general undefined, and the definition of "company" (discussed below) is fairly standard. However quite different definitions of trusts are used in different taxes.

I discuss terminology in more detail in 69.2.1 (terminology); in summary:

"**IHT-settlement**" means a settlement within the IHT definition

**"Standard IT/CGT settlement"** is a settlement within the standard IT/CGT definition.

**"Settlement-arrangement"** is a settlement within s.620 ITTOIA, which applies for the purposes of the IT settlement provisions and many other purposes of which the most important is s.87 TCGA**.**

The terms trust and settlement are used interchangeably.

Because the definitions are different, it is a mistake to ask if an entity is a trust "for tax purposes". One must ask if it is a trust for IT/CGT, or for IHT purposes or if it is a settlement-arrangement. An entity may be a trust within one, or two, or all three definitions.

I discuss the IT/CGT and settlement-arrangement definitions elsewhere.[9] Section 43(2) IHTA provides the IHT definition:

> "Settlement" means any disposition or dispositions of property, whether effected by instrument, by parol or by operation of law, or partly in one way and partly in another, whereby the property is for the time being—
> (a) held in trust for persons in succession or for any person subject to a contingency, or
> (b) held by trustees on trust to accumulate the whole or part of any income of the property or with power to make payments out of that income at the discretion of the trustees or some other person, with or without power to accumulate surplus income, or
> (c) charged or burdened (otherwise than for full consideration in money or money's worth paid for his own use or benefit to the person making the disposition) with the payment of any annuity or other periodical payment payable for a life or any other limited or terminable period,
> [d] or would be so held or charged or burdened if the disposition or

9 See 69.2 (Definition of "settlement").

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.

### 72.2.1 *Limb [d]: would be so held if disposition were regulated by UK law*

This limb is present for historic reasons only. The estate duty definition of "settlement" in s.22(1)(i) FA 1894 formerly provided (so far as relevant):

> The expression 'settlement' means any instrument, whether relating to real property or personal property, which is a settlement within the meaning of the Settled Land Act, 1925, or if it related to real property would be a settlement within the meaning of that Act

Dick Taverne, then Financial Secretary to the Treasury, explained the problem posed by this definition:

> The definition is primarily by reference to the Settled Land Act 1925, but it brings in property other than settled land by references to instruments which if related to real properly in England and Wales would be a settlement within the meaning of the Act. We now see that it is arguable that we have done no more than equate an English settlement of personalty with one of realty and that we have not caught foreign settlements.[10]

Hence s.36(5) FA 1969 extended the definition:

> In the enactments relating to estate duty—
> (a) the expression 'settlement'— (i) for the avoidance of doubt is hereby declared to include—
> (aa) any disposition whereby property is held by trustees on trust to accumulate the whole or part of any income of that property or with a power for the trustees to make payments out of that income at the discretion of the trustees or some other person with or without a power to accumulate surplus income; and

10 Hansard Standing Committee F, 24 June 1969, col 721.

> *(bb) any disposition regulated by the law of a territory outside Great Britain which would constitute a settlement within the meaning of section 22(1)(i) of the Finance Act 1894 if it had been regulated by the law of England or, as the case may require, of Scotland;*

The words now in s.43(2)[d] IHTA are derived from s.36(5)(i)(bb) FA 1969. Now, the definition of settlement for IHT is not by reference to the SLA 1925 and applies to UK and foreign law trusts, so the words in s.36(5)(i)(bb) FA 1969 were not needed. The drafter of the current definition possibly did not notice, but probably thought the words desirable to preclude an argument that "trust" in s.43 meant a trust governed by a UK law. That argument would not have been very convincing but given the history of the provisions might not have been self-evidently wrong.

Limb [d] therefore has no practical effect.

### 72.2.2 *Limb [e]: governed by provisions equivalent in effect to a trust*

The standard IT/CGT definition has no equivalent of s.43(2)[e]. So while the IT/CGT definition requires that property is held "in trust" it is (in short) sufficient for IHT that the property is governed by provisions which are equivalent in effect.

The statute refers to the *administration* of the property being governed by provisions equivalent in effect. Trust law draws a distinction between administrative and dispositive provisions, but the context here shows that this is referring to all the provisions which govern the use of the property, and not just administrative provisions in the strict sense.

Two difficulties lie in the short phrase "equivalent in effect":

(1) Equivalent *in effect* presumably requires effective (or substantive) rather than exact equivalence, but where does one draw the line?

(2) Trusts can have the effect as entails, usufructs, wills, corporations, charges by way of security over assets, and so on, though they are none of those things. A trust is a flexible, protean institution which can have markedly different effects.

In deciding whether a foreign institution is equivalent in effect to a trust, a court should have regard to the context - is it appropriate in the scheme of IHT that an entity should be subject to IHT in the same manner as a trust? This consideration supports the view taken below that a foundation (stiftung) is an IHT-settlement but a usufruct is not.

## 72.3 Meaning of "company"

Section 1121(1) CTA 2010 provides the definition for the corporation tax acts:

> In the Corporation Tax Acts "company" means any body corporate or unincorporated association, but does not include a partnership, a local authority or a local authority association.[11]

Section 992(1) ITA provides the identical definition for the income tax acts. Section 288 TCGA provides a similar definition for the TCGA:

> "company" includes any body corporate or unincorporated association but does not include a partnership, and shall be construed in accordance with section 99;

The IHTA does not provide a definition of "company" but the definition of close company in the close company rules incorporates the CTA definition. Section 102(1) IHTA provides:

> (1) In this Part of this Act—
> 'close company' means a company within the meaning of the Corporation Tax Acts which is (or would be if resident in the UK) a close company for the purposes of those Acts;

## 72.4 Nomineeships

### 72.4.1 *Definition(s) of nomineeship*

I use the term "**nomineeship**" to mean the situation where property falls within s.466(3) ITA, that is, property 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 to the property as against the trustee, or
> (c) it is held by a person as trustee for another person who would be

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11 This is subject to some minor (unnecessarily complicated) exceptions but those need not be considered here.

> absolutely entitled[12] to the property as against the trustee if that other person were not an infant or otherwise lacking legal capacity.

The phrase "absolutely entitled to property as against a trustee" is defined in s.466(5) ITA:

> 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).

### 72.4.2 *Tax treatment of nomineeship*

A nomineeship is transparent for CGT,[13] for IT and for IHT.

If an entity is a nomineeship then:

(1) It is not an IT/CGT settlement (even if property is held on trust): s.466(3) ITA.

(2) It is not an IHT-settlement as the property is not held on trust for persons in succession (or governed by provisions equivalent in effect).

(3) A nomineeship may be a settlement-arrangement; however it is not within s.87 TCGA as gains do not accrue to the trustees.

The question of whether a trust is a nomineeship or a substantive trust (ie not a nomineeship) is therefore of some importance. Of course a foreign law entity may be classified as a nomineeship, just as an English law entity may constitute a nomineeship and the question arises more for foreign law entities than for English law ones (because in English law cases the answer is usually obvious.)

### 72.4.3 *Testamentary/non testamentary dispositions*

In order to understand the law here it is helpful to begin with the distinction which English law (and foreign laws which adopt English law principles) draw between:

(1) testamentary dispositions;

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12 The term "absolutely entitled" is defined in s.466(6) ITA:
"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."

13 Section 60 TCGA.

(2) non-testamentary dispositions (here called "lifetime dispositions").

The distinction matters for many reasons. The most important are:

(1) Different (stricter) formalities apply to testamentary dispositions.[14]

(2) A testamentary disposition takes effect on death. A lifetime disposition takes effect before death, normally when executed.

(3) A testamentary disposition is revocable until death. A lifetime disposition is only revocable if this is expressly stated, and even if it is revocable, circumstances which revoke a testamentary disposition (eg making a new will in common form, or marriage) may not revoke a lifetime disposition.

Statute law recognises the distinction[15] but gives no guidance on it. There is a certain amount of (mainly antique) case law. A disposition is testamentary if it is the intention of the writer of the document "that death was the event that was to give effect to it".[16]

A lifetime disposition may confer a life interest on the settlor and also a power of revocation. In *Thompson v Browne*[17] the Master of the Rolls referred to an earlier decision, *Attorney-General v Jones,* and commented:

> If there be anything in that decision to support the notion, that where a person by deed settles property to his own use during his life, and after his decease for the benefit of other persons, a power of revocation reserved in such a deed alters the character of the instrument, and renders it testamentary, … I can only say that, if this were law, a great number of transactions of which the validity has never been doubted

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14 If a foreign entity were a testamentary disposition under English law, it might be valid under foreign law even though it would not satisfy English law formalities. The grantor trust may then be void in English law, lacking the formalities required for a valid will; but it may be saved by the Wills Act 1963. If the entity is void in English law but valid in foreign law, the applicable conflicts principles must be applied to see which legal system has priority.

15 Section 1 Wills Act 1837 merely says that the term "will" includes a testamentary disposition.

16 *Milnes v Foden* (1890) 15 PD 105 at 107; or (which comes to the same thing) "that it is dependent on the death for its vigour and effect"; *Cock v Cooke* (1866) 1 P&D 241 at 243. If the document calls itself a will, the intention is usually obvious, but it is not necessary to use the word "will". For instance, a conveyance "not to take effect until after my decease" is obviously testamentary: *In the Goods of Morgan* (1866) 1 P&D 214.

17 (1835) 3 My & K 32.

would be liable to be impeached.[18]

The beneficiaries of a lifetime trust have an equitable interest from the date of the gift. They could in theory take proceedings in the event of a breach of trust. However in practice this may be a theoretical possibility only. The difference is then essentially one of form and not one of substance. There is no economic difference between a lifetime disposition of this kind and a will. In cases of this kind it could be harder to construe the document and determine whether the intention of the writer is:

(1) to confer a present future interest or
(2) that death is the event which gives effect to the document.

Since it makes no real (economic) difference, the writer of the document may not have formed a clear intention on the point, and even if they have, they may not have expressed that intention clearly in the document. In these cases the form of the document is an important guide to construction. If the document takes the form of a will, (ie describing itself as a will and executed with the formalities of a will) the intention of the writer must be that it is testamentary. If it takes the form of a lifetime settlement (ie describing itself as such and executed as a deed), the intention of the writer must be that it is a lifetime disposition. Of course the form of the document is not decisive. The context may show otherwise. However, the form certainly gives some guidance and in the absence of contrary indications it must be determinative.

### 72.4.4 *Nominteeship/substantive trusts*

With this in mind we can turn to the distinction between nomineeships (or bare trusts, I use the terms as synonyms) and substantive trusts. English law (and foreign laws which adopt English law principles) draw a distinction between:

(1) trusts where a single beneficiary is absolutely entitled (here called "bare trusts"); and
(2) non-bare trusts (here called "substantive trusts").

Whether a trust is a bare trust or substantive is a question of construction. The bare/substantive trusts distinction is conceptually distinct from the testamentary/non-testamentary disposition distinction. In the latter case

18 The point is also stated in *Baird v Baird* [1990] 2 AC 548 at p.556.

there would normally be someone who is intended to benefit after the death of the writer of the document, but the question is whether they are intended to benefit immediately or on death. However, in practice, factors which might tend to show that the intention of the writer of the document is testamentary might also show that their intention was to create a bare trust rather than a substantive trust, so the two distinctions substantially overlap.

A document is a valid lifetime gift if it confers any interest (including a mere present future interest of no economic value) on any beneficiary (other than the settlor) during the settlor's lifetime.

Lewin on Trusts says:

> The reservation by the settlor of large beneficial powers and interests may leave the lifetime trusts declared in favour of others so squeletic[19] as to be considered illusory. If a power of revocation is also reserved, this can turn a settlement into a will.[20]

Lewin's tentative suggestion is that a trust may purport to confer some interest on other beneficiaries, but if that interest is insufficiently large or important it does not count. I refer to this as a *de minimis* principle. The term sometimes used is "illusory trusts".

This is not correct. It is not consistent with the principle set out above. The question is the intention of the writer of the document. The question is not whether an interest declared in favour of others is so small it should be disregarded. That would be to cease to look for the intention of the writer of the document, but to impose some other requirement on the document altogether.

Secondly, a *de minimis* test is too vague. A reversionary interest subject to the settlor's power of revocation is not so small it should be disregarded: see above. But as noted such an interest may have a nil economic value and the lifetime settlement in substance has the same effect as a will. How does one distinguish between revocable reversionary interests, which are valid, and (even) less significant interests (which are not)? Unless one knows what is too small an interest (and different views on that would be possible) it will be impossible to say whether documents

19 This word is not in the OED, but one of the authors of Lewin tells me it means: skeletal.

20 18th ed, 2008, para. 1-14

are valid or invalid.

The suggested *de minimis* principle is contrary to the authorities. The relevant cases are concerned with the distinction between testamentary dispositions and lifetime trusts. The cases are relevant because they do tend to contradict Lewin's proposed *de minimis* principle (which is not put forward as a principle of construction at all, but a rule of law). Thus in *Corlet v Isle of Man Bank Limited* [1937] 3 DLR 163, and *Anderson v Patton* [1948] 2 DLR 202 lifetime trusts which conferred what one might regard as minimal future revocable interests on beneficiaries other than the settlor, were both held to be valid. The latter case concerned a document reciting:

> received from A $5,000 which I am to hold in trust for A and which I am to pay out as instructed to X and Y if anything should happen to A. The money will be returned if A should demand it.

The Court held by a majority that even this was a valid trust. One can see the force of the minority view that this was actually intended to be testamentary. But the important point is that neither side looked at the matter as being determined by whether or not the interest given away was "squeletic".

## 72.5 Sham under foreign entities

The English law conception of "sham" has no application to foreign law entities. Whether or not a foreign entity is void as a sham depends on the foreign law of sham, or some similar doctrine, if the foreign law has one.

## 72.6 Foundation (*Stiftung*)[21]

This section is concerned with non-charitable foundations which are found in Liechtenstein, Jersey, the Bahamas and many civil law jurisdictions. I focus on Liechtenstein foundations (*Stiftungen*) though I refer at points to Jersey foundations. Foundation jurisdictions differ widely on points of detail, but I am not aware of any differences that matter for the purposes

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21 On this topic see Venables, *The Taxation of Foundations* (2010); Easun, "Trusts & Foundations", ITPA Journal Vol 5, No. 3; Baker "Beneficiaries of Trusts and Foundations" accessible *www.taxbar.com/gitc.html*.

of this section.

The word "foundation" is sometimes used in the UK as a name for a charity (eg "the British Heart Foundation") but the word has no specific technical meaning in English law. In the USA "private foundation" is a technical term used to describe a specific category of charities and NPOs, in short, those which receive their funds from one person and which are regarded as donor-controlled.[22] I am not concerned with charitable foundations here.[23]

### 72.6.1 *Is a foundation an IT/CGT settlement, or a company?*

A Liechtenstein foundation normally has legal personality. 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.[24]

On the evidence of this passage it is considered that property in a foundation is not held "in trust". An essential (or almost essential)[25] characteristic of a trust is that "the assets constitute a separate fund and are

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22 See US Internal Revenue Code § 509 (Private foundation defined).

23 For the question of whether foreign charities qualify for UK charity tax reliefs, see Kessler & Brown, *Taxation of Charities and Non-profit Organisations* (8th ed, 2011), chapter 2 (Definitions of Charity).

24 Biedermann, "Foundations vs Trusts" [1993] PCB 283.

25 It is hard to make any comment about trusts without qualification. A charitable trustee incorporated under s.50 Charities Act 1993 might not constitute a separate fund. But that is an anomalous and unusual case and perhaps itself not a "trust" in the ordinary sense.

not a part of the trustee's own estate".[26] A foundation does not have this characteristic. So it is not an IT/CGT settlement. There are of course other significant differences between a Liechtenstein foundation and a trust, in particular the beneficiaries of a foundation have different and somewhat weaker rights. But the failure to meet what the Hague Convention on the law applicable to Trusts identifies as a defining characteristic is crucial.

Since a foundation is a body corporate, it is a company for UK tax purposes. This is consistent with the comment in the OECD commentary on the Model Treaty that a foundation is a body corporate for tax purposes.[27] A foundation is therefore subject to UK corporation tax on its income and gains if UK resident and subject to income tax if non-resident. The test of residence is the company test of central management and control.

A foundation is usually a close company as:

(1) The members of the board are directors.
(2) The members of the board are participators.
(3) The foundation is under the control of directors who are participators.

However this depends on the constitution of the foundation.

A foundation is a settlement-arrangement[28] so it is a "settlement" for the purposes of s.87 TCGA; see too 45.2 ("Settlement" and "trustee").

As to whether a foundation is within s.13 TCGA, see 47.7 (Foundations).

### 72.6.2 *Is a foundation an IHT-settlement?*

Foundation property is normally held "for persons in succession" or "held

26 See Article 2 Hague Convention on the Law applicable to Trusts and on their Recognition. *Lewin on Trusts* (18th ed., 2008) regards the Hague Convention definition as "generally applicable": para 1-01. See too Hayton "Principles of European Trust Law" p.23 in *Modern International Developments in Trust Law* 1999, ed. Hayton ("While many mainland European jurisdictions have the functional equivalent of a charitable purpose trust in the guise of a foundation which has legal personality, we deliberately rejected extending our [conception of] trust to cover such functions. It is because a trust is not a company, not a corporate person, but a segregated fund owned by trustees, that different rules from those for companies developed for trusts.")

27 OECD Commentary on article 3(3): " ... the term 'person' includes any entity that, although not incorporated, is treated as a body corporate for tax purposes. Thus, e.g. a foundation (*fondation, Stiftung*) may fall within the meaning of the term 'person'."

28 Assuming (as will generally be the case) that the bounty test is satisfied.

with power to make payments out of the income". The question is whether a foundation is "governed by provisions equivalent in effect" to a trust. This raises a question of Liechtenstein law as to the effect of a foundation. Lorenz says:

> It now appears that the Liechtenstein Supreme Court has used Liechtenstein trust law as a basis for the development of a coherent pattern of principles applicable to all types of Liechtenstein asset planning devices, in particular foundations and establishments, and not just the trust …
> … 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.[29]

Biedermann says:

> Operationally speaking, there is no difference between a family foundation and a family trust.[30]

HMRC say:

> In case of family foundations, business activity is not permitted. Accordingly, while a foundation has its own legal personality, its essence and purpose is to preserve and maintain assets for the beneficiaries, as is that of a trust.[31]

On the basis of this evidence it is considered that a foundation is "equivalent in effect" to a trust and is therefore an IHT-settlement. (The contrary argument would focus on the word "equivalent", and state that since there are undoubtedly some differences, the two are not equivalent.

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29 *Disputes involving Trusts*, edited by Ledim Vogt, published by C H Beck, 1999, p.213.

30 Biedermann, "Foundations vs Trusts" [1993] PCB 283. Noseda makes a similar point: "The Foundations (Jersey) Law 2009: A Civilian Perspective" [2010] The Jersey & Guernsey Law Review 48 at [13].

31 Joint Declaration by the Government of the Principality of Liechtenstein and HMRC Concerning the Memorandum of Understanding Relating to Cooperation in Tax Matters, 11 August 2009 *www.hmrc.gov.uk/international/joint-declaration-lich.pdf*.

The expression "equivalent in effect" is looking at the broad substance rather than absolute equivalence but where to draw the line is hard to tell.)

It is sometimes argued that a foundation cannot be an IHT-settlement if beneficiaries of the foundation have no enforceable rights and no interest in foundation property. But beneficiaries of a charitable trust have no rights and no interests in the trust property, and a charitable trust is clearly an IHT-settlement. All that matters is that there is some legal mechanism which recognises their rights and prevents the board of a foundation treating the foundation property as their own.

### 72.6.3 *Is a foundation an interest in possession settlement for IHT purposes?*

Since a foundation is an IHT settlement, the question may arise whether a beneficiary's interest under the settlement is an interest in possession. (This question does not often matter for IHT for foundations made after 2006.)

This raises two issues: what exactly is the test for an "interest in possession", a question of UK law; and whether any particular interest meets those requirements (a matter of applying Liechtenstein law to the document in question).

It is arguable a beneficiary of a foundation cannot have an interest in possession. "Interest in possession" is a term of English trust law, a foundation is not a trust, so the beneficiary's interest cannot be an IP. This view is supported by s.46 IHTA which expressly extends the definition of IP to Scottish entities which confer rights somewhat less than those of a life tenant of an English law trust. However the better view is that where "settlement" is given an extended meaning, the meaning of related terms such as interest in possession should be given a comparable extended meaning. Thus a beneficiary has an IP if they have the right to the income of the foundation as it arises. It might follow from this view that s.46 IHTA is otiose, but that is not a very strong objection.

Whether that requirement is met depends on the drafting (construed in accordance with Liechtenstein law). At the borderline the distinction between IP and non-IP trusts 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.

### 68.6.4 *Is a foundation transparent for IT purposes; nature of foundation distributions for IT*

The taxation of a UK resident beneficiary on a distribution from a foundation raises interesting and unexplored questions. It is suggested that one should apply trust law principles by analogy rather than company law principles even though a foundation is a company and not an IT/CGT trust.

If that is right, the position depends on the drafting of the power which the foundation uses to make or authorise the distribution.[32] If the receipt is classified as income, it is classified as an annual payment, like a trust distribution. Where the terms of the foundation require distributions to a beneficiary, the distributions are income and the question is whether the foundation are classified as transparent under *Baker/Garland* principles

If the receipt is classified as capital the position is more straightforward as the usual s.731 and s.87 rules will apply.

### 72.6.4 *HMRC view*

HMRC say:

> ... foundations ("Stiftungen") [are] to be characterised, recognised and treated as *trusts* for UK tax purposes.[33]

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32 See 22.8 (Payment from discretionary trust: income or capital?).

33 Joint Declaration by the Government of the Principality of Liechtenstein and HMRC Concerning the Memorandum of Understanding Relating to Cooperation in Tax Matters, 11 August 2009 *www.hmrc.gov.uk/international/joint-declaration-lich.pdf*. This is subject to a disclaimer and qualification:

> "The Government of the Principality of Liechtenstein has considered and agreed with HMRC the following written guidance and consistent approach on characterisation, recognition and treatment of legal entities and fiduciary relationships for purposes related to the MOU, provided that provisions under Liechtenstein and UK law remain the same as currently as related to such characterisation, recognition, and treatment.
>
> For avoidance of doubt, nothing contained herein is to affect the ability of affected persons to rely on UK law or practice permitting alternative characterisation, recognition and treatment. The parties further recognise that the ultimate UK taxation consequences for UK taxpayers will depend on the particular facts as is the case where UK or other common law entities or fiduciary relationships, such as trusts, are involved."

TDSI guidance notes[34] para 2.3 provide:

> **Anstalts & Stiftungs** [March 2010]
> [1] Anstalts and Stiftungs are Liechtenstein business entities which are fiscally opaque. ...
> [2] The current HMRC view is that Stiftungs are Trusts for UK tax purposes. For TDSI purposes, the deposit should be considered to belong to the settlor[35] and the TDSI treatment depends on the nature of the settlor – so if the settlor is an individual, BRT [basic rate of tax] must be deducted.
> [3] If the settlor can show that they have not retained an interest, the Financial Institution can treat the Stiftung as an interest in possession trust ... and the TDSI position will depend on the nature of the beneficiary. If the beneficiary is an individual, BRT must be deducted.

Point [3] assumes that a foundation can be transparent for IT which contradicts point [1].

HMRC do not refer to any statutory provisions but are clearly saying that in their view foundations are trusts for all tax purposes. It is true that HMRC recognise that there may be special circumstances but in the absence of special circumstances, if it suits the foundation to take the view that the foundation is a trust for all tax purposes, including the IT/CGT definition, it could properly do so. That might be relevant, for instance, to obtain the benefit of ESC B18, or if a taxpayer wished to argue that a foundation was an interest in possession trust and transparent for income tax purposes.

## 72.7 Liechtenstein *Anstalt* (Establishment)

Liechtenstein Companies House explains the nature of an anstalt.[36]

TDSI guidance notes[37] para 2.3 provide:

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34 *www.hmrc.gov.uk/tdsi/guidance-notes.pdf.* For TDSI (tax deduction scheme for interest) see 17.11 (Withholding tax on interest from deposit-takers).

35 [Author's footnote] It is assumed that the foundation is a settlor-interested trust.

36 *www.llv.li/pdf-llv-gboera-merkblatt_zur_neueintragung_einer_anstalt.pdf*

37 Accessible *www.hmrc.gov.uk/tdsi/guidance-notes.pdf.* For TDSI (tax deduction scheme for interest) see 17.11 (Withholding tax on interest from deposit-takers).

> **Anstalts & Stiftungs**
> Anstalts ... are Liechtenstein business entities which are fiscally opaque. The current HMRC view is that Anstalts should all be dealt with as if they are companies. For TDSI, this means that Anstalts should receive gross interest.

Despite this statement, and classification in the official list as "opaque", HMRC practice has not always been consistent.[38] The Liechtenstein disclosure facility takes a different approach:

> 1) An establishment ("Anstalt") in Liechtenstein to be characterised, recognised, and treated for UK tax purposes as follows:
> a) An establishment that according to its articles is permitted to undertake a business activity ("*nach kaufmännischer Art geführtes Gewerbe*"), and therefore is obliged to have an audit, to be characterised, recognised, and treated for UK tax purposes as a *company.*
> b) An establishment that according to its articles is *not* permitted to undertake a business activity ("*nach kaufmännischer Art geführtes Gewerbe*"), and therefore is *not* obliged to have an audit, to be characterised, recognised, and treated for UK tax purposes as follows:
>    i) *An establishment with founder's rights or shares* to be characterised, recognised and treated as a *company*.
>    ii) *An establishment with no founder's rights or shares* to be characterised, recognised and treated as a *trust.*
>
>    For avoidance of doubt, in case of an establishment with founder's rights as used above, the founder (settlor) with founder's rights has full powers to decide upon who the beneficiaries are and to change the beneficiaries, and such powers are transferrable.[39]

## 72.8 Liechtenstein Treuunternehmen

The Liechtenstein disclosure facility records the HMRC view:

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38 Private correspondence.

39 Joint Declaration by the Government of the Principality of Liechtenstein and HMRC Concerning the Memorandum of Understanding Relating to Cooperation in Tax Matters Signed on 11 August 2009 *www.hmrc.gov.uk/international/joint-declaration-lich.pdf*. This statement is subject to a disclaimer and qualifications set out at 72.6.4 (HMRC view).

> 2) A trust enterprise ("Treuunternehmen") in Liechtenstein to be characterised, recognised, and treated for UK tax purposes in an analogous way as an establishment.[40]

This is controversial.

## 72.9 Liechtenstein Treuhandschaften

HMRC say:

> Trusts ("Treuhandschaften") ... [are] to be characterised, recognised and treated as *trusts* for UK tax purposes.[41]

## 72.10 Other Liechtenstein entities

The Liechtenstein disclosure facility provides:

> 1) The European Union harmonised company forms, such as "Aktiengesellschaft" or "AG"; "Gesellschaft mit beschränkter Haftung" or "GmbH"; "Societas Europaea" or "SE", to be characterised, recognised and treated as a *company* for UK tax purposes.
> 2) Entities formed as "Kommanditgesellschaft" or "KG" or "Kollektivgesellschaft" to be characterised, recognised and treated as a *partnership* for UK tax purposes.

## 72.11 American revocable trusts (grantor trusts)

Revocable trusts are commonly used in the US for estate planning.[42] With an American settlor these are almost always grantor trusts (a US income tax concept) and transparent for US tax purposes as to income and capital gains, though with non-US settlors they are only transparent in limited

40 See above footnote.

41 Joint Declaration by the Government of the Principality of Liechtenstein and HMRC Concerning the Memorandum of Understanding Relating to Cooperation in Tax Matters, 11 August 2009 *www.hmrc.gov.uk/international/joint-declaration-lich.pdf*. This statement is subject to a disclaimer and qualifications set out at 72.6.4 (HMRC view).

42 I am grateful to Ian Watson for his comments on this section. For other US trusts, see Von E. Sanborn, "US tax classification of trusts", (2005) TQR Vol 3 issue 2 p.16 accessible to STEP members on *www.step.org*.

circumstances.

The classification of a US revocable trust turns on the nature of the rights conferred by the trust, which depends on the drafting and proper law of the trust.[43] Only general comments are possible here.

Under a common form revocable trust, the settlor (the synonymous terms grantor, trustor, creator or donor are often used in American trust documentation) is sole trustee, the trust is revocable and the income and capital is paid to the settlor on demand. Section 603 of the America Uniform Trust Code[44] provides:

> While a trust is revocable [and the settlor has capacity to revoke the trust],[45] rights of the beneficiaries are subject to the control of, and the duties of the trustee are owed exclusively to, the settlor.

A US revocable trust of this kind is not an IT/CGT settlement as the property is not held "in trust". This seems paradoxical, but the fact that American lawyers describe something as a trust does not mean that it is a trust within the meaning of the word as used in UK statutes. In English law, "there is an irreducible core of obligations owed by the trustees to the beneficiaries and enforceable by them which is fundamental to the concept of a trust. If the beneficiaries have no rights enforceable against the trustees there are no trusts."[46] Any rights which purport to be granted under the US revocable trust during the lifetime of the settlor (or at least while the settlor is mentally competent) are illusory (unassignable and unenforceable).

If the settlor is not the sole trustee, there is a trust; but if (in the words of the Uniform Trust Code) "the duties of the trustee are owed exclusively

43 Each US state is a separate common law jurisdiction, with its own trust law, ultimately derived from English law but with statutory and case law variations.

44 Accessible *www.nccusl.org*. The uniform code project is an attempt to standardise US law. Adoption of uniform codes is far from universal, however, and each state adopting them may do so with variations. Some state statutes (eg, California Probate Code section 15800) impose rules almost identical in effect to UPC section 603, though independently of the uniform code project.

45 Square brackets in original, as the wording is intended to be optional.

46 *Armitage v Nurse* [1998] Ch 241 at p.253. Likewise Hague Convention art.2 ("A trust has the following characteristics ... (c) the trustee has the power and the duty, *in respect of which he is accountable,* to manage, employ or dispose of the assets in accordance with the terms of the trust ..."

to the settlor" it is considered that the US revocable trust is a bare trust for CGT as the settlor is absolutely entitled as against the trustee.[47]

A US revocable trust of this kind is similarly not an IHT-settlement, since:

(1) if the settlor is sole trustee there is no trust;

(2) if the settlor is not sole trustee there is only a bare trust.

The property is not held in trust for persons in succession. The better view is that a US revocable trust is also not equivalent in effect to a trust for persons in succession. The element of succession is that of a will. In other words, a US revocable trust is in English law a nomineeship or testamentary disposition.[48] This view was adopted in *BQ v DQ*.[49]

Depending on the wording, the US revocable trust may become a settlement (for IHT and IT/CGT) if the settlor loses mental capacity. This could of course have significant UK tax consequences.

One could if desired draft a trust which meets the US requirements to be a grantor trust and which is a settlement for IT/CGT and IHT purposes. It would need to be one where the trustees owed duties to beneficiaries other than just the settlor.

## 72.12 Legal life interest (Northern Ireland)

Legal life interests (Northern Ireland) and proper liferents (Scotland) are rare in practice, but I discuss them here because (aside from the intrinsic interest of the questions which arise) that sheds some light on the treatment of civil law usufructs.

The CG Manual provides:

> **31303 Northern Ireland**
> The land law of Northern Ireland, except where there is specific legislation to the contrary, is basically the same as the pre-1925 law of England & Wales. Accordingly it is possible to have a legal interest 'limited for life'. Under Section 43(5) IHTA 1984 in such a situation the property is deemed to be settled property.

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47 See s.60 TCGA.

48 See 72.4 (Nomineeships). Underhill & Hayton agree: *Law Relating to Trusts & Trustees* (17th ed 2006), para 4.8 fn1.

49 Supreme Court of Bermuda [2011] WTLR 373; 2011] TLI 23 accessible *www.gov.bm*.

This is correct. Section 43(5) IHTA provides:

> In the application of this Act to Northern Ireland this section shall have effect as if references to property held in trust for persons included references to property standing limited to persons...

The Manual continues:

> There was no comparable provision for CGT until Section 63A TCGA 1992 was enacted in FA 2006 with effect from 6 April 2006. Under this provision where a person with a legal interest limited for life dies, a person who acquires in fee simple or fee tail in possession as a consequence of the former person's death is deemed to acquire all the assets forming part of the property at market value at death. This does not apply to land in Ireland outside Northern Ireland.

Section 63A TCGA provides:

> (1) The provisions of this Act, so far as relating to the consequences of the death of a person to whom property in Northern Ireland stands limited for life ("the deceased"), shall have effect subject to the provisions of this section.
> (2) A person who acquires property in fee simple absolute or fee tail in possession as a consequence of the deceased's death shall be deemed to have acquired all the assets forming part of the property at the date of the deceased's death for a consideration equal to their market value at that date.

This confers a tax free uplift on death[50] but does not make the legal life interest into a settlement for IT/CGT purposes. Thus if the life tenant and the remainderman sell their interests:

(1) the relief in s.76 TCGA does not apply.
(2) the life tenant may qualify for CGT private residence relief but the remainderman will not qualify (unless they occupy the property as their main private residence, which would not be usual). The relief in s.225 TCGA will not apply.

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50 This applies even if the life interest is not an estate IP: the drafter of the 2006 reforms overlooked Northern Ireland life interests.

In practice, if private residence relief applies, it is better to create a classic settlement and not a legal life interest because then the property can be sold during the lifetime of the life tenant free of CGT.

## 72.13 Proper liferent (Scotland)

The CG Manual helpfully explains the Scots law background:

> **31301 Scottish proper liferents** [August 2007]
> In Scotland the expression 'liferent' is used to describe the situation where the income from particular property is to be paid to a person, the liferenter, for a specified period, generally his or her lifetime. At the end of the period the property will generally pass to a person known as the fiar.
> There are two ways in which a liferent can be set up. In the first case, where the interest is known as an improper liferent, the property is vested in trustees who administer the property and pay the income to the liferenter. In general the trustees have the power to sell the property in question and replace it by other property, whether land and buildings or other assets. On the death of the liferenter the provisions of s.72, s.73 and s.74 TCGA apply as appropriate. See CG36450+.

An improper liferent appears to be a classic settlement, and its tax treatment is straightforward. We are concerned with proper liferents. The Manual continues:

> In the second case, the title to heritable property (land and/or buildings) is held by the liferenter. In this situation he or she is a proper liferenter. A proper liferenter cannot dispose of a greater title than his own. He cannot dispose of the property in his will. On his death the property passes to the fiar.
> Where property in Scotland passes to a person for life under a will, and there is no suggestion that it is to be held by trustees, he has a proper liferent.

The Manual goes on to consider the CGT treatment:

> A proper liferent does not make the relevant property settled property [for CGT]. Section 43(4)(c) IHTA 1984 provides that it is settled property for IHT purposes. TCGA does not go so far, but Section 63 provides that the person entitled to possession on the death of a proper

liferenter shall be deemed to have acquired all the assets forming part of the property at their market value at death.

Section 63 TCGA provides:

> (1) The provisions of this Act, so far as relating to the consequences of the death of a proper liferenter of any property, shall have effect subject to the provisions of this section.
> (2) On the death of any such liferenter the person (if any) who, on the death of the liferenter, becomes entitled to possession of the property as fiar[51] shall be deemed to have acquired all the assets forming part of the property at the date of the deceased's death for a consideration equal to their market value at that date.

The Manual concludes:

> The disposal or termination of a proper liferent may qualify for private residence relief under section 222 TCGA as it is an interest in land.

As in Northern Ireland, this confers a tax free uplift on death[52] but it does not make the proper liferent a settlement for CGT purposes. Thus if the liferenter and the remainderman sell their interests:

(1) The relief in s.76 TCGA does not apply.
(2) The liferenter may qualify for CGT private residence relief but the remainderman will not qualify (unless they occupy the property as their main private residence, which would not be usual). The relief in s.225 TCGA will not apply.

In practice, if CGT private residence relief applies, it is better to create a classic settlement and not a proper liferent, because then the property can be sold during the lifetime of the liferenter free of CGT.

The IHT Manual provides:

> **16071 Introduction** [June 2007]
> The original view was that a proper liferenter was beneficially entitled to the property which was the subject of the liferent and that a proper liferent was a "settlement" within the meaning of [s.43 IHTA 1984]

51 Some databases erroneously read "heir".
52 This applies even if the liferent is not an estate IP: the drafter of the 2006 reforms overlooked Scottish liferents.

with the result that the liferenter fell to be treated as beneficially entitled to the settled property.

However the Board were advised that a proper liferenter was beneficially entitled only to his right to the liferent and not to the property itself so that on the death of a proper liferenter the liferenter was beneficially entitled to the liferent and not to the capital in which it subsisted. It follows that on the death of the liferenter the value to be placed on the proper liferent was nil.

**16072. IHT position** [June 2007]

Section 93 FA 1980 brought proper liferents into line with the settled property regime of the [IHTA] ... [The Manual then summarises the legislative provisions referred to below].

Section 43(4) IHTA provides:

In relation to Scotland "settlement" also includes...

(c) any deed creating or reserving a proper liferent of any property whether heritable or moveable (the property from time to time subject to the proper liferent being treated as the property comprised in the settlement);

and for the purposes of this subsection "deed" includes any disposition, arrangement, contract, resolution, instrument or writing.

Sections 46, 47 IHTA provide:

**46 Interest in possession: Scotland**

In the application of this Act to Scotland,

[1] [a] any reference to an interest in possession in settled property is a reference to an interest of any kind under a settlement by virtue of which
  - [i] the person in right of that interest is entitled to the enjoyment of the property or
  - [ii] would be so entitled if the property were capable of enjoyment,

[b] including an interest of an assignee under an assignation of an interest of any kind (other than a reversionary interest) in property subject to a proper liferent;

[2] and the person in right of such an interest at any time shall be deemed to be entitled to a corresponding interest in the whole or any part of the property comprised in the settlement.

**47 Reversionary interest**

In this Act "reversionary interest" means

> [a] a future interest under a settlement, whether it is vested or contingent (including an interest expectant on the termination of an interest in possession which, by virtue of section 50 below, is treated as subsisting in part of any property) and
> [b] in relation to Scotland includes an interest in the fee of property subject to a proper liferent.

Lastly, for completeness, s. 142(7) IHTA provides that for the purposes of s. 142 IHTA (deeds of variation):

> In the application of subsection (4) above to Scotland, property which is subject to a proper liferent shall be deemed to be held in trust for the liferenter.

## 72.14 Usufructs

### 72.14.1 *The property law background*

A discussion of the law(s) of usufructs[53] is not possible here. In outline, Article 578 of the French Code Civil provides:

> An usufruct is the right to enjoy property belonging to another, as if its owner, at the expense of preserving that property.[54]

The owner of the right is called "**the usufructuary**" and the owner of the property subject to the right is here called "**the encumbered owner**". (I think this is a clearer term than "bare owner" which would be a more literal translation of the French term *nu-propriétaire*.)

### 72.14.2 *Is a usufruct an IT/CGT settlement?*

The CG Manual provides:

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53 I do not distinguish here between usufructs under different civil law jurisdictions, though it is possible that there are material differences; I would be grateful for the comments of any reader with expertise in these areas.

54 *L'usufruit est le droit de jouir des choses dont un autre a la propriété, comme le propriétaire lui-même, mais à la charge d'en conserver la substance.* The Code Civil is accessible in French on *www.legifrance.gouv.fr*.

> **31305 Other interests** [August 2007]
> ... A usufruct governed by French law would be regarded as a non-trust arrangement as it is broadly similar to a Scottish proper liferent.

This is clearly right. Thus if the usufructuary and the encumbered owner sell their interests:

(1) The relief in s.76 TCGA does not apply.
(2) The usufructuary may qualify for CGT private residence relief but the encumbered owner will not qualify (unless they occupy the property, which would be unusual). The relief in s.225 TCGA will not apply.

There is no CGT uplift on the death of the usufructuary.

It is not possible to avoid this problem by creating a classic settlement instead of a usufruct, because civil law systems do not usually recognise trusts; even if a trust is theoretically possible, it is probably not practical for tax reasons or because it raises too many uncertainties.

The result is a CGT discrimination against usufructs. If the usufruct is in an EU jurisdiction, this discrimination is very difficult to justify, and it is suggested that an uplift on death should be available under EU law principles, and, arguably, private residence relief on a sale during the lifetime of the usufructuary.

If an individual creates a usufruct under which they retain an interest, this is a part disposal for CGT purposes as s.70 TCGA (transfers into settlement) does not apply.

### 72.14.3 *Is a usufruct an IHT-settlement?*

Is a usufruct governed by provisions equivalent in effect to a classic life interest settlement, and so a settlement within the IHT definition? There is an element of succession, but there are major differences. A usufruct is more like a lease for life or a legal life interest than a classic settlement. Overall it is sufficiently unlike a settlement that it is suggested that the two should not be regarded as equivalent in effect, so it is not an IHT-settlement.[55] It has no settled property and no trustees.[56]

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55 This issue does not arise for proper liferents (Scotland) or legal life interests (Northern Ireland) since the last paragraph of the definition dealing with provisions “equivalent in effect” only applies to non-UK legal systems.

56 See too 45.2 ("Settlement" and "trustee").

If a usufruct is an IHT-settlement, there could be charges to IHT on the creation of the usufruct, on ten-year anniversaries[57] and on the death of the usufructuary, though the property will often qualify as excluded property (depending of course on the domicile of the settlor and, if a spouse, the domicile of the usufructuary). DTA relief will sometimes be available. Pre-owned assets would also need consideration.

On the other hand, if the usufruct is an IHT-settlement, the interest of the encumbered owner is a reversionary interest and so in principle excluded property, which is helpful to the taxpayer if the encumbered owner is UK domiciled. So depending on the circumstances it will sometimes be in the taxpayers' interest to argue the issue one way and sometimes the other; and the same applies for HMRC.

A common case is where an owner of property creates a usufruct under which they are the usufructary and a child is the encumbered owner. If the usufruct is an IHT-settlement, and the owner is UK domiciled, then:

(1) the owner makes a transfer of value equal to the value of the property[58] but
(2) the gift is a PET so far as attributable to the child's reversionary interest.[59]

That is so absurd as to make one question whether the analysis that a usufruct is an IHT-settlement can be correct.

In practice I expect that (if the issue is considered at all) a taxpayer takes whichever view suits them better and indeed in this toss-a-coin area, and in the absence of HMRC guidance, a taxpayer is entitled to do that. HMRC might adopt whichever view suits them better, or whichever view the taxpayer adopts or even perhaps whichever view leads to a fair result on the facts of the case. It appears that HMRC have on occasion accepted the view that a usufruct is an IHT-settlement[60] but one cannot infer guidance from specific instances.

57 Though a usufruct created on death will qualify as an IPDI.

58 See s. 3(1) IHTA; the value of the usufructuary's interest is disregarded as an interest in possession in settled property: s.5(1)(a)(ii) IHTA.

59 See s.3A(1)(c) and 3A(2)(a) IHTA. The encumbered owner's interest is excluded property but nevertheless forms part of their estate

60 McCutcheon on Inheritance Tax, 5th edition para 32.60.

## 72.15 Société civile and société en nom collectif

The former ITH provided:

**304. Company and partnership distinguished**
A company, therefore, acts for itself and not as agent or representative of its members. When profits arise they arise to the company and not to the shareholders. The shareholders have no right to them as profit. The rights of the shareholders include the right to a dividend when formally declared. In a partnership, on the other hand, each partner is the agent of the other partners. The profits arise to each partner according to the provisions of the partnership agreement. It is the existence of that agency relationship which distinguishes a partnership from a company. It is broadly true to say that a partnership does not have, as a company does, distinct legal persona but the presence of legal persona is not in itself conclusive. In Scotland a partnership is a distinct legal entity but there is, at the same time, an agency relationship between the firm and its members and between its members. That agency relationship is the hallmark of partnership and characterises the Scots partnership as a partnership rather than as a company. Considerations of this sort are important when dealing with some unfamiliar European company cum partnership creations. The French Société Civile is one such body and the Société en nom Collectif is another. Broadly speaking we regard the first as a company the second as a partnership. Both have legal personality but in the former case the profits arise to the body itself and in the latter case we take the view that the profits arise to the partners. There is more about how we decide which category is appropriate in chapter 16 (ITH1672–ITH1675). ...
**1673. Establish facts**
The first stage is one of factual enquiry and in relation to any appeal procedure is a matter for the Appeal Commissioners. It can be a difficult stage – even for trained Revenue lawyers. Experts have been known to differ and in a case about these bodies *Dreyfus v IRC* 14 TC 560 we think the Commissioners came to a wrong decision and we do not follow the Courts ruling. The case involved a French SNC and the Courts said it was a company, being guided by the Commissioners' finding of fact about foreign law. We – after listening to expert advice – think it analogous to a partnership. This question of foreign law is difficult. Where the foreign law is a common law it will often share basic concepts with English law and that eases things a little. But if the foreign law is a civil law – a written code of law – the chances of a communications gap developing between a foreign expert adviser and

an English lawyer seeking his advice are much greater.

There are no hard and fast rules governing this question of foreign law; every association has to be considered separately and in the light of its Articles of Association or equivalent code. We look for indicators as to whether the Association carries on the business itself or whether the participators do so jointly; and whether the profits accrue directly to the participators or whether they accrue to the Association which then distributes them to the participators. These conclusions should then help us decide whether the members of the Association are carrying on a trade, profession or vocation solely or in partnerships and, if so, whether the income is immediately derived by the member from the carrying on of that trade.

### 72.15.1 *Société civile immobilière*

The Employment Income Manual provides:

> **11371 Homes outside the United Kingdom owned through a company: General background** [December 2008]
>
> ...Meaning of company
>
> Company is defined in section 992 ITA 2007 as any body corporate or unincorporated association other than a partnership, a local authority or a local authority association. This wide definition is not restricted to companies registered in the UK and includes a number of entities formed under foreign law through which individuals may acquire homes outside the UK. Such entities will generally be classified as opaque for UK tax purposes. Examples include the ownership of a home in France through a "Societe Civile Immobiliere" (SCI) or in the United States through a Limited Liability Company (LLC).

The view that a SCI is a company for UK tax purposes is controversial.[61] A société civile is classified as a partnership in the UK/France IHT DTA.[62] The introduction of benefit in kind foreign homes relief and the subsequent UK/France DTA have made the issue somewhat less important but it still matters.

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61 See Frimston and Urquhart "La Vie en France" Taxation, 13 Jun 2002 (Vol 149, Issue 3861), p.296.

62 See 60.5.2 (Treaty situs rules: France and Italy). See too John Avery Jones "Characterisation of Other States' Partnerships for Income Tax", [2002] BTR at p.425.

The issue arose in *Joseph Carter v Baird* 72 TC 303 where a company sold land and purchased a SCI. The company claimed roll-over relief which only applied on a purchase of land. The company failed since it acquired an interest in the SCI and not land. Unfortunately the question of whether an SCI was transparent for CGT was not argued and the necessary expert evidence was not put to the general commissioners. (The litigant appeared in person and was not represented by counsel). The case therefore has no authority at all, and on another occasion there is nothing to stop a taxpayer putting forward the argument for transparency, properly supported by evidence.

## 72.16 Jersey general and limited partnerships

A Jersey general partnership is transparent.[63] It is considered that a Jersey limited partnership is transparent. It is similar to a Guernsey limited partnership which HMRC classify as transparent in the official list.

## 72.17 Foreign limited liability partnership

References to a LLP in UK legislation are references to UK incorporated LLP (unless the context otherwise requires.)[64] It is considered that the statutory rules which (generally) make a UK LLP transparent for IT and CGT do not apply to a foreign LLP.
HMRC agree. Business Income Manual provides:

> **72145Limited Liability Partnership: International aspects** [January 2006]
> *UK branches of overseas LLPs*
> The tax treatment of a UK branch of an overseas LLP, and the members of such a LLP, depends on how the foreign entity is regarded for the purposes of the UK taxation provisions. Where the foreign LLP is regarded as a 'body corporate' for the purposes of the UK Taxes Acts the profits of the UK branch will be chargeable to CT. On the other hand if it is regarded as a partnership then members are separately liable to tax

63 *Padmore v IRC* 62 TC 352; see Jersey Law Commission "The Jersey Law of Partnership" (consultation paper, 2008) para 21.12 ("Viewed as a whole, in fact the law of partnership of [England and Jersey is] essentially the same...").
64 See 36.7.1 (Definition of LLP).

> on their share of the branch's profits under the existing legislation for partnerships rather than under the LLP Act. The latter Act only applies to UK registered LLPs.

HMRC classify a Jersey LLP as opaque in the official list. This is controvertial.[65] However the issue is at present academic because (partly as a result of the HMRC view and partly due to burdensome Jersey law requirements) no Jersey LLP has yet been registered.

## 72.18 Hindu undivided property

The CG Manual provides:

> **31305 Other interests** [August 2007]
> ... a case involving Hindu Undivided Property would be regarded as a discretionary trust rather than an unincorporated association.

## 72.19 Japanese tokkin

HMRC regard a tokkin as transparent. The INTM provides:

> **355160 Claims by Japanese "Tokkin" funds** [July 2005]
> 'Tokkin' is an abbreviation of 'tokutei kinsen', and means 'designated monetary trust'.
> Cash or other assets for this type of fund are deposited by the investor(s) with a trustee who manages them on behalf of the investor(s), and in accordance with his/her/their instructions. The tokkin is set up and managed under the terms of a written agreement between the parties, drawn up under Law No 62 of 21/4/1922 of Japan.
> Because the Dividends and Interest Articles of the convention provide for relief **only to the beneficial owner** (INTM332000) of the income, claims in respect of income paid to tokkin funds **must** be made by the beneficial owner of the tokkin (the 'investor(s)'above), and **cannot** validly be made by the tokkin's manager.

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65 Walker "Limited Liability Partnerships: True Partnerships" [1998] JLR 1 argues that a Jersey limited liability partnership is a partnership in the ordinary sense of the word. In *R v IRC ex p. Bishopp* 72 TC 322 the Court was asked but refused to express a view on that. On the transparency of partnerships generally, see 36.3 (Transparency of partnership for IT) and 36.6 (Transparency of partnership for CGT).

So if you see a claim or supporting voucher which makes any reference to tokkin, you should ensure that you consider only claims made by the beneficial owner, that is, the **original investor**, in respect of his/her/their share in the tokkin.
There is no reason why a single investor should not own **all** the funds in a tokkin, but you should make certain that your claim has been made by the beneficial owner and not by the trustee, or an investment manager.
The original investors/beneficial owners may be either individuals or companies.
But it should be clear in either case that **no** relief can be due to the tokkin **itself**.

## 72.20 Dutch bewind

Kortmann and Verhagen say:

> The *bewind* cannot be characterised as a trust in the sense of Article 1 of the Principles. A trust in the sense of the Principles only exists in situations where the trustee legally owns the assets to be managed, which is not so in the case of *bewind*. In the case of *bewind* the beneficiary is legal owner of the assets to be managed. There are, however, restrictions on the beneficiary's right to dispose of the assets placed under *bewind*. Either the legal owner cannot dispose of these assets at all, or he can only do so subject to the *bewind*. The *bewindvoerder*, as the administrator is usually called, acts in the case of *bewind* only as agent for the owner of the assets (the beneficiary). Because the assets to be managed are not legally owned by the *bewindvoerder*, the assets remain unaffected by the bankruptcy of the *bewindvoerder*.[66]

On this basis it is considered that a bewind is a nomineeship.[67]

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66 Hayton, Kortmann and Verhagen, *Principles of European Trust Law, Law of Business and Finance* Vol 1,(1999) p.199. Similarly Gretton "Trusts Without Equity" (2000) 49 Int'l & Comp. L.Q. 599: "Though it functions as a trust, the *bewind* is not a trust, for a simple reason: the location of legal title is the reverse of the trust."

67 See 72.4 (Nomineeships).

## 72.21 Netherlands Fonds voor gemene rekening (closed funds for mutual account)

In 2010 the UK and the Netherlands reached the following agreement regarding the application of the UK/Netherlands DTA to investors in closed funds for mutual account *fonds voor gemene rekening* ("closed FGR"):

> This Agreement applies to closed FGRs formed in conformity with the Decree of 11 January 2007, CPP2006/1870M, Dutch. Gov. Gaz. No 15, 2007. A closed FGR can act as a pooled investment vehicle for the assets of pension funds and other investors. The closed FGR invests these assets on behalf of those investors.
>
> The competent authorities of the Netherlands and the UK agree that a closed FGR[68] is fiscally transparent.
>
> A closed FGR can also consist of several closed FGRs as described in par. 4 of the Decree of 11 January 2007, CPP2006/1870M, Dutch. Gov. Gaz. No 15, 2007. Such an umbrella fund is also fiscally transparent.
>
> Since a closed FGR is fiscally transparent, all income and gains derived by the fund from the fund assets are allocated to the investors in the closed FGR in proportion to their participations in the fund.
>
> *Request for application of the benefits of a Convention on behalf of the participants*
>
> A closed FGR which is established in the Netherlands and which receives income arising in the UK may itself, represented by its fund manager or its depository, in lieu of and instead of the investors in the closed FGR, claim the benefits of an agreement for the avoidance of double taxation to which the UK is a party and which is applicable to those investors on behalf of those investors in the closed FGR.
>
> Such claims may be subject to enquiry and, where requested, a fund manager or depository shall provide relevant information which may include a schedule of investors and allocated income relevant to a claim.
>
> A closed FGR may not make a claim for benefits on behalf of any investor in the closed FGR if the investor has itself made a claim for benefits in respect of the same income. If a closed FGR intends to make a claim for benefits on behalf of an investor, the fund manager or its depositary should clearly communicate this to the investor to avoid duplicate claims in respect of the same income.

68 [Footnote original] Various translations of 'Fonds voor Gemene Rekening' are possible, such as 'fund for mutual account' or 'fund for joint account'.

This Agreement shall be subject to regular review.

## 72.22 US limited liability company

### 72.22.1 *Transparency*

TG IT manual provides:

> **DT19853A United States of America: United States limited liability companies**
> Generally speaking, United States federal income tax is charged on the profits of LLCs on the basis that they are fiscally transparent, ie tax is imposed on the members of the LLC and not on the LLC itself.
> However, for the purposes of UK tax we have taken the view in relation to those LLCs that we have so far considered that they should be regarded as taxable entities and not as fiscally transparent. Accordingly we tax a UK member of a LLC by reference to distributions of profits made by the LLC and not by reference to the income of the LLC as it arises.

In *Swift v HMRC*[69] a Delaware LLC was held to be transparent. HMRC say:

> HMRC has appealed the decision and intends, for the time being, to continue with its current general practices in relation to US LLCs. If, however, any member of a US LLC feels that the UK treatment of a particular LLC should be reviewed in the light of the decision of the Tribunal, they should write to [HMRC contact] setting out fully why they believe that to be the case.[70]

Tax Bulletin 29 also contained a concession but the problem is now dealt with in the 2001 treaty, see 50.20 (US/UK DTA). Also see 72.25.3 (Ordinary share capital: Delaware LLC).

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69 [2010] UKFTT 88. The Tribunal noted at [17] that its decision concerned only this particular Delaware LLC, and since there is wide freedom to contract the terms of a Delaware LLC, it may not be of general application. However I understand that the LLC did not in fact have any particularly unusual features.

70 "Swift v HMRC: UK tax treatment of a US LLC" 20 May 2010 *www.hmrc.gov.uk/international/swift-v-hmrc.htm*.

## 72.22.2 *Capital contribution: company law background*

Capital contributions are a common method for Delaware companies to raise additional capital. The CG Manual explains the company law background:

> **43500 General** [April 2009]
> The company law provisions of some foreign jurisdictions, notably the USA, provide for the making of capital contributions to companies. A capital contribution is a contribution to the equity capital of a company, but is not made in exchange for shares issued to the contributor and it does not constitute a separate asset in its own right. See INTM503050 where any equity function arguments are raised.
> An overseas company receiving a capital contribution may treat it in a number of ways, depending on the law of the foreign jurisdiction concerned and the conditions attaching to the payment. These may give the company a choice whether to designate the contribution as 'surplus' or as 'capital'. Amounts designated as 'surplus' may be available for distribution to shareholders, subject to solvency requirements. Amounts designated as 'capital' may only be repayable by way of a capital reduction. A company's balance sheet will generally show capital contributions made to it as an item of shareholders' funds separate from paid up share capital. Capital contributions may be described, for example, as 'additional paid in capital'.
> Capital contributions are not recognised under UK company law and if a payment is not made as part of the terms of issue of shares, it is possible it is either a loan or a gift. If a UK taxpayer contends that a sum paid to an overseas company is a capital contribution rather than a loan or gift, evidence to support that contention should be sought.
> For example if a UK company suggests a payment to an overseas affiliate is a capital contribution rather than a loan or gift there should be evidence of the appropriate treatment in the company accounts. If however there is a possibility that the money can be repaid, it is likely to be a debt within the loan relationships regime, see CTM51200. It is therefore necessary to examine all the circumstances surrounding the money transfer before coming to any conclusion as to what the nature of the payment is. If however agreement cannot be reached as to the nature of the payment and therefore the tax consequences (see CG43501 and CG43502 below), the decision lies with the Tribunals and the Courts.
> Occasionally a capital contribution may be made to a UK company. As capital contributions are not a concept formally recognised within UK company law, a contribution received by a UK company should be

reported within distributable reserves either as a gift or possibly a donation. If however it can be repaid in any circumstances it should be considered as a loan falling within the loan relationships regime.

The International Manual also makes some comments:

> **503050 Issues affecting equity function cases** [March 2007]
> ... *Capital contributions*
> The company law provisions of some foreign jurisdictions, notably the USA, allow for the making of capital contributions to companies. A capital contribution is a contribution to the equity capital of a company. It is not a loan and creates no obligation to transfer economic benefit to the maker of the contribution.
> In the UK there is no company law provision regarding capital contributions. If a UK company receives a capital contribution it is normally reported within shareholders' funds. If it makes a capital contribution it will normally be included in the accounts as an added cost of investment in a subsidiary.
> If a UK company contends that a sum paid to an overseas affiliate is a capital contribution rather than a loan, HM Revenue & Customs can only accept the contention if there is evidence supporting it. For example, there should be a written agreement that a capital contribution has been made rather than a loan, and evidence of the appropriate treatment in the company accounts. If there is a possibility that the money can be repaid, it is a 'money debt' under the loan relationships legislation. It is necessary to examine all the circumstances surrounding the money transfer before making a decision. From HMRC's point of view, the amount contributed should not be distributable.

In *Fenston v HMRC* [2007] STC (SCD) the position was explained as follows:

> ... assuming that at all relevant times the assets of the Company exceeded its liabilities, ... as a result of the Contributions, the state of the Company's stock changed in the sense that the amount of funds distributable with respect to the Shares as a dividend or upon liquidation was increased by the amount of the Contributions.
> Under Delaware law, the funds available for payment of dividends, if and when declared by a corporation's board of directors, are payable out of "surplus". 8 Del. C.§ 170. "Surplus" is defined in relation to "capital". "Capital" with respect to no par stock, such as the Shares, is defined as that portion of the consideration received by a corporation for the issued

shares of its capital stock that the directors determine to be capital, or if no such determination is made, the amount of consideration received. 8 Del. C. § 154. The excess, if any, at any given time, of the net assets of the corporation over the amount so determined to be capital shall be "surplus". 8 Del. C. § 154. "Net assets" means the amount by which total assets exceed total liabilities. 8 Del. C. § 154. Therefore, the "surplus" of a corporation is an amount equal to the total assets of the corporation, minus the total liabilities of the corporation, minus the capital of corporation, minus the total liabilities of the corporation, minus the capital of the corporation (as just described). Here, the Contributions increased the Company's net assets, and thus its surplus, thus increasing the amount of funds the Company could lawfully have distributed to the trustees (as stockholders) as a dividend.

With respect to entitlement to distributions on dissolution, when a corporation dissolves, its assets are held in trust for the benefit of creditors, and if creditors are paid in full, the stockholders. Accordingly, when a corporation dissolves it must first pay or provide for its creditors, both fixed and contingent, in full before any distribution can be made to stockholders. However, once creditors are paid or provided for, any residual assets are to be distributed to the corporation's stockholders. 8 Del. C. § 281. As described above, the Contributions increased the Company's total assets. If the Company had been dissolved immediately after such Contributions had been made (which the trustees, as the sole stockholders, could have done pursuant to Section 275(c) of the General Corporation Law, 8 Del. C. § 275(c), then the amounts the trustees (as stockholders) would have been entitled to receive as stockholders upon dissolution with respect to the Shares would [have] been increased by the amount of the Contributions assuming, in each case, that amounts would remain for distribution to the stockholders following the payment in full of the Company's creditors.

Therefore, the Contributions would have increased the amounts that could have been distributed with respect to the Shares either as a dividend or as a liquidating distribution.'

### 72.22.3 *Capital contribution: tax analysis*

The CG Manual then turns to the tax analysis:

**43501 Made under terms of share issue**

A shareholder may make a capital contribution to a company at the same time as the shareholder acquires shares in the company. If the capital contribution is made as part of the terms of issue of the shares, then the capital contribution should be accepted as consideration given wholly and exclusively for the acquisition of the shares within TCGA 1992, Section 38(1)(a). If a capital contribution is made as part of the terms of a share issue which is treated as a reorganisation for capital gains purposes, then the capital contribution should be accepted as consideration given for the new holding for the purposes of TCGA 1992, Section 128(1). The amount of the capital gains deduction will remain subject to the other general rules, such as TCGA 1992, Section 17 and TCGA 1992, Section 128(2), see CG14530+ and CG51840+-

So far the law is fair. However the Manual continues:

**43502. Other contributions not allowable** [November 2007]
Where shares are disposed of in a company to which a capital contribution has been paid a claim may be made for a deduction in respect of that contribution in the capital gain computation. The claim will normally be for the contribution to be allowable as enhancement expenditure under Section 38(1)(b)TCGA 1992.
Although a capital contribution will typically affect the value of the shares in the company to which the contribution is made, it does not represent either
[1] expenditure on the shares,[71] or
[2] expenditure reflected in the state or nature of the shares at the time of their disposal.
The Special Commissioners decision in the case of The Trustees of the F. D. Fenston Will Trusts v HMRC (SpC589/07) confirmed that a capital contribution which is not made as part of the terms for the issue of shares is not, in the absence of anything to indicate that the rights and privileges attaching to the shares have been enhanced, an allowable deduction within Section 38 TCGA 1992 when shares in the company are disposed of. In particular, the capital contribution does not represent enhancement expenditure within Section 38(1)(b)TCGA 1992.
In applying this decision it may be argued there are circumstances were the tax result will be distorted if the amount of tax payable takes account of value realised, directly or indirectly, by a shareholder from a capital contribution, but the capital contribution itself is not reflected in allowable expenditure for capital gains purposes. Below are some

71 Author's footnote: Point [1] is wrong and directly contradicted by the decision in *Fenston* but it would be sufficient if HMRC are right on point [2].

examples where such distortion may be alleged.[72]

[1] A capital contribution is returned by a company to its shareholders as a dividend or distribution and they are taxed on the distribution but the shareholder will have had no deduction for the contribution. Our view is that a dividend or distribution is paid out of the surplus of the company so therefore is not a direct return of the capital contribution paid by the shareholder (in which case it is probably a loan). The nature of the receipt is changed when a dividend or distribution is made in comparison with the time when the capital contribution was paid.

[2] A capital contribution is retained by the company at a time when there is a sale of shares in the company. The contribution may be reflected in an increased consideration for the disposal of the shares but a capital gains deduction will not be given.

[3] There is similar scope for distortions where a capital contribution is followed by a share exchange, reconstruction or amalgamation treated as a share reorganisation for capital gains purposes, see CG52500+. This is then followed by a disposal of the new holding for an amount which reflects the capital contribution made to the company in which the original shares were held, and the capital contribution is not allowable expenditure on the original shares.

In these last two cases, unless the capital contribution resulted in a change in the rights and privileges attaching to the shares, and that change is reflected in the nature of the shares at the time of their disposal, it is not an allowable deduction within Section 38(1)(b)TCGA 1992 when those shares in the company, or replacement shares in that or a different company acquired by virtue of a share reorganisation are disposed of.

Section 38(1)(b) TCGA allows a deduction for:

> the amount of any expenditure wholly and exclusively incurred on the asset by him or on his behalf for the purpose of enhancing the value of the asset, being expenditure reflected in the state or nature of the asset at the time of the disposal ...

In *Fenston*, the Special Commissioners correctly held that the capital contribution was expenditure "on the asset for the purpose of enhancing the value of the asset." Unfortunately they held that the expenditure was

72 Author's footnote: "Distortion" is a euphemism for unfairness, and "alleged" is tendentious since the unfairness of [2] and [3] is obvious and undeniable.

not reflected in the state or nature of the asset at the time of the disposal:

> 23 ... [1] Further, 'state and nature' for these purposes must be something other than merely the value of the asset—otherwise this phrase would add nothing to the immediately preceding words.
> [2] In this case the capital contributions did not result in any increase in the number of shares in issue, or result in any change in the rights or restrictions attaching to the shares. The only effect of the capital contributions was to increase the surplus of the company—which would increase the amount available for distribution to shareholders, and therefore presumably the value of the shares. We do not consider this sufficient for the expenditure on the capital contributions to be reflected in the state and nature of the shares, either at the time the expenditure was incurred or at any time subsequently.

Point [1] is wrong[73] and point [2] is not in the least convincing. It is considered that the decision ought not to be followed, though a taxpayer who challenges it risks litigating to the Court of Appeal.

The CG manual discusses the possibility of relief under the last part of s.38(1)(b) TCGA which allows a deduction for "expenditure wholly and exclusively incurred by them in establishing, preserving or defending his title to, or to a right over, the asset."

> There may also be cases where companies call on their shareholders to provide further capital to meet a specified purpose, in circumstances where a shareholder who fails to provide the additional funds may lose the entitlement to the shares held. In this situation, depending on the particular facts, the shareholder may be able to establish that the additional payment represents expenditure on preserving or defending the title to the shares within the terms of Section 38(1)(b)TCGA 1992.

### 72.22.4 *Planning implications*

The tax planning advice is that companies should if possible be funded by

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73 The words "reflected in the state or nature of the asset" are needed to cover this situation: suppose T spends £x on a kitchen inT's home. 15 years later the kitchen is replaced by a new kitchen. The £x was "incurred on the asset for the purpose of enhancing the value of the asset" but was not "reflected in the state or nature of the asset" at the time of disposal. In this case it is sensible to disallow the capital expenditure in a CGT computation.

subscriptions for shares or loans, and not by capital contributions, because the expense of the capital contributions will in most cases be disallowed for CGT purposes (or else the taxpayer will have to litigate to a high level to obtain them).

The HMRC view that “If there is a possibility that the money can be repaid, it is likely to be a debt” mitigates some of the unfairness of the treatment of capital contributions by reducing the number of occasions where a transaction is categorised as a capital contribution.

### 72.22.5 *Commentary: fairness and the tax system*

*Fenston* raises an interesting question of policy, leaving aside the narrower legal question of whether it was rightly decided by the Tribunal. Assuming this was an issue where two views of a legal provision were possible, it was a case where one view lead to a fair and sensible result - tax on an economic gain. The other view lead to a patently unfair result. There can be no doubt about that.

(1) Adopting the traditional view summarised in the slogan that “there is no equity in a taxing statute” a tax administration would be expected to take any point. The only criterion is the prospect of success in a court:

> The Inland Revenue is not slow - *and quite rightly* - to take every advantage which is open to it under the taxing statutes for the purpose of depleting the taxpayer's pocket. And the taxpayer is, in like manner, entitled to be astute to prevent, so far as he honestly can, the depletion of his means by the Revenue.[74]

(2) The more modern view pays much more regard to fairness and “the right amount of tax.” On this view the appeal should not have been taken, and the decision to take the appeal is greatly to be regretted. One might perhaps adopt the view that fairness applies in favour of HMRC but not the taxpayer; but no-one has had the temerity to

74 *Ayrshire Pullman Motor Services v IRC* 14 TC 794. (The passage is well known for its statement that immediately preceded this: “No man in this country is under the smallest obligation, moral or other, so to arrange his legal relations to his business or to his property as to enable the Inland Revenue to put the largest possible shovel into his stores.”)

advocate that.

Of course the consequence of unfair taxation may be to some extent to increase the tax yield, but unfair tax law has an intangible cost in that it brings the UK tax system into disrepute. There seems no prospect of legislative reform, indeed such reform would difficult to draft. This is another reason for hoping that an appeal will eventually overturn *Fenston:* that would restore credibility to the UK tax system. But there it is.

## 72.23 HMRC official list of transparent and opaque entities

The International Manual provides:

> **180020 Considerations when using the List of Classifications of Foreign Entities for UK tax purposes** [November 2010]
> A list of foreign entities where we have been asked our view on the question of transparency/opacity is set out in INTM180030.

I refer to this as "**the HMRC official list**".

> It should be noted that the list only gives our general view as to the treatment of the specified foreign entity. In a particular case regard may also need to be had to:
> (a) The specific terms of the UK taxation provision under which the matter requires to be considered:
> (b) The provisions of any legislation, articles of association, by-laws, agreement or other document governing the entity's creation, continued existence and management, and;
> (c) The terms of any relevant Double Taxation Agreement.
> It should also be borne in mind that in relation to the classifications set out on the list:
> In some instances HMRCs view was given many years ago, and there may have been significant changes in the relevant foreign law which may mean that a different conclusion as to the status of that entity might now be reached. Changes in foreign law after the publication of this article may be significant for the same reason. ...
> Where clarification is sought in relation to a foreign entity we will attempt to give a view in particular cases in line with Code of Practice 10.

An OECD Report[75] sets out a helpful list of entities of OECD countries giving their main characteristics. I here set out a combination of three lists: the TB 83 list in full, together with the additional references in the version of that list in INT Manual 180030 [November 2010].[76] I add the English translation from the OECD list, and the reader who needs basic information about an entity in that list should turn to the OECD report.

| **Country and name of entity** | **UK tax treatment & date last considered** | **Translation** *OECD list unless marked* * |
|---|---|---|
| **ANGUILLA** | | |
| Partnership | Transparent Oct 91 | |
| Limited Liability Company (LLC) | Opaque Jan 08 | |
| **ARGENTINA** | | |
| Sociedad de responsabilidad limitada | Opaque Jun 58 | |
| **ARMENIA** | | |
| Limited Liability Company (LLC) | Opaque May 06 | |
| **AUSTRALIA** | | |
| Limited Partnership (LP) | Transparent Sep 07 | |
| Unit Trust | Transparent Apr 07 | |
| **AUSTRIA** | | |
| Kommanditgesellschaft (KG) | Transparent Aug 71 | Limited Partnership |
| Kommandit[77] Erwerbsgesellschaft (KEG) | Transparent Nov 03 | Limited Partnership |
| GmbH & Co KG | Transparent May 02 | |
| Gesellschaft mit Beschränkter Haftung (GmbH) | Opaque Nov 05 | Limited liability company |
| Aktiengesellschaft (AG) | Opaque Nov 05 | Company |
| **BELGIUM** | | |
| Société privée à responsabilité limitée (SPRL) | Opaque Aug 94 | Limited liability partnership |
| Société en nom collectif (SNC) | Transparent May 92 | General partnership |
| Société Anonyme (SA) | Opaque Nov 05 | Limited company |
| Naamloze Vennootschap (NV) | Opaque Nov 05 | Limited company |
| Société en commandite[78] par actions (SCA) | Opaque Nov 05 | Co limited by shares |
| Commanditaire vennootschap[79] op aandelen (CVA) | Opaque Nov 05 | Company limited by shares |

75 "The Application of the OECD Model Tax Convention to Partnerships" (OECD, 1999) accessible (at a small charge) from *www.oecd.org*.

76 I have restored diacritical marks which HMRC somewhat illiterately omitted in the official list.

77 HMRC original erroneously reads: Kommand.

78 HMRC original erroneously reads: commanditaire.

79 HMRC original erroneously reads: venootschap.

| | | |
|---|---|---|
| **BERMUDA** | | |
| Limited partnership with legal personality (LP) | Transparent Dec 07 | |
| **BRAZIL** | | |
| Sociedade[80] por quotas de responsabilidade limitada (Srl) | Opaque Jan 77 | |
| Fundo de Investimento en participacoes (FPI) | Transparent Dec 07 | |
| **BVI** | | |
| Limited Partnership (LP) | Transparent Mar 09 | |
| **CANADA** | | |
| Partnership and limited partnership | Transparent Nov 05 | |
| **CAYMAN ISLANDS** | | |
| Limited partnership | Transparent Nov 93 | |
| **CHILE** | | |
| Sociedad de responsabilidad limitada (SRL) | Transparent Sep 03 | |
| **CHINA** | | |
| Wholly foreign owned entity (WFOE) | Opaque Oct 05 | |
| **CZECH REPUBLIC** | | |
| Akciová společnost (as) | Opaque Nov 05 | Joint-stock company |
| Společnost s ručením omezeným (sro) | Opaque Nov 05 | Limited liability company |
| **DENMARK** | | |
| Danske Investingsforening | Opaque Jan 09 | |
| **EUROPEAN UNION** | | |
| Societas Europeas (SE) | Opaque Jul 05 | |
| **FINLAND** | | |
| Kommandiittiyhtiö (Ky) | Transparent May 91 | Limited partnership |
| Osakeyhtiö (Oy) | Opaque Nov 05 | Limited company |
| Aktiebolag (Ab) | Opaque Nov 05 | Limited company |
| **FRANCE** | | |
| Groupement d'intérêt économique (GIE) | Transparent May 88 | Economic interest grouping |
| Société en nom collectif (SNC) | Transparent[81] Aug 00 | General partnership |
| Société civile immobilière (SCI) | Opaque[82] Nov 05 | |
| Société civile exploitation agricole (SCEA)[83] | Opaque Feb 98 | |
| Société en commandite simple (SCS) | Transparent Sep 97 | Limited partnership |
| Société en participation (SP) | Transparent Jun 92 | Undeclared partnership |
| Société à responsabilité limitée (SARL) | Opaque | Limited liability company |

80 HMRC original erroneously reads: Sociedad.

81 See 72.15 (Société Civile and Société en nom collectif).

82 See 72.15 (Société Civile and Société en nom collectif).

83 Tax Bulletin 83 referred to a Société civile agricole (SCA) which I assume is the same entity.

| | | |
|---|---|---|
| Fonds Commun de Placement à risques (FCPR) | Transparent Jan 97 | |
| Société par Actions Simplifiée (SAS) | Opaque Apr 04 | |
| Société anonyme (SA) | Opaque Apr 04 | Co limited by shares |
| Groupement Foncier d'Agricole (GFA)[84] | Opaque May 01 | |
| Société Civile (SC) | Opaque[85] Nov 05 | Civil partnership |
| Société en Commandite par action (SCA) | Opaque Nov 07 | |
| **GERMANY** | | |
| Stille Gesellschaft | Opaque Jun 98 | Silent partnership |
| Kommanditgesellschaft[86] (KG) | Transparent Feb 97 | Limited partnership |
| Offene Handelsgesellschaft (OHG) | Transparent Sep 96 | General partnership |
| Gesellschaft mit beschränkter Haftung (GmbH)[87] | Opaque Feb 97 | Limited liability company |
| GmbH & Co. KG | Transparent Feb 97 | |
| GmbH & Co. KGaA | Opaque Apr 08 | |
| Gesellschaft des bürgerlichen Rechts (GbR) | Transparent Apr 94 | Civil law partnership |
| Aktiengesellschaft (AG) | Opaque Nov 05 | Limited liability company |
| **GIBRALTAR** | | |
| Limited Partnership (LP) | Transparent Jan 09 | |
| **GUERNSEY** | | |
| Limited Partnership (LP) | Transparent Jan 05 | |
| Protected Cell Company (PCC)[88] | Opaque Nov 04 | |
| Open Ended Investment Company with Limited Liability | Opaque Nov 04 | |
| **HUNGARY** | | |
| Korlátolt felelösségü társaság (Kft) | Opaque Nov 05 | Limited liability company |
| Részvénytársaság (Rt) | Opaque Nov 05 | Co limited by shares |
| **ICELAND** | | |
| Hlutafélag | Opaque Nov 05 | Public limited liability co |
| **IRELAND** | | |
| Limited Partnership | Transparent | |
| Irish Investment Limited Partnership | Transparent | |
| Common Contractual Fund (CCF) | Transparent Jan 04 | |
| Unit Trust (UT) | Opaque Aug 08 | |
| **ISLE OF MAN** | | |
| Limited Liability Company (LLC) | Opaque Nov 08 | |
| **ITALY** | | |
| Societa per Azioni (SpA) | Opaque Nov 05 | |
| Societa a responsibilita Limitada (SrL) | Opaque Feb 08 | |

84 This is a misprint but I do not know what is intended.

85 See 72.15 (Société Civile and Société en nom Collectif).

86 HMRC original erroneously reads: Kommandit Gesellschaft.

87 See 72.25.4 (Ordinary share capital: German GmbH).

88 See McCarthy, "Protected Cell Companies and s.13 TCGA" [2009] PCB 316.

| | | |
|---|---|---|
| **JAPAN** | | |
| Goshi-Kaisha | Transparent Feb 97 | |
| Gomei Kaisha | Transparent | |
| Tokumei Kumiai (TK) | Transparent Nov 05 | |
| Kabushikikaisha[89] | Opaque Nov 05 | Joint stock company |
| Yugen-kaisha | Opaque Nov 05 | Limited liability company |
| **JERSEY** | | |
| Limited Liability Partnership (LLP )[90] | Opaque Feb 01 | |
| Limited Partnership (LP) | Transparent | |
| **KAZAKHSTAN** | | |
| Limited Liability Company (LLC) | Opaque Nov 06 | |
| **LIECHTENSTEIN** | | |
| Anstalt[91] | Opaque Mar 04 | |
| **LUXEMBOURG** | | |
| Société en commandite par actions (SCA) | Opaque Jul 92 | Limited partnership with share capital |
| Fonds commun de placement (FCP)[92] | Transparent May 05 | |
| Société anonyme (SA) | Opaque Nov 05 | Co limited by shares |
| Société à responsabilité limitée (SARL) | Opaque Nov05 | Limited liability company |
| Société en nom collectif (SNC) | Transparent Feb 07 | |
| Société civile (SC) | Opaque Dec 07 | |
| Société d'investissement à capital variable (SICAV) | Opaque Jul 08 | |
| **MALTA** | | |
| Société d'investissement à capital variable (SICAV) | Opaque Jul 08 | |
| En Nom Collectif (ENC) | Transparent Sep 07 | |
| Société civile (SC) | Opaque Dec 07 | |
| **NETHERLANDS** | | |
| Vennootschap Onder Firma (VOF) | Transparent Feb 95 | General partnership |
| Commanditaire Vennootschap both "open" and "closed" (CV) | Transparent Aug 00 | Limited partnership |
| Naamloze Vennootschap (NV) | Opaque Oct 81 | Joint stock company |
| Besloten Vennootschap Met Beperkte Aansprakelijkheid[93] (BV) | Opaque Oct 81 | Limited liability company |
| Maatschap | Transparent Oct 93 | Partnership |
| Stichting | Transparent Jul 05 | Foundation* |
| Cooperatie uitsluiting Aansprakelijkheid (Coop UA) | Opaque Aug 00 | |

89 HMRC original erroneously reads: Kabushiki Kaisha.
90 See 72.17 (Foreign limited liability partnership).
91 See 72.7 (Liechtenstein Anstalt (Establishment)).
92 See 31.3.4 (Luxembourg Fonds Commun de Placement).
93 HMRC original erroneously reads: Aansprakelijheid.

| | | |
|---|---|---|
| Cooperatie beperkte Aansprakelijheid (Coop BA) | Transparent Sep 08 | |
| Cooperatie wettelijke aansprakelijkheid (Co-op WA) | Transparent Sep 08 | |
| Besloten Fonds voor Gemene Rekening (FGR)[94] | Transparent Jan 08 | |
| **NEW CALEDONIA** | | |
| Société en nom collectif (SNC) | Transparent Jul 05 | |
| **NORWAY** | | |
| Aksjeselskap[95] (AS) | Opaque | Limited liability company |
| Kommandittselskap[96] (KS) | Transparent Jan 81 | Limited partnership |
| **OMAN** | | |
| Limited Liability Company (LLC) | Opaque Jun 08 | |
| **POLAND** | | |
| Spólka z ograniczona odpowiedzialnoscia[97] (SP. zo. o) | Opaque Mar 96 | |
| **PORTUGAL** | | |
| Sociedade por quotas (Lda) | Opaque Apr 93 | |
| Sociedade Anónima (SA) | Opaque 4/1993 | |
| **RUSSIA** | | |
| Joint Venture under "Decree No. 49" | Opaque Jan 93 | |
| Limited Liability Company (LLC) | Opaque Nov 03 | |
| **SEYCHELLES** | | |
| Limited Partnership (LP) | Transparent Mar 09 | |
| **SLOVAK REPUBLIC** | | |
| Spoločnost's ručenim obmedzením (sro) | Opaque Nov 05 | Limited liability company |
| **SOUTH AFRICA** | | |
| Close Corporation | Opaque Nov 05 | |
| **SPAIN** | | |
| Fondo de Capital Riesgo (FCR) | Transparent Dec 08 | |
| Sociedad Civil[98] (SC) | Opaque Dec 80 | Civil law partnership |
| Sociedad Anónima (SA) | Opaque Nov 05 | Co limited by shares |
| Comunidad de bienes | Transparent Jun 01 | |
| Sociedad Collectiva (SC) | Opaque Jun 08 | |
| Sociedad Civil Professional (SCP) | Transparent Jun 08 | |
| Sociedad Commanditaria Simple (SCS) | Transparent Oct 07 | |
| Uniones Temporales de Empresas (UTE) | Transparent Jul 08 | |
| Sociedad de Responsabilidad Limitada (Srl) | Opaque Nov 05 | |

94 See 72.21 (Netherlands Fonds voor gemene rekening (closed funds for mutual account)).

95 HMRC original erroneously reads: Alkjeselskap.

96 HMRC original erroneously reads: Kommandittselkap.

97 HMRC original erroneously reads: Spolkaz ograniczonaodpowiedzialnoscia.

98 HMRC original erroneously reads: Civila.

| | | |
|---|---|---|
| **SWEDEN** | | |
| Aktiebolag (AB) | Opaque Nov 05 | Limited company |
| Kommanditbolag (KB) | Transparent Oct 05 | Limited partnership |
| **SWITZERLAND** | | |
| Société Simple (SS) | Transparent Dec 90 | |
| Gesellschaft mit beschränkter Haftung (GmbH) | Opaque Nov 05 | Limited liability company |
| Kommanditgesellschaft (KG) | Transparent Sep 07 | |
| **TURKEY** | | |
| Attorney Partnership (AP) | Transparent Apr 04 | |
| Anonim Şirket (AŞ) | Opaque Nov 05 | Joint stock company |
| Limited Şirket (Ltd Ş) | Opaque Nov 05 | Limited liability company |
| **USA** | | |
| Partnership set up under the Uniform Partnership Act | Transparent Sep 83 | |
| Limited Partnership set up under the Uniform Limited Partnership Act | Transparent Aug 00 | |
| Limited Liability Company including New York (LLC)[99] | Opaque Jun 97 | |
| Limited Liability Partnership (LLP) | Transparent Dec 99 | |
| Massachusetts Business Trust (MBT) | Transparent Feb 80 | |
| S. Corporation (S. Corp) | Opaque Jul 05 | |
| Real Estate Investment Trust (REIT) | Opaque Jun 07 | |
| Limited liability limited partnership set up under the Revised Uniform Limited Partnership Act (LLLP) | Transparent Aug 07 | |

## 72.24 Stamp Taxes Manual body corporate list

The Stamp Taxes Manual offers another list (with some overlap) addressing the question of whether a foreign entity is a body corporate:

> **6.124 Foreign Companies**
> Some foreign companies have been accepted as falling within the term 'body corporate' for the purposes of the intra group relief. The following is a list of examples of foreign bodies accepted by us as falling within the definition of "body corporate" for Section 42 [FA 1930] and Section 151 [FA 1995] purposes:–

Although the list is expressed to be for the purposes of two specific provisions, there is no special definition of "body corporate" in those sections; if an entity is an entity for those purposes, it is a body corporate

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99 See 72.22 (US limited liability company).

(and normally a company) for tax purposes generally.

| | |
|---|---|
| Australia | Private companies which do not need to comply with certain requirements, are known as 'proprietary' companies. Such companies registered in New South Wales are bodies corporate. |
| Bahamas | Companies described as limited. |
| Belgium | Société de personnes à responsabilité limitée (descussocies).[100] |
| Bermuda | Companies described as limited. |
| British Virgin Islands | A company described as limited and which is incorporated under the Companies Act 243. |
| Canada | Companies described as limited. (Ltd) |
| Cayman Islands | Companies described as Ltd. |
| Denmark | A company described as an A/S. |
| Finland | An 'Oy' (Osakeyhtiö) is a Finnish limited company which may be public or private. |
| France | Société Anonyme (SA) and Société en commandite par actions. |
| Germany | Aktiengesellschaft. (AG) Gesellschaft mit Beschränkte Haftung. (GmbH) Kommanditgesellschaft[101] 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[102] (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'. |

100 "descussocies" is a misprint but I do not know what is intended.

101 HMRC original erroneously reads: Kommanditfellschaft.

102 HMRC original erroneously reads: Aktieselscap.

| | |
|---|---|
| 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[103] par actions and Aktiengesellschaft (AG). A verein.[104] |
| 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. |

## 72.25 Share capital

### 72.25.1 *Significance of ordinary share capital*

If an entity issues ordinary share capital, it may be a "75% subsidiary" for tax purposes. It follows that it is possible for the entity to qualify for CGT and IT group reliefs, and to benefit from CGT reliefs for share exchanges.

### 72.25.2 *When does a body have ordinary share capital?*

HMRC Brief 87/09[105] provides:

**Corporation Tax: Meaning of Ordinary Share Capital**
HM Revenue & Customs (HMRC) have been asked to provide a list of foreign entities that they consider to have 'Ordinary Share Capital' for the purposes of TA 1988, s 832. Unfortunately as each case will have its own particular set of facts it is not feasible for an exhaustive list to be created, nor, in the context of considering legal systems other than the UK's, that are subject to change, would it be practical to do so.
Set out below is HMRC's interpretation of TA 1988 s 832 and information that, it is hoped, will be useful to companies and advisors, as well as officers within HMRC, in deciding whether a particular non-UK entity has 'Ordinary Share Capital' for the purposes of TA 1988 s 832. Also included below are some details of our position on two of the most often queried foreign entities, the Delaware LLC and the German GmbH.
Please note, this brief only seeks to consider the meaning of 'Ordinary Share Capital' for the purposes of TA 1988 s 832. Specifically, it does not cover the classification of a foreign entity for UK tax purposes (whether it is 'transparent' or 'opaque'). Information on that topic is contained in Tax Bulletin 83 published in June 2006.
The reader should also note that the Companies Act 2006 received Royal Assent on 8

103 HMRC original erroneously reads: commandit.
104 "A verein" is a misprint but I do not know what is intended.
105 12 January 2010. An earlier version appeared in HMRC Brief 54/07.

November 2006 and the Government has announced its intention to commence all parts of the act by 31 October 2008. The DBERR has published an implementation timetable according to which the relevant sections of Part 17, A Company's Share Capital, will come into force on 1 October 2008. This article will be reviewed in due course to ensure it takes account of any necessary amendments due to legislative changes.

**Definition**

Ordinary share capital is defined in TA 1988 s 832 as follows:

" 'ordinary share capital', in relation to a company, means all the issued share capital (by whatever name called) of the company, other than capital the holders of which have a right to a dividend at a fixed rate but have no other right to share in the profits of the company;"

This definition therefore includes all of the issued share capital of a company, apart from capital carrying a right to a dividend at a fixed rate only. The bracketed wording 'by whatever name called' should not be overlooked as it is important to note that companies often categorise share capital into shares bearing different names, eg A Ordinary; B Ordinary, for purposes which may be of no relevance to the application of the definition above.

**Characteristics of issued share capital in a UK company—general principles**

**UK companies**

Ordinarily, references to a company will be understood to mean a limited liability company. Limited liability companies are so called because the liability of each shareholder for the company's debts and other liabilities is limited to the amount which remains unpaid on his shares. There are two types of limited liability company in the UK, public and private. The main difference between these types of company is that a public company can apply to be listed and offer its shares to the public in order to raise capital. There are, however, other types of less commonly used company forms: unlimited companies, with or without share capital, and companies limited by guarantee.

In the latter case the members' liability is limited to amounts they undertake to contribute in the event of a winding up; the amount of this maximum liability of each of the members will be set out in the 'guarantee clause' of the company's memorandum. The total commitment of the members, taken together, is known as the 'guarantee fund'; this fund only comes into existence on a winding up. In practice, this form of vehicle is usually unsuitable for most businesses but is often used, for example, by charities.

Companies limited by guarantee incorporated on or after 22 December 1980 cannot also have a share capital (Section 1(4) Companies Act 1985). Companies limited by guarantee incorporated before that date may, however, also have share capital.

In 1999 the Special Commissioners considered the status of 'founders' deposits' with a company limited by guarantee in the case South Shore Mutual Insurance Co Ltd v Blair [1999] STC (SCD) 296. They came to the conclusion that the deposits were not issued share capital; the company did not, in fact, have any authorised share capital and, as a consequence, could not have issued share capital. Although the decision is not binding authority, the case contains a useful review of some of the authorities about share capital.

**Shares in UK companies**

A company limited by shares is currently required to stipulate the maximum share capital the company may issue and the number and nominal value of the shares into which it is divided, its 'authorised share capital', in a document called the company's memorandum of association (section 2(5)(a), Companies Act 1985).

Note: The reader should note that the Companies Act 2006 abolishes the requirement for a company to have an authorised share capital by the repeal of section 2(5)(a). This should take effect from 1 October 2008. The new act nonetheless requires that, on formation, a company with a share capital will be required to submit a statement of capital and initial shareholdings to the Registrar at Companies House.

The memorandum is one of two essential documents that must be filed at Companies House on incorporation, the second is the company's articles of association; these documents together set out provisions governing the manner in which the company will operate. The amount of authorised share capital set out in the company's memorandum may be later increased by an ordinary resolution of the shareholders (requiring a simple majority of the vote).

The company's assets are owned by the company itself, not by the shareholders individually, although in turn the shareholders together have ownership of the company. The shares express the shareholders' proprietary relationship with the company.

In principle, shares are transferable, but in practice there are often restrictions on transfer, found in the company's articles of association.

The principal rights that usually attach to a share are rights to dividends declared, a right to vote and a right to share in the company's assets in a winding up. The principal responsibility that attaches to a share is to pay what is due on the share. The rights and duties are all subject to the memorandum and articles of association.

For a company limited by shares, the share capital must be stated in a fixed amount. In Ooregum Gold Mining Co of India v Roper [1892] AC 125 Lord Halsbury said:

> "The capital is fixed and certain, and every creditor is entitled to look at that capital as his security."

A share certificate is prima facie evidence of ownership of a share. However, it does not, of itself, constitute ownership of the share and is not essential to demonstrate that share capital has been issued. In order to be a member of a company, under the Companies Act, a person must be entered in the company's register of members. See s 22, Companies Act 1985 (s 112 Companies Act 2006). The decision in National Westminster Bank plc v IRC ([1994] STC 580), confirms this position, ie the 'issue' of share capital is only complete when members are recorded in the company's register of members.

**Characteristics of issued share capital in a body incorporated in another country—relevant factors**

When looking at whether a body incorporated under the law of another country, it is self evident that UK company law is not directly applicable. In Ryall v The Du Bois Co Ltd 18 TC431, Lord Hanworth M.R. said:

'a share in a foreign company may be something different from and, indeed, is almost necessarily different from, a share as we know it in an incorporated company.'

Slesser L.J. said

'We have to consider what would be analogous to stocks and shares in Germany in dealing with what is a company, and allowing for differences of law in that country'.

Slesser L.J.'s comments were given in the statutory context of whether foreign income was income from stocks and shares for the purposes of Case V Schedule D. However we consider them as authority for proceeding by analogy in deciding whether the capital of a foreign company can be considered as 'issued share capital'.

A number of factors are relevant in deciding whether or not a foreign 'company' has 'issued share capital'.

Firstly the body concerned must have a legal personality separate and distinct from that of its members, able to carry on business and owning its assets in its own right, in the same way as a UK company. If that characteristic is absent the members cannot have the type of proprietorial interest which is characteristic of holders of issued share capital of a company incorporated under the laws of the UK.

If the body concerned possesses a separate legal personality, as described above, the following factors will then become relevant to the question of whether a member's interest in such company is analogous to an interest in 'issued share capital' as understood in the UK:

• whether the member's interest is like shares (that is, a portion of the fixed capital of the corporate body) or like debt (that is, money owed by the body corporate to the members)

• whether any subscription for the members' interests is payable

• whether the subscription payable for the 'shares' remains the member's property or whether it becomes the property of company

• what proprietary rights, such as rights to participate in control by voting, rights to receive a dividend out of the company's profits and rights to share in a distribution out of the company's assets in the event of a winding up, attach to the member's interests and what responsibilities, such as a responsibility to pay up on the 'share' if called, attach to the member

• whether the member's interest can be legally evidenced in accordance with local laws; for example, by being registered in a company-held document, or with a public authority, or by a certificate or similar document

• whether the member's interest is denominated in a stated fixed value

• whether the member's interest forms a fixed and certain amount of capital, or a part of that, to which creditors can look as security

• whether the non-UK law concerned requires amounts subscribed to be allocated to capital of the company which is fixed capital, and the extent to which subscriptions are so allocated

• whether the member's interests is capable of transfer and if so whether such a transfer would be similar to a transfer of a portion of the capital of the company, with attendant proprietary rights, rather than similar to a transfer of money or a loan account; and

• any other factors which point to the member's interests being 'issued' and having the character of ordinary share capital.

The background information a company or its advisers are likely to want to consider includes the following documentation:

• The corporate law of the foreign country which governs the body in question.

• Whatever general commentaries are available on the legal and commercial status of the body in question.

• The documents establishing the body, and any other documents which regulate its activities, especially those which deal with subscription for capital and those which govern what happens to the profits and assets of the body.

The accounts that show the state of affairs of the body, in particular the balance sheet, may be helpful in showing whether, and to what extent, money subscribed or otherwise provided by the members of the body is allocated to a fixed amount of permanent capital or whether it is loan debt.

In deciding whether the body has issued share capital, it is not necessary for every factor to be present, but there should be a preponderance of indicators pointing to there being issued share capital. Different weight may need to be given to the various factors. For instance it would be of considerable importance if the member's interest had the character of debt. However restrictions on transfer of a member's interest would be of lesser importance. It is by no means uncommon for there to be restrictions on transfer of shares in a UK company.

### 72.25.3 *Ordinary share capital: Delaware LLC*

HMRC Brief 87/09 provides:

> **Delaware Limited Liability Companies**
>
> ... Section 18–702c of the Delaware Limited Liability Act provides that:
>
> > 'Unless otherwise provided in a limited liability company agreement, a member's interest in a limited liability company may be evidenced by a certificate of limited liability company interest issued by the limited liability company.'
>
> If a DLLC issues 'shares' in this way and the other factors relating to the company suggest that it has share capital then we will accept that these 'shares' may be regarded as 'ordinary share capital' for the purpose of Section 832 ICTA 1988.
>
> It should be noted that not all DLLCs issue share certificates but they may still have 'ordinary share capital'. Regard must be had to the particular terms of the agreement by which the LLC has been created. In any case of doubt or difficulty regarding the status of the share certificates HMRC will advise in particular cases in line with Code of Practice 10. The contact point is ...
>
> Other States within the United States of America have comparable legislation to Delaware. Where it can be shown that a particular State has legislation analogous to the Delaware legislation with which we are familiar, HMRC would expect to be able to provide advice in line with that for DLLCs.

In *Swift v HMRC* [2010] UKFTT 88 the Tribunal found that the membership interest in a Delaware LLC was not similar to share capital but something more similar to partnership capital of an English partnership. The interest would not have been ordinary share capital. However HMRC do not intend to take any notice of that, at least for now:

> HMRC similarly intends to continue its general practice in this respect

in relation to US LLC's.[106]

Taxpayers are not likely to complain about that.

### 72.25.4 *Ordinary share capital: German GmbH*

HMRC Brief 87/09 provides:

> A Gesellschaft mit beschränkter Haftung (GmbH) in Germany, literally a 'company with limited liability', is an entity of a very similar kind to a UK private limited liability company. An Aktiengesellschaft (AG), sometimes called a 'joint stock company' may be considered more akin to a UK public limited liability company (plc) as its stock may be listed.
> Under German law, the capital of a GmbH is not divided up into small units. However, a GmbH has a fixed amount of capital (Stammkapital) which corresponds to the maximum amount of share capital that the company may issue, similarly to a UK limited liability company's 'authorised share capital'. The amounts originally contributed (Stammeinlagen) by the members (Gesellschafter) will also be noted, just as in the UK the initial subscriber shares will be noted in the memorandum of a limited liability company.
> Article 5 of the German GmbH law sets out a minimum amount of Stammkapital (authorised share capital) as EUR 25,000, and the minimum amount of Stammeinlage (original contribution/subscription) of each Gesellschafter (member) at EUR 100.
> Based upon GmbH cases HMRC have previously considered, the amounts of Stammeinlage subscribed by the members may normally be regarded as issued share capital for the purposes of the Taxes Acts.

106 "Swift v HMRC: UK tax treatment of a US LLC" 20 May 2010 *www.hmrc.gov.uk/international/swift-v-hmrc.htm*. The position will need to be reviewed when the decision is final.

CHAPTER SEVENTY THREE

# CONTROL, CONNECTED, CLOSE AND RELATED EXPRESSIONS

## 73.1 Introduction

This chapter considers definitions of the following terms:

- control;
- associate;
- connected person;
- participator;
- loan creditor;
- close company.

The definitions interlink but need to be considered separately.

## 73.2 Control – Introduction

Control of a company is a concept used so often in tax legislation that it is impossible to write a full list. The concept is important in particular in the definitions of close company and connected person.

There are two main definitions of control in the Taxes Acts (as well as numerous specialist definitions not considered here). The legislation does not have terminology to describe them, so I coin the following terminology:

(1) "**Control in the ultra-wide sense**"- the definition in s.450 CTA 2010.
(2) "**Control in the strict sense**" - the definition in s.995 ITA.

Section 989 ITA provides:

> The following definitions apply for the purposes of the Income Tax Acts—
> "control", in relation to the control of a body corporate or a partnership, is to be read in accordance with section 995,

Thus for IT the strict sense is the default meaning, though in practice the ultra-wide sense is more common.

By contrast, s.288(1) TCGA provides:

> In this Act, unless the context otherwise requires—
> "control" shall be construed in accordance with sections 450 and 451 of CTA 2010;

Thus for CGT the ultra-wide sense is the default meaning.

For IHT, s.269 IHTA provides yet another definition of control. Such is the patchwork nature of UK taxation. The IHT definition is not discussed here as it does not arise in the IHT issues closest to the themes of this book.

## 73.3 Control in strict sense

Section 995 ITA provides:

> (1) This section has effect for the purposes of the provisions of the Income Tax Acts which apply this section.
> (2) In relation to a body corporate ("company A"), "control" means the power of a person ("P") to secure—
> (a) by means of the holding of shares or the possession of voting power in relation to that or any other body corporate, or
> (b) as a result of any powers conferred by the articles of association or other document regulating that or any other body corporate,
> that the affairs of company A are conducted in accordance with P's wishes.
> (3) In relation to a partnership, "control" means the right to a share of more than half the assets, or of more than half the income, of the partnership.

For corporation tax the equivalent definition is in s.1124 CTA 2010.

## 73.4 Control in ultra-wide sense

### 73.4.1 *Five heads of definition of control*

Section 450 CTA 2010 provides:

(1) This section applies for the purpose of this Part.
(2) A person ("P") is treated as having control of a company ("C") if P—
(a) exercises,
(b) is able to exercise,[1] or
(c) is entitled to acquire,
direct or indirect control over C's affairs.
(3) In particular, P is treated as having control of C if P possesses or is entitled to acquire—
(a) the greater part of the share capital or issued share capital of C,
(b) the greater part of the voting power in C,
(c) so much of the issued share capital of C as would, on the assumption that the whole of the income of C were distributed among the participators, entitle P to receive the greater part of the amount so distributed, or
(d) such rights as would entitle P, in the event of the winding up of C or in any other circumstances, to receive the greater part of the assets of C which would then be available for distribution among the participators.

Section 450(2) refers to a person who is *able to exercise* or is entitled to acquire control; s.450(3) refers to a person who *possesses* or is entitled to acquire certain rights; but there is no difference in meaning. Presumably the drafter felt that the correct legal terminology is that one *exercises* control but one *possesses* rights.

The CT Manual identifies the five heads of control:

**60210 Control: Definition**
Control is defined under several headings:
[1] Control over the affairs of the company (see CTM60220).
[2] Control through voting power (see (a) of CTM60220).
[3] Control through share capital or through issued share capital (see (b) of CTM60220).
[4] Control over income of the company (see (c) of CTM60220).
[5] Control over assets of the company (see (d) of CTM60220).

In *R v IRC ex p. Newfields Developments* 73 TC 532 Lord Hoffmann said:

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1 Section 450(2)(a) is otiose for any person within (a), who *exercises* control, must also be within (b), *able to exercise* control. But it does not matter.

> [10] It will be seen that although this definition starts in subs (2) with a concept of control which reflects its meaning in ordinary speech ('a person shall be taken to have control of a company if he exercises, or is able to exercise or is entitled to acquire, direct or indirect control over the company's affairs'), that fairly simple notion is enormously widened by subsequent subsections. ...
> [11]… The effect of those cumulative definitions is that for the purpose of deciding whether a person 'shall be taken to have control of a company' under s 416(2), it may be necessary to attribute to him the rights and powers of persons over whom he may in real life have little or no power of control. Plainly the intention of the legislature was to spread the net very wide.''

### 73.4.2 *Control over a company's affairs*

*P is treated as having control C if P—*
*(a) exercises,*
*(b) is able to exercise, or*
*(c) is entitled to acquire,*
*direct or indirect control over C's affairs.*

The CT Manual provides:

> **60220 Control: Over the company's affairs**
> The House of Lords' judgment in the case of *R v IRC ex parte Newfields Developments Ltd* 73 TC 532 makes it clear that Section 416(2) ICTA 1988 approaches the question of control of a company from two angles. It begins with the proposition in the opening words of Section 416(2) that a person has control of a company if he or she exercises or is able to exercise or is entitled to acquire control, whether direct or indirect, over the company's affairs. That is a test of actual control, reflecting its meaning in ordinary speech.
> As regards the level at which control is exercised, the judgment in *Steele v EVC International NV* 69 TC 88 confirms that what is required is control at the participator or general meeting level, not at administrative or board level.

SP 1/01 provides:

> 54. Where the establishment of a connected person's relationship depends on the question of whether a person falls to be regarded as having control of a company's affairs within the terms of s 416(2) ICTA

1988, it is not considered that a person's ability (whether de facto or de jure) to appoint the majority of the Board of directors will itself constitute control of the company's affairs—unless, that is, the Board exercises powers which would normally be exercised by the shareholders at a general meeting.

### 73.4.3 *Shares*

> *P is treated as having control of C if P possesses or is entitled to acquire ... (a) the greater part of the share capital or issued share capital of C.*

This is straightforward.

### 73.4.4 *Votes*

> *P is treated as having control of C if P possesses or is entitled to acquire ... (b) the greater part of the voting power in C.*

This is otiose, since a person with the greater part of the votes has control under s.450(2) CTA 2010: they are able to exercise control over the company's affairs.

### 73.4.5 *Right to income*

> *P is treated as having control of C if P possesses or is entitled to acquire ... (c) so much of the issued share capital of C as would, on the assumption that the whole of the income of C were distributed among the participators, entitle P to receive the greater part of the amount so distributed.*

The CT Manual provides:

> **60240. Control: Summary**
> ... The test in (c) of CTM60220 depends on the dividend rights of the issued capital and will be mainly of interest where shares with no voting rights carry the right to a high dividend.

But this is not the only case. The life tenant of an IP trust holding a majority of the shares in a company in principle has control of the company under this head.

### 73.4.6 *Right to capital*

> *P is treated as having control of C if P possesses or is entitled to acquire ... such rights as would entitle P, in the event of the winding up of C or in any other circumstances, to receive the greater part of the assets of C which would then be available for distribution among the participators.*

The CT Manual provides:

> **60230. Control: Right to receive most assets**
> Control under (d) of CTM60220 exists where a person or persons have a right to receive the greater part of the assets then available for distribution among participators, in any circumstances, (for example, on redemption of redeemable share capital or on repayment of loans to the company) but also, specifically, on a winding up of the company.
> 'Participators' for this purpose includes loan creditors (unlike (c) of CTM60220). As regards the definition of loan creditors, see CTM60130. If a loan creditor is an open company, see CTM60300.
> The test under Section 416(2)(c) ICTA 1988 only applies to the assets that would come to a participator in that capacity. In the case of a bank, for example, no regard would be had to any assets that would come to it in respect of loans made in the ordinary course of its banking business, because it is not deemed to be a loan creditor (and, hence it is not a participator) in respect of such loans by virtue of Section 417(9) ICTA 1988.
> **60240. Control: Summary**
> ...3. The test in CTM60230 will normally be of interest only where loan creditors are participators (see CTM60130) or there exist special rights to participate in the assets available for distribution in a winding-up or in any other circumstances for example, on redemption of redeemable share capital.

But this is not the only case. If trustees hold a company on trust for A for life, remainder to B absolutely, then B has control under this head: for B will in the future be entitled to the assets of the company. If trustees hold a company on trust for B contingently (eg on attaining the age of 25, if B is under 25) then B does not have control under this head.

### 73.4.7 *"Entitled to acquire"*

Section 451 CTA 2010 provides:

> (1) This section applies for the purposes of section 450.
> (2) A person is treated as entitled to acquire anything which the person—
> (a) is entitled to acquire at a future date, or
> (b) will at a future date be entitled to acquire.

The INT Manual comments on identical wording in the CFC legislation, s. 749B ICTA:

> **210050 'Entitled to acquire' and 'entitled to secure'**
> The terms 'entitled to acquire' and 'entitled to secure' in (a), (b) and (c) of INTM210040 apply both where a person is presently entitled to acquire or secure an asset at a future date and where a person will at a future date be entitled to acquire or secure that asset. They do not extend to situations where, in an entirely arm's length transaction, one party temporarily has future rights over the other's property, for instance, in the period between exchange of contracts and completion of a sale of land.
> A person whose entitlement to acquire or secure is contingent on a default of any person, including the controlled foreign company in question, will not be treated as having an interest in the controlled foreign company, unless that default has occurred.
> So, for example, a person will have an interest in a controlled foreign company if, by means of a contractual right or some other arrangement, he can
> - require a shareholder to transfer shares to him, or
> - secure the issue to him of unissued share capital of the company, or
> - secure that if a distribution is made by the company he has a share in the distribution or premium.
>
> A person will not have an interest in a controlled foreign company solely by virtue of rights over the income or assets of the company which are exercisable on the default of any person. Thus the contingent rights of banks, trade creditors, etc. to acquire some or all of the company's assets in the event of a default would not amount to an interest in the company in advance of the default.

See too 73.15.5 ("Entitled to do").

## 73.5 "Nominees"

Section 451(3) CTA 2010 provides:

> If a person—
> (a) possesses any rights or powers on behalf of another person (A), or
> (b) may be required to exercise any rights or powers on A's direction or behalf,
> those rights or powers are to be attributed to A.

It is self-evident that the powers of a nominee should be attributed to its principal. The section is in fact wider than that, since the cases where "A may be required to exercise rights at the direction of B" extend beyond the case where A is a nominee for B in the strict sense of nominee. However the subsection is otiose, for if A may be required to exercise rights on the direction of B, or on behalf of B, then these are rights which B possesses or is entitled to acquire, so the rights would be taken into account in any event in the test of control.

## 73.6 Meaning of "associate"

Section 448(1) CTA 2010 provides:

> In this Part "associate", in relation to a person ("P"), means—
> (a) any relative or partner of P,
> (b) the trustees of any settlement in relation to which P is a settlor,
> (c) the trustees of any settlement in relation to which any relative of P (living or dead) is or was a settlor,
> (d) if P has an interest in any shares or obligations of a company which are subject to any trust, the trustees of any settlement concerned,
> (e) if P—
> (i) is a company, and
> (ii) has an interest in any shares or obligations of a company which are subject to any trust,
> any other company which has an interest in those shares or obligations,
> (f) if P has an interest in any shares or obligations of a company which are part of the estate of a deceased person, the personal representatives of the deceased, or
> (g) if P—
> (i) is a company, and

(ii) has an interest in any shares or obligations of a company which are part of the estate of a deceased person,

any other company which has an interest in those shares or obligations.

Section 448(2) CTA 2010 defines relative:

> In this section, "relative" means—
> (a) a spouse or civil partner,
> (b) a parent or remoter forebear,
> (c) a child or remoter issue, or
> (d) a brother or sister.

Contrast the definition of relative in the definition of connected person, under which a spouse is not a relative;[2] but one can get to the same result with either definition.

### 73.6.1 *Partners as associates*

The modern use of partnerships as investment vehicles has made the definition of "associate" absurdly wide, because investment partnerships have vast numbers of partners, and indeed partners do not know who their fellow partners are. This has been recognised on a piecemeal basis[3] but the root of the problem, which is the definition of associate and connected person, has not been addressed.

## 73.7 Attribution of rights of associates and controlled companies

Section 451(4) CTA 2010 provides that for the purposes of the definition of control in the ultra-wide sense:

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2 See 73.10 (Connection with family members).

3 For instance, in s.27 CTA 2010:

> "(2) In the application of section 451 (meaning of 'control': rights to be attributed) for the purposes of the determination, the references in section 451(4) and (5) to an associate of a person ("P") include a partner of the person only if the condition in subsection (3) below is met.
> (3) The condition is that tax planning arrangements which—
> (a) involve P and the partner, and
> (b) secure a relevant tax advantage,
> have at any time had effect in relation to the taxpayer company."

> There may also be attributed to a person all the rights and powers—
> (a) of any company of which the person has, or the person and associates of the person have, control,
> (b) of any two or more companies within paragraph (a),
> (c) of any associate of the person, or
> (d) of any two or more associates of the person.[4]
> (5) The rights and powers which may be attributed under subsection (4)—
> (a) include those attributed to a company or associate under subsection (3) [nominees], but
> (b) do not include those attributed to an associate under subsection (4).

This uses the word "may" but here that means "shall". Section 451(6) provides:

> Such attributions are to be made under subsection (4) as will result in a company being treated as under the control of 5 or fewer participators if it can be so treated.

I refer to this as "**the attribution rule**". This rule does not apply for the purposes of the definition of participator (that is, the fact that A is an associate of a participator does not mean that A is a participator).

### 73.7.1 *Commentary*

This attribution rule - more than any other - is what makes the s.450 definition of control ultra-wide. It is so wide that the word "control" is not apt to describe the concept ("some loose association" would be nearer the mark). It is confusing to depart from statutory terminology, but where the ultra-wide sense of control is used, the actualities demand quotation marks. For instance:

(1) A has "control" of a company owned by a relative (say, a sister in law) even though A has no beneficial interest in the company, and, of course, no right to know that the relative owns the company or anything about the company.
(2) A has "control" of a company owned by a trust of which a relative is a settlor, even though A is not a beneficiary and has no right to know

4 Para (b) and (d) must be otiose, but it does not matter.

that the trust had been made, let alone to know anything about the trust or its property. Indeed the relative need not be the settlor but only *a* settlor, so the rule would apply if (say) a sister in law provides a nominal amount of property to a trust.

(3) A partner has "control" of a company owned by a partnership even if it is an investment partnership with large numbers of unconnected partners.

This has three noteworthy consequences.

The first is practical: it is not possible for a person to know whether they control a company, or to draw up a list of all companies which they control. In practice there is substantial innocent non-compliance and selective or arbitrary enforcement, where HMRC sufficiently dislike a taxpayer to make enquiries not normally made.

The second point is presentational but nevertheless important: anti-avoidance provisions which refer to control may appear to the non-tax specialist to be reasonable because control seems a sensible limiting factor; but they generally operate unreasonably widely (because the meaning of *control* is so wide).

Thirdly, this leads to complexity. On occasions where the difficulty caused by the extravagance of the definition has come to be recognised, the definition of control[5] is then restricted.[6] However this is only done on a piecemeal basis, where taxpayer lobbying has for some reason given rise to governmental action. So the result is a complexity which would not arise if a more restrained definition of control had been adopted in the first place.

The same difficulties apply to provisions using the term "connected person" (since that term uses the concept of "control" in the ultra-wide sense).[7]

## 73.8 Control by two or more persons together

Section 450(5) CTA 2010 provides:

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5 or some concept in which the word control is used, such as associate or connected person.

6 For instance, ss.27, 29, 30 CTA 2010.

7 See for instance the Substantial Donors to Charity Consultation Responses Document, 2 January 2009 para 3.12, [2009] STI 65, where charities describe the connected persons rule as it applies in that context as an "impossible requirement", a "substantial administrative burden" and a "compliance nightmare".

> If two or more persons together satisfy any of the conditions in subsections (2) and (3), they are treated as having control of C.

For instance, if A and B each hold 50% of a company, then A and B together have control. Why does it matter? This does not mean that A (alone) has control or that B (alone) has control. It matters for the following purposes:

(1) Two companies are connected if (in short) they are under the control of the same (or connected) persons.[8]

(2) Two companies are associated (for the purposes of small companies relief) if (in short) both are under the control of the same persons.

So it is often necessary to identify the persons who together control a company.

The CT Manual provides:

> **60250 Control: In multiple**
> More than one person or one group of persons may 'control' a company. For example, one person may have the greater part of the voting power, while two people hold the greater part of the issued share capital and a group of three people are entitled to the greater part of the assets in a winding up. All three combinations of people can be taken to have control of the company at the same time.
> If say three persons, A, B and C, each hold one third of the shares in a company, and they are not connected in any way which would allow the rights and powers of one to be attributed to another, then control is held by A and B, or B and C, or A and C but not A, B and C together.
> This is because in determining whether companies are 'associated companies', you should only consider 'minimum' controlling combinations. You should disregard combinations containing superfluous members. For example, a company controlled by the unconnected persons A, B and C, but not by any one or two of them alone should not be regarded as associated with any company controlled by one of them alone (as in the first subparagraph above) or by any two of them (as in the second subparagraph above). (See also CTM03730 for an example of this.)
> However deciding on the 'minimum' controlling combination for any of the tests set out at ICTA 1988/416(2)(a) to (c) does not mean you have to establish the smallest controlling combination of each company

8 See 73.13 (Connection with company).

> when determining whether companies are associated companies.
> In his High Court judgment in *R v IRC ex parte Newfields Developments Ltd* (73 TC 532 at page 541B) Moses J said that Section 416 [ICTA] had to be exercised for the statutory purposes for which it was conferred:
> "In the context of Section 13 [ICTA], that purpose is to ascertain whether, in the instant case, two companies are under the control of the same person pursuant to Section 13(4). That is the statutory question. If it is possible to answer that in the affirmative, by exercising the power of attribution, in my judgment, that power must be exercised. Conversely, if that question, namely, are the two companies under the control of the same person, can only be answered in the affirmative by refraining from the exercise of the power, then the power should not be exercised".
> So in the first sub-paragraph above, you may be able to determine that two companies are associated because the three people who together have an entitlement to the greater part of the assets in a winding up also together hold the greater part of the voting power in another company. In that case you would take this group as controlling the company and not the single or two person combinations. As this example shows, the identical controlling combination does not need to be established by the same test in each company.

This passage is written in the context of (what is now) s.25(4) CTA 2010 which provides:

> For the purposes of this Part, a company is an associated company of another at any time when—
> (a) one of the two has control of the other, or
> (b) both are under the control of the same person or persons.

The same approach would apply to the definition of connected person: see 73.13 (Connection with company).

## 73.9 Connected person

### 73.9.1 *Definitions of connected person*

There are separate definitions for the separate taxes.

"Connected person" is defined for CGT in s.286 TCGA. Section 286(1) TCGA provides:

> [a] Any question whether a person is connected with another shall for the purposes of this Act be determined in accordance with the following subsections of this section ...

For IT, s.993 ITA provides:

> **993 Meaning of "connected" persons**
> (1) This section has effect for the purposes of the provisions of the Income Tax Acts which apply this section.

So for IT this definition applies only if expressly incorporated: it is not an ITA-wide definition.

IHT adopts the CGT definition of "connected person" with a little tinkering.[9]

The CT position is more complicated. The definition is in s.1122 CTA 2010 which is similar to s.993 ITA. Section 1122(1) CTA 2010 provides:

> This section has effect for the purposes of the provisions of the Corporation Tax Acts which apply this section (or to which this section is applied).

However s.1176(1) CTA 2010 incorporates this definition for the purposes of the CTA 2010:

> Section 1122 (how to tell whether persons are connected) applies for the purposes of this Act unless otherwise indicated (whether expressly or by implication).

Thus the CT definition applies for the CTA 2009 if expressly incorporated but applies for the CTA 2010 unless disapplied.

This section considers the CGT and IT definitions but what is said about IT is generally applicable to CT. The IT definition is substantially the same as the CGT definition but the drafting is improved in some respects.

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9 Section 270 IHTA provides:
"For the purposes of this Act any question whether a person is connected with another shall be determined as, for the purposes of the 1992 Act] it falls to be determined under section 286 of that Act, but as if in that section 'relative' included uncle, aunt, nephew and niece and 'settlement', 'settlor' and 'trustee' had the same meanings as in this Act."

Where they are the same, I give the text of the TCGA and the IT provision in footnotes.

There are many other definitions elsewhere, sometimes the same[10] and sometimes entirely different.

It is a pity that the tax law rewrite did not tidy up this mess; the opportunity is now lost. However the definition considered here can be considered the standard definition.

### 73.9.2 *Definition in outline*

The definition of connected person has five parts:
(1) Family members
(2) Trustees
(3) Companies held by trusts
(4) Partnerships
(5) Companies generally

### 73.9.3 *Reciprocity of connection*

Section 286(1) TCGA continues:

> [b] (any provision that one person is connected with another being taken to mean that they are connected with one another).

The effect of s.286(1)[b] is that "connected" is a reflexive relationship: if A is connected with B then B is connected with A. Section 994(4) ITA is more clearly drafted for IT:

> If any provision of section 993 provides that a person ("A") is connected with another person ("B"), it also follows that B is connected with A.

## 73.10 Connection with family members

Section 286(2) TCGA provides:

> A person is connected with an individual if that person is
> [a] the individual's spouse or civil partner,

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10 eg s.933 CTA 2010.

[b] or is a relative,
[c] or the spouse or civil partner of a relative,
  [i] of the individual or
  [ii] of the individual's spouse or civil partner.[11]

The CG Manual unpacks this definition:

> **14580 Connected persons** [August 2009]
> A person is connected with an individual if that person is
> [1] the individual's spouse or civil partner
> [2] a relative of the individual
> [3] the spouse or civil partner of a relative of the individual
> [4] a relative of the individual's spouse or civil partner
> [5] the spouse or civil partner of a relative of the individual's spouse or civil partner.

Section 286(8) TCGA provides:

> In this section "relative" means brother, sister, ancestor or lineal descendant.

The CG Manual provides:

> **14580. Connected persons** [August 2009]
> ... The term 'relative' does not cover all family relationships. In particular, it does not include nephews, nieces, uncles and aunts.
> **14583. Connected persons: Relatives** [August 2009]
> The following diagram illustrates the provisions of Section 286(2) TCGA 1992. All of the people in the diagram are connected with the individual. They are not all connected with each other[12]

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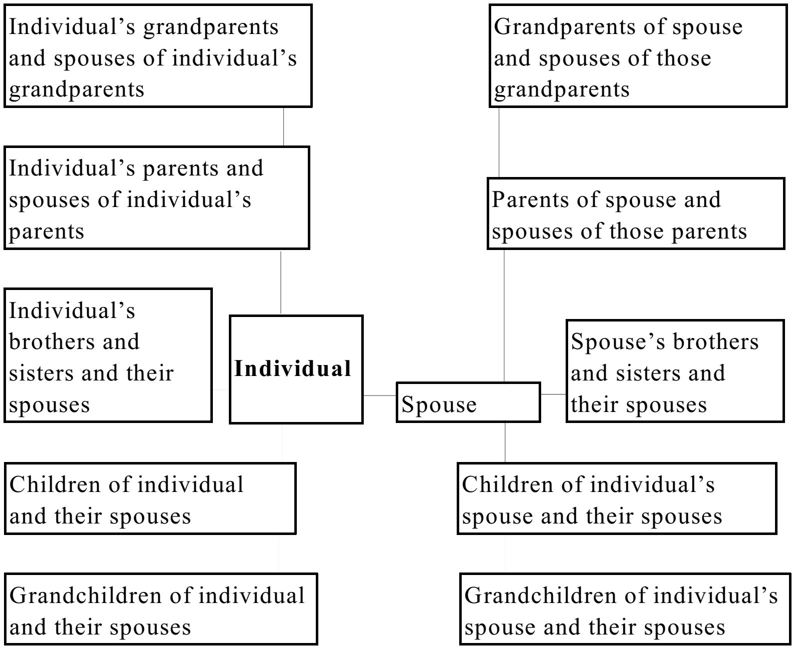
11 For IT, s.993(2) provides similarly:
"An individual ("A") is connected with another individual ("B") if—
(a) A is B's spouse or civil partner,
(b) A is a relative of B,
(c) A is the spouse or civil partner of a relative of B,
(d) A is a relative of B's spouse or civil partner, or
(e) A is the spouse or civil partner of a relative of B's spouse or civil partner."

12 In this diagram "spouse" includes civil partner.




> All the persons in the diagram are connected with the individual. Excluded are the widows or widowers, or surviving civil partners, of deceased persons, or relatives of a deceased spouse or of a deceased civil partner unless connection can be established by a route not involving the deceased. A dissolution of a civil partnership or a divorce can similarly lead to persons in addition to the former civil partner or spouse ceasing to be connected with the individual.

Readers are invited to speculate whether this diagram is or is not a useful aid to comprehension.

For the definition of control for IHT purposes, "relative" also includes an aunt, uncle, nephew and niece. See s.270 IHTA. A two dimensional diagram could not do justice to that.

## 73.11 Connection with trustees

### 73.11.1 *Settlors and settlor-connected persons*

Section 286(3) TCGA provides:

> A person, in his capacity as trustee of a settlement, is connected with-
> (a) any individual who in relation to the settlement is a settlor,
> (b) any person who is connected with such an individual ... [13]

The CG Manual provides:

> **14590. Connected persons: Trustees** [August 2009]
> ... The trustees are no longer connected to the persons connected to the settlor after the settlor has died.

More accurately, trustees are not connected with family members or other persons who would have been connected with the settlor when the settlor was alive.[14]

The CG Manual provides:

> **14590. Connected persons: Trustees** [August 2009]
> [1] A settlor is considered to be connected with the trustee at the moment when property is put into the settlement.
> [2] For the purposes of determining whether a trustee is connected with an individual, the identity of the trustee is irrelevant. So, for example, if the trustee is the wife or civil partner of the individual, he or she is only connected in his or her capacity as trustee if the case is within one of the three cases in CG14590.

Point [2] is correct since trustees are regarded as distinct from the persons who are actually the trustees.

The CG manual provides:

> **14590. Connected persons: Trustees** [August 2009]
> Although under the tests outlined an individual is not connected with particular trustees, this may not prevent him or her from being connected with a company controlled by the trustees.

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13 For IT, s.993 ITA provides similarly:

> (3) A person, in the capacity as trustee of a settlement, is connected with—
> (a) any individual who is a settlor in relation to the settlement,
> (b) any person connected with such an individual ...

14 Contrast the definition of associates. See 73.6 (Meaning of "associate").

This is correct: see 73.13 (Connection with company). The Manual continues:

> Under ICTA 1988, S 417, a beneficiary of a trust can be attributed with the rights and powers of trustees. In such circumstances he or she may control the company through the tests in ICTA 1988, S 416 and ICTA 1988, S 417 and hence be connected under TCGA 1992, S 286.

There is no general rule that the rights of trustees are attributed to beneficiaries. However the attribution will often be made on the grounds that the beneficiaries are relatives of the settlor[15] or (sometimes) that they possess the rights to income or capital.[16]

Suppose:

(1) A creates a trust (trust A) and

(2) B (who is connected with A, eg a spouse) creates a trust (trust B).

A is connected with the trustees of trust A (A is the settlor). A is connected with the trustees of trust B (a connected person is the settlor). However the trustees of trust A are not connected with the trustees of trust B. For the position if the trusts own companies, see 73.13.10 (Connected trusts owning separate companies).

For completeness: s.286(3)(d)(e) TCGA deal with sub-fund settlements.[17] Since these settlements are (virtually) never found in practice, this is dead-letter law which need not be considered even in a work which seeks to be comprehensive.

Trustees are not connected with a corporate settlor.

### 73.11.2 *Company connected with trustees*

Section 286(3) TCGA provides:

> A person, in his capacity as trustee of a settlement, is connected with ...

15 See 73.7 (Attribution of rights of associates and controlled companies).

16 See 73.4.5 (Right to income); 73.4.6 (Right to capital).

17 (d) if the settlement is the principal settlement in relation to one or more sub-fund settlements, the trustees of the sub-fund settlements, and

(e) if the settlement is a sub-fund settlement in relation to a principal settlement, the trustees of any other sub-fund settlements in relation to the principal settlement.

(c) any body corporate[18] which is connected with that settlement,

This takes us to s.286(3A) TCGA which provides:

> For the purpose of subsection (3) above a body corporate is connected with a settlement if-
> (a) it is a close company (or only not a close company because it is not resident in the UK) and the participators include the trustees of the settlement; or
> (b) it is controlled (within the meaning of section 1124 of the Corporation Tax Act 2010) by a company falling within paragraph (a) above.

It is confusing that the drafter used the expression "connected with a settlement" since in that expression the term "connected" is not used in the normal CGT sense of connected persons. But it does not matter.

The IT equivalent is more clearly drafted. Section 993(3) ITA provides:

> A person, in the capacity as trustee of a settlement, is connected with ...
> (c) any close company whose participators include the trustees of the settlement,
> (d) any non-UK resident company which, if it were UK resident, would be a close company whose participators include the trustees of the settlement,
> (e) any body corporate controlled (within the meaning of section 995) by a company within paragraph (c) or (d)

Thus trustees are connected with any close company in which they have any interest, no matter how small, but non-trustees are connected only if there is some element of "control".

### 73.11.3 *Meaning of settlement and trustee*

Section 286(3ZA) TCGA defines "settlement":

> For the purpose of subsection (3) above-

18 I do not know why the subsection refers to body corporate rather than company, but I don't think it makes any difference.

(a) "settlement" has the same meaning as in section 620 of ITTOIA 2005

One wonders why the decision was made in 2006 to disapply the standard IT/CGT definition of settlement and apply the settlement-arrangement definition instead. (Contrast the definition of associate.) Perhaps non-corporate employers complained that a transfer by them to a pension fund was (before 2006) a connected person transaction whereas a transfer by a company to a pension fund was not. Now a transfer to a pension fund is not a connected person as the transferor is not in principle connected with the pension trust.[19] But that is speculation as no reason was ever provided. A consequence is that will trusts are not settlements for the purposes of the connected persons rules, which is odd. Had a reason for the change been given, the issue might have been more fully discussed. But there it is.

Section 286(3ZA)(b) TCGA defines "trustee":

> "trustee", in relation to a settlement in relation to which there would be no trustees apart from this paragraph, means any person in whom the settled property or its management is for the time being vested.

For the definition of control for IHT purposes, "settlement" "settlor" and "trustee" have their IHTA meanings: s.270 IHTA.

## 73.12 Connection with partnership

Section 286(4) TCGA provides:

> Except in relation to acquisitions or disposals of partnership assets pursuant to bona fide commercial arrangements, a person is connected with
> [a] any person with whom he is in partnership,
> [b] and with
> [i] the spouse or civil partner
> [ii] or a relative

19 See 69.31.1 (Is a pension trust or employee trust a settlement?)

of any individual with whom he is in partnership.[20]

For the difficulties this causes, see 73.6.1 (Partners as associates).

## 73.13 Connection with company

Apart from the rule connecting trustees with companies, s.286 TCGA provides two ways by which a company may be connected with another person:
(1) company and person with control;
(2) company and persons acting together to exercise control.
In addition there are two ways by which a company may be connected with another company (an "inter-company connection"):
(1) 2 companies with common control;
(2) 2 companies with groups of connected controllers;
For completeness: the usual definition of company is disapplied for the purposes of s. 993 and 994 ITA (though not for CGT purposes).[21] So s. 994 needs to provide its own definition of company,[22] but since the definition is the same as the standard definition, this drafting quirk makes no difference. Perhaps some day someone will tidy up this mess, but it does not matter.

Since "control" has the ultra-wide sense, this head of the definition of connected person is also ultra-wide and no-one can draw a complete list

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20 For IT, s.993 (4) ITA provides similarly:
"A person who is a partner in a partnership is connected with—
(a) any partner in the partnership,
(b) the spouse or civil partner of any individual who is a partner in the partnership, and
(c) a relative of any individual who is a partner in the partnership.
But this subsection does not apply in relation to acquisitions or disposals of assets of the partnership pursuant to genuine commercial arrangements."

21 See 72.3 (Meaning of "company")

22 Section 994 ITA provides:
"(1) In section 993 and this section—
'company' includes any body corporate or unincorporated association, but does not include a partnership (and see also subsection (2)),...
(2) For the purposes of section 993—
(a) a unit trust scheme is treated as if it were a company, and
(b) the rights of the unit holders are treated as if they were shares in the company."

of all the companies with which they are connected.

### 73.13.1 *Inter-company connection: one person controls two companies*

Section 286(5)(a) TCGA provides:

> A company is connected with another company-
> (a) if the same person has control of both...

### 73.13.2 *Inter-company connection: connected persons control two companies*

Section 286(5)(a) TCGA provides:

> A company is connected with another company-
> (a) if .. [i]a person has control of one and
> [ii] [A] persons connected with him, or
> [B] he and persons connected with him,
> have control of the other,

If two persons ("X" and "Y") are associates, this is not needed because the rights of X are attributed to Y.[23] For instance, suppose:
(1) X and Y are relatives or partners, and
(2) X owns X Ltd and Y owns Y Ltd.
X controls X Ltd and also "controls" Y Ltd, so this provision is not needed. The same person has "control" of both companies. This provision is only relevant in a case where two persons are connected but not "associates".

### 73.13.3 *One group controls two companies*

Section 286(5)(b) TCGA provides:

> A company is connected with another company...
> (b) if
> [i] a group of 2 or more persons has control of each company, and
> [ii] the groups either
> [A]consist of the same persons or

23 See 73.7 (Attribution of rights of associates and controlled companies).

[B] could be regarded as consisting of the same persons by treating (in one or more cases) a member of either group as replaced by a person with whom he is connected.

The group may be vast and does not need any common purpose or identity. In *Kellogg Brown v HMRC* [2010] STC 925, two quoted companies each with over 16,000 shareholders were connected by a somewhat unimaginative construction of this head, since there was sufficient overlap between the two groups.

### 73.13.4 *Person controls a company*

Section 286(6) TCGA provides:

A company is connected with another person, if
[a] that person has control of it ...

### 73.13.5 *Connected persons control a company*

Section 286(6) TCGA provides:

A company is connected with another person, if ...
[b] if that person and persons connected with him together have control of it.[24]

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24 For IT, s.993 ITA provides similarly:
(5) A company is connected with another company if—
(a) the same person has control of both companies,
(b) a person ("A") has control of one company and persons connected with A have control of the other company,
(c) A has control of one company and A together with persons connected with A have control of the other company, or
(d) a group of two or more persons has control of both companies and the groups either consist of the same persons or could be so regarded if (in one or more cases) a member of either group were replaced by a person with whom the member is connected.
(6) A company is connected with another person ("A") if—
(a) A has control of the company, or
(b) A together with persons connected with A have control of the company.

If two persons ("X" and "Y") are associates, this is not needed because the rights of X are attributed to Y.[25] For instance, suppose:
(1) X and Y are relatives or partners.
(2) X owns 30% of A Ltd and Y owns 30% of A Ltd.
X "controls" A Ltd so this provision is not needed. It is only relevant in a case where two persons are connected but not "associates".

Suppose
(1) A and B are connected persons but not associates.
(2) B controls X Ltd and A has no interest in X Ltd.
It is considered that A is connected to X Ltd. It might be argued that A and B do not *together* have control, but various anomalies would arise, and that is reading too much into the word *together*.

### 73.13.6 *Persons acting together to exercise control*

Section 286(7) TCGA provides:

> Any 2 or more persons acting together to secure or exercise control of a company shall be treated in relation to that company as connected with one another and with any person acting on the directions of any of them to secure or exercise control of the company.[26]

For the purposes of discussion I abbreviate "secure or exercise control" to "exercise control".

The CG Manual quotes s.286(7) and then comments on the phrase "acting together to exercise control":

> **14622 Companies: 2 or more persons acting together to control** [August 2009]

---

25 See 73.7 (Attribution of rights of associates and controlled companies).

26 For IT, s.993(7) ITA provides similarly:
"In relation to a company, any two or more persons acting together to secure or exercise control of the company are connected with—
(a) one another, and
(b) any person acting on the directions of any of them to secure or exercise control of the company."

> ... For this subsection to operate it is not sufficient for the persons to have control of the company, the persons do have to act in some way to control the company. However, for example, exercising control could mean refraining from voting in a particular way and so enabling another person to win a vote, as well as by actually voting.

The CG Manual then considers the position of directors:

> **14623. Directors of a company** [August 2009]
> Directors of a company are not necessarily connected persons in relation to transactions between themselves. Whether or not one of them controls the company or two or more together control the company, they are not connected persons unless they are 'relatives', see CG14581, or partners, see CG14610.

That is correct. The manual then explains what it means to be connected "in relation to the company:

> TCGA 1992, S 286(7) makes two or more directors connected persons only in relation to transactions with the company.

(This sentence assumes that the directors are acting together to exercise control at shareholder level.)

For examples where person have been held to be acting together to exercise control, see *Foulser v Mac Dougall* [2007] STC 973; *Steele v EVC International* 69 TC 88.

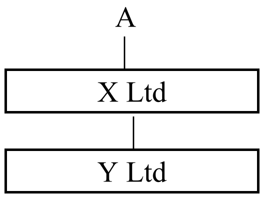
### 73.13.7 *Personal representatives*

The definition of control does not mention PRs (unlike the definition of "associates"). PRs cannot be connected with individuals or trustees. PRs may be connected with a company. They are "persons" so they are connected if (inter alia) they have control of the company or if they act with others to exercise control.

### 73.13.8 *Example 1: chain of wholly owned companies*

In actual cases, many different rules may find some role.

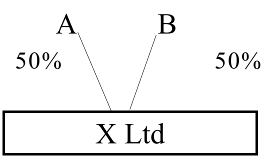
Suppose a straightforward chain of companies thus:




A controls X Ltd and so is connected with it.
A controls Y Ltd (either as he controls it indirectly in the general sense or because the rights of X Ltd are attributed to A.) So A is connected to Y Ltd.

73.13.9 *Example 2: unconnected persons jointly own a company*

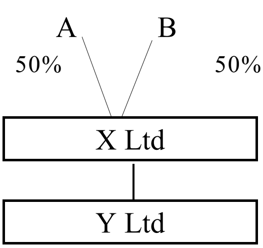
Suppose individuals A and B (who are not otherwise connected) each own 50% of X Ltd.




If A and B are not acting together to exercise control then they are not connected with each other or to X Ltd.

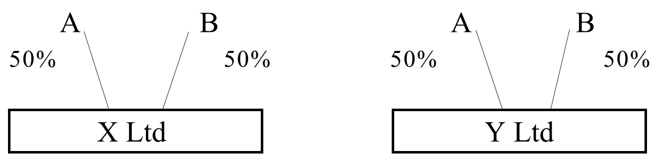
Suppose A and B are acting together to exercise control (as is likely to be the case). In that case they are "treated in relation to that company as connected with one another." A and B are also connected with the company. However, A does not control the company.

Suppose X Ltd has a subsidiary thus:




It is considered that A is connected to Y Ltd since A and persons connected to A (ie X Ltd) together control Y Ltd.[27]

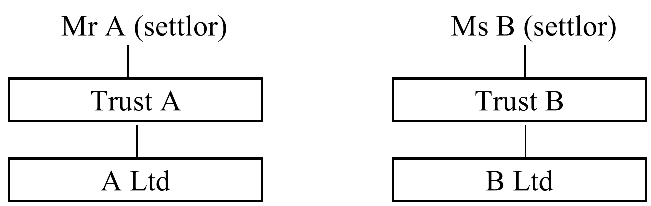
Of course, A and B together control X Ltd. Suppose A and B own two companies thus:




X Ltd and Y Ltd are connected with each other.

73.13.10 *Example 3: Connected trusts own separate companies*

Suppose:
(1) A creates a trust (trust A) which owns a company (A Ltd) and
(2) B (who is a relative or spouse of A) creates a trust (trust B) which owns a company (B Ltd), thus:




The analysis is as follows:
(1) A is connected with Trust A (because A is the settlor).
(2) A has "control" of A Ltd (the trustees of trust A are associates of A, because A is the settlor; so their rights are attributed to him).
(3) A is connected with A Ltd (because of that control).
(4) A is connected with the trustees of trust B (because a connected person is the settlor).
(5) A has "control" of B Ltd (the trustees of trust B are associates of A because a relative is the settlor; so their rights are attributed to him).
(6) A is connected with B Ltd (because of that control).

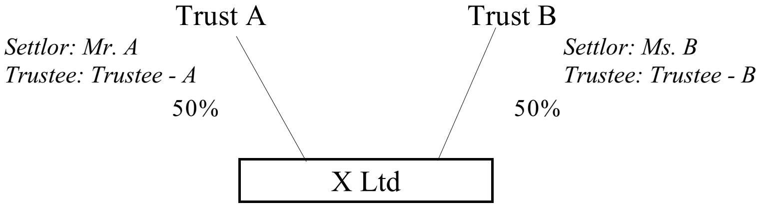
27 See 73.13.5 (Connected persons control a company).

(7) A Ltd is connected with B Ltd (because A has "control" of both). The trustees of trust A are not connected with the trustees of trust B but that does not stop their companies from being connected. Note that it is not necessarily possible for A Ltd or the trustees of trust A to know that A Ltd is connected with B Ltd.

What if A and B have died? If there is any person alive who is a relative of A and B, as defined, the relative has control of both companies and so A Ltd and B Ltd are still connected. But if A and B have no relatives (as defined) then the two companies are not in principle connected.

73.13.11 *Example 4: Unconnected trusts jointly own a company*

Suppose individuals Mr A and Ms B (who are not otherwise connected) are settlors of trusts which each own 50% of X Ltd. The trustees are Trustee-A and Trustee-B.




If none of Mr A, Ms B, Trustee-A and Trustee-B are acting together to exercise control then none of Mr A, Mr B, Trustee-A, Trustee-B or X Ltd are connected.

Suppose Mr A, Ms B, Trustee-A and Trustee-B are all acting together to exercise control (as is likely to be the case). In that case they are "treated in relation to that company as connected with one another." Mr A is also connected with the company. They would similarly be connected with a subsidiary of the company. Mr A does not control the company.

## 73.14 Why does it matter who is a participator?

The term "participator" is used throughout the Taxes Acts, and it is not practical to give a full list. For the purposes of this book the term is particularly important in the following contexts:

(1) The definition of "relevant person" for the ITA remittance basis.
(2) Section 13 TCGA (non-resident company gains attributed to participators).
(3) The test of whether trustees control a company.[28]
(4) The definition of "close company".

## 73.15 Definition of participator

Section 454(1) CTA 2010 provides a general statement:

> For the purposes of this Part, "participator", in relation to a company, means a person having a share or interest in the capital or income of the company.

However s.454(2) CTA 2010 goes on to list five categories of participator which are so wide that it is difficult to think of a case falling within (1) which is not within (2):

> In particular, "participator" includes—
> (a) a person who possesses, or is entitled to acquire, share capital or voting rights in the company,
> (b) a loan creditor of the company,
> (c) a person who possesses a right to receive or participate in
> [i] distributions[29] of the company or
> [ii] any amounts payable by the company (in cash or in kind) to loan creditors by way of premium on redemption,
> (d) a person who is entitled to acquire such a right as is mentioned in paragraph (c), and
> (e) a person who is entitled to secure that income or assets (whether present or future) of the company will be applied directly or indirectly for the person's benefit.

This definition is expressed to apply for the purposes of Part 10 CTA 2010, but it should be a taxes-act-wide definition. When the word participator is used in connection with close companies, the definition is almost

28 See 73.11.2 (Company connected with trustees).
29 Section 454(4) CTA 2010 defines "distribution": "In subsection (2) 'distribution' is to be construed without regard to section 1000(2) (extended definition of distribution for close companies)."

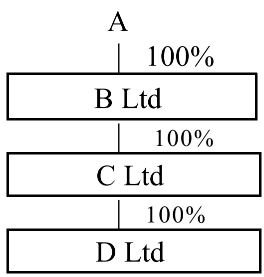
always incorporated and where there is no definition it must be implied.

Occasionally the definition is adopted with changes: s.454(6) CTA 2010 anticipates this:

> This section does not affect any provision of this Part requiring a participator in one company to be treated as being also a participator in another company.

### 73.15.1 *Chain of wholly owned companies*

Suppose a chain of wholly owned companies:

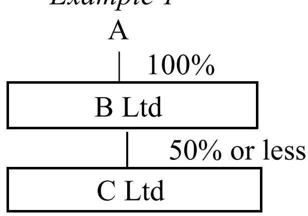



C Ltd is obviously a participator in D Ltd. But A and B Ltd are also participators in D Ltd, under s.454(2)(e) CTA 2010.[30] This is so wherever the companies are resident.

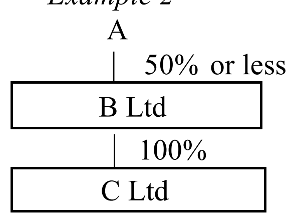
### 73.15.2 *Chain of partly owned companies*

Suppose a chain of partly owned companies which do not confer control, such as:

*Example 1*




*Example 2*




30 This view is not universally held.

A is a participator in B Ltd. A does not control C Ltd[31] and it is considered that A is not a participator in C Ltd. It might be argued that the rights of a minority shareholder are such that A is a participator within s.454(2)(e) - ie that A has the right to secure that the income of C Ltd is applied for A's benefit. I refer to this as the wide view. But this is very doubtful and in practice it appears that HMRC do not take the wide view. Section 455(5) CTA 2010 provides a wider than standard definition of "participator":

> If a company (C) controls[32] another company (D), a participator in C is to be treated for the purposes of this section as being also a participator in D.[33]

This applies in a few specific circumstances, in particular:
(1) For the definition of relevant person in the ITA remittance basis.[34]
(1) For s.1064 CTA 2010 (extended meaning of "distribution" for close companies.)
(2) For s.455 CTA 2010 (loans to participators).
The CT Manual provides:

> **60110 Participator: Extended meaning of**
> ... If, for example, Company B holds all the issued share capital of Company T and Company T makes a loan to W, a shareholder in Company B, that loan is within [s.455 CTA 2010] since W as well as being a participator in Company B is deemed also to be a participator in Company T.

This example is essentially example 2 above. It assumes that the wide view is not correct; that is why the extended definition of "participator" is needed.

### 73.15.3 *Trustees and beneficiaries*

Suppose trustees hold a share or interest in a company. The trustees are

31 In the absence of special facts, eg provisions in the company articles or shareholder agreements.
32 The ultra-wide definition of "control" applies: see 73.4 (Control in ultra-wide sense).
33 This provision is also found in s.459(4) CTA 2010.
34 See 10.4.1 ("Participator").

participators under s.454(1) CTA 2010. A person holding a share or interest as trustee is not a participator in their personal capacity since trustees are (at least for IT and CGT purposes) deemed to be a separate person.[35] Beneficiaries of the trust, other than merely discretionary beneficiaries, are also clearly participators under s.454(1) since they too have an interest in the trust property. HMRC agree. The CT Manual provides:

> **60160. 'Interested in'**
> The words 'interested in' have a wide meaning and, for example, where shares are held by trustees, the trustees, the beneficiaries and the remainderman (if any) of the trust are interested in the shares. Where shares are held by trustees under a will for persons in succession, the life tenant and the remainderman, as well as the trustees, are interested in the shares. (See, in this connection, *IRC v Park Investments Ltd* 43 TC 200, particularly the judgment of Danckwerts LJ at page 225, *IRC v Tring Investments Ltd* 22 TC 679, and *Alexander Drew and Sons Ltd v IRC* 17 TC 140.)

As to whether a person holding as nominee is a participator in their private capacity, see *Bramwell on Corporation Tax* (looseleaf) para A.11.1.16.

What about beneficiaries of a discretionary trust? The question is whether they have an "interest" in the company. The general rule is that the word "interest" is ambiguous and may or may not be taken to include the rights of a discretionary beneficiary: the context must decide the question; see *Leedale v Lewis* 56 TC 501. The difficulty is that the concept of participator is used in many contexts, and the definition section itself does not offer much context. *Bramwell on Corporation Tax* takes the view that beneficiaries of a discretionary trust are participators, and for practical purposes it would be safest to proceed on the basis that that may well be correct.

### 73.15.4 *Personal representatives and beneficiaries of estates*

Suppose PRs hold shares in a company. The PRs are participators under s.454(1) CTA 2010. A person holding shares as PR is also a participator

35 *Bibby v IRC* 29 TC 167 is no longer applicable to trustees except, possibly, for IHT.

in their private capacity, for IT purposes,[36] but not for CGT purposes as for CGT the PRs are deemed to be a separate person.

Beneficiaries of the estate are not participators under s.454(1) since they do not have a legal or equitable "interest" (in the strict sense) in the assets of the estate. However they are participators under s.454(2)(a)(c)(d) by virtue of their right to compel administration of the estate.

The CT Manual provides:

> **60160. 'Interested in'**
> ...The executors or administrators are interested in the assets of a deceased person's estate during the period of administration (*Willingale v Islington Green Investment Co* 48 TC 547). The beneficiaries should be regarded as interested in any assets of the estate from which they may benefit.

### 73.15.5 *"Entitled to do"*

Section 454(3) CTA 2010 provides:

> For the purposes of subsection (2), a person is treated as entitled to do anything which the person—
> (a) is entitled to do at a future date, or
> (b) will at a future date be entitled to do.

The CT Manual provides:

> **60120. Entitled to acquire or secure**
> The words 'entitled to acquire' and 'entitled to secure' introduce the concept of a potential participator. So, for example, a person is a participator if, by means of a contractual right or by rights arising under a trust deed, they can:
> - require a shareholder to transfer shares to that person, or
> - secure the issue to that person of unissued capital of the company, or
> - secure that if the company makes a distribution or if a loan is redeemed by the company at a premium, that person has a share in the distribution or the premium.

Similarly, a person is a participator if by means of a contractual right or

36 *Bibby v IRC* 29 TC 167.

some other arrangement they can secure that income or assets of the company will be applied directly or indirectly for their benefit. See too 73.4.7 ("Entitled to acquire").

## 73.16 Loan Creditor

### 73.16.1 *Why does it matter who is a loan creditor?*

The expression is used too often to set out a full list, but in particular:
(1) A loan creditor is a participator.
(2) The expression is used in the definition of close company.

### 73.16.2 *Definition of loan creditor*

Section 453 CTA 2010 provides:

> (1) For the purposes of this Part, "loan creditor", in relation to a company, means a creditor—
> (a) in respect of any debt within subsection (2), or
> (b) in respect of any redeemable loan capital issued by the company.
> But this is subject to subsection (4).
> (2) Debt is within this subsection if it is incurred by the company—
> (a) for any money borrowed or capital assets acquired by the company,
> (b) for any right to receive income created in favour of the company, or
> (c) for consideration the value of which to the company was (at the time when the debt was incurred) substantially less than the amount of the debt (including any premium on the debt).

The CT Manual paraphrases this provision and continues:

> **60130. Loan creditor**
> A person is not a participator merely because he or she is a normal trade creditor of the company.
> As the normal debenture issued by a company is redeemable, debenture holders are participators.
> Payments to be made under a hire purchase agreement would not normally be regarded as part of the company's loan capital. This is because under the usual hire purchase agreement there will be no debt for capital assets acquired by the company. The terms of the typical agreement make it clear that the assets remain in the ownership of the

hire company until the final instalment is paid. The payments not made in order to acquire a capital asset, but rather they are rent for the use of the asset.

An example of a sum owing in the circumstances described in [s.453(2)(b)] is where a person contracts to make annual payments to the company, in return for a capital sum due at some later date. The capital sum is treated as loan capital of the company and the person will be a participator.

... It should be borne in mind that [s.1000 CTA 2010] provides that the interest etc on certain loans is a distribution. As regards such loans, the creditor is in any case a participator as he or she 'possesses a right to receive or participate in distributions of the company' (see [s.454(2)(c)]).

73.16.3 *Interest in debt*

Section 453(3) CTA 2010 provides:

(3) A person who—
(a) is not the creditor in respect of any debt or loan capital to which subsection (1) applies, but
(b) has a beneficial interest in that debt or loan capital,
is, to the extent of that interest, treated for the purposes of this Part as a loan creditor in respect of that debt or loan capital (but this is subject to subsection (4)).

The words "to the extent of that interest" are not well expressed, since a person either is or is not a loan creditor. One cannot be a loan creditor "to an extent". But it does not matter.

73.16.4 *Bank creditor*

Section 453(4) CTA 2010 provides:

A person carrying on a business of banking is not treated as a loan creditor in respect of any debt or loan capital incurred or issued by the company for money lent by the person to the company in the ordinary course of that business.

The CT Manual provides:

**60130. Loan creditor**
*Banking business*
[The manual summarises the provision and continues:] There is no statutory definition of what constitutes carrying on a banking business (the definition of bank in Section 840A ICTA 1988 does not apply to Section 417 ICTA 1988) so we rely instead on the common characteristics of banking established in the (non-tax) case of *United Dominions Trust Ltd v Kirkwood* 1966 2 QB 431 and endorsed in *Hafton Properties Ltd v McHugh* 59 TC 420.
If you have any queries on whether a person is carrying on a business of banking, or whether a loan is made in the ordinary course of that business, please consult CT&VAT (Technical).

## 73.17 Close company - Introduction

"Close" company is a concept used so often in tax legislation that it is impossible to write a full list. For the purposes of this book, the concept is important in particular in the definitions of relevant person (for remittances); connected person, and for the application of s.13 TCGA.

"Close company" is one of the most elaborately defined expressions in the taxes acts, and that is really saying something. There are two main tests of close, the control test and the winding up test.

The definition in the CTA is for the purposes of the corporation tax acts. This is extended to income tax by s. 989 ITA:

> The following definitions apply for the purposes of the Income Tax Acts—
> "close company" is to be read in accordance with Chapter 2 of Part 10 of CTA 2010 (see in particular section 439 of that Act)

The definition is extended to CGT by s.288(1) TCGA:

> In this Act, unless the context otherwise requires—
> "close company" shall be construed in accordance with Chapter 2 of Part 10 of CTA 2010 (see in particular section 439)

## 73.18 Control test

Section 439(1) CTA 2010 provides:

> For the purposes of the Corporation Tax Acts, a "close company" is a company in relation to which condition A or B is met.

I refer to **"close company conditions A and B"** to avoid confusion with the myriad other conditions in the CTA.

### 73.18.1 *Close company condition A: Control of five or fewer participators*

Section 439(1) CTA 2010 provides:

> Condition A is that the company is under the control—
> (a) of 5 or fewer participators, or
> (b) of participators who are directors

Control has the ultra-wide sense.

### 73.18.2 *Control of participators who are directors*

This takes us to the idiosyncratic definition of director in s.452 CTA 2010:

> (1) In this Part, "director", in relation to a company, includes—
> (a) a person occupying the position of director of the company, by whatever name called,
> (b) a person in accordance with whose directions or instructions the directors of the company are accustomed to act, and
> (c) a person within subsection (2).

(1)(a)(b) are standard form; but (c) leads to a distinctly non-standard extension:

> (2) A person (P) is within this subsection if P—
> (a) is a manager of the company or otherwise concerned in the management of the company's trade or business, and
> (b) is—
> (i) the beneficial owner of, or
> (ii) directly or indirectly able to control,
> at least 20% of the ordinary share capital of the company.
> (3) For the purposes of subsection (2)(b), P is treated as owning or controlling (as the case may be) what any associate of P owns or controls.

A company controlled by director-participators is a close company, even if the number of director-participators exceeds five. Directors have "control" of a company if (*inter alia*) they exercise direct or indirect control over the company's affairs. This is puzzling as (under standard articles)[37] company law directors manage the business of the company, and may exercise all the powers of the company. In one sense, directors always control their company. It cannot be that every company whose directors happen to be participators is made a close company under this part of the definition. The answer is that "control" here means control at shareholder level, the ability to pass an ordinary resolution in general meeting. Directors do not "control" a company, in the relevant sense, unless they control the company at that level.[38]

It follows that a charitable company is normally close if its directors constitute all or a majority of the members of the company.[39]

As to whether a foundation is a close company, see

The CT Manual gives some examples:[40]

> **60420 Examples**
>
> The examples refer to companies having shares that are not dealt in or quoted on a stock exchange.
>
> *Example 1*
>
> Company X has 1,000 issued shares of £1 held as below.

| | |
|---|---|
| Trustees of A's settlement | 449 |
| Mrs A (settlor) | 60 |
| Ten other shareholders | 491 |
| Total issued ordinary shares | 1,000 |

> The ten shareholders are not associated with each other or with A or Mrs A and

37 Table A paragraph 70.

38 *Steele v EVC International* 69 TC 88 at p.127. See Venables, *The Taxation of Foundations* (2010) para E2.1.4.3 (Direct or Indirect Control over the Company's Affairs).

39 For example, an Oxford college (a body corporate) may be a close company, since:
(1) Its fellows may be "participators", if they possess voting rights in the body corporate.
(2) Its fellows manage the business of the body corporate, so they are (in principle) "directors".
(3) Its fellows control the body corporate, at shareholder level (or more accurately, at corporate member level).
It appears that HMRC do not take this point in practice.

40 In these examples I omit internal Manual cross references and alter the formatting for increased clarity.

no one of them holds more than 50 shares.
The trustees of A's settlement are associates of Mrs A by virtue of Section 417(3)(b) ICTA 1988, and their rights and powers may be attributed to Mrs A who therefore controls the company.
Company X is therefore a close company.

This is correct, but it is not necessary to rely on the associates rule. The company would be close even if Mrs A were not the settlor since it is under the control of two (less than five) persons. The Manual continues:

*Example 2*
The £1 issued shares in a trading company are owned as follows.

| | |
|---|---|
| **Ordinary shares** | |
| Directors | |
| A | 4 |
| B (cousin of A) | 4 |
| Others | |
| 12 individuals equally, none of whom is a nominee associate, etc, of any other shareholder | 4,992 |
| Total issued ordinary shares | 5,000 |
| **5% preference shares** | |
| A (see above) | 5,000 |
| **Total nominal and issued capital** | 10,000 |

There are no loan creditors ranking as participators or members.
Control by reference to possession of the greater part of the issued share capital (Section 416(2)(a) ICTA 1988).
The company is a close company because A possesses more than half the issued capital.
*Example 3*
The issued ordinary shares in a trading company carry one vote each but the 'A' ordinary shares do not confer voting rights. The shareholders are as below.

| | Ordinary | 'A' ordinary |
|---|---|---|
| A | 280 | |
| Wife of A | 100 | |
| B (brother of A) | 10 | |
| Trustees of A's settlement | 40 | |
| Company X (controlled by A) | 80 | |
| | 510 | |
| Mrs C (daughter of B) | 20 | |
| 10 other equal holdings | 470 | 500 |
| Total issued shares | 1,000 | 500 |

The shares carry equal rights to dividend. A's wife has made a loan of £20,000 to the company at 5% interest. There is no share premium account or other comparable account.
Control by voting rights (Section 416(2)(a) ICTA 1988).

> The associates of A are:
> 1. his wife and his brother, (Section 417(3)(a) and (4) ICTA 1988, and
> 2. the trustees of A's settlement, (Section 417(3)(b) ICTA 1988.
>
> The rights and powers attributable to A are:
> a. the rights and powers of his associates Section 416(6) ICTA 1988, and
> b. the rights and powers of Company X Section 416(6) ICTA 1988.
>
> As a total of 510 votes are thus possessed by A or attributable to him, the company is a close company controlled by one person.

This is correct, but it is not necessary to rely on the associates rule. The company would be close even if none of the shareholders were associates, since it is under the control of five participators. A's wife's loan is wholly irrelevant and it is difficult to see why the example mentions it.

> Alternatively control by holding the greater part of the issued share capital, (Section 416(2)(a) ICTA 1988, - any eight of the other equal holdings will control the company by holding the greater part of the issued share capital.

I do not understand this comment. Perhaps the text of the example is corrupt.

> ***Example 4***
>
> The authorised and issued share capital of Company X is £1,000 in the form of 1,000 ordinary shares of £1 each, held as below.

| | |
|---|---|
| A | 200 |
| B | 100 |
| C | 50 |
| D | 50 |
| E | 40 |
| Company Y | 99 |
| Other shareholders | 461 |
| Total issued ordinary shares | 1000 |

> A, B and C are directors.
>
> The issued capital of Company Y, is £100 in the form of 100 ordinary shares of £1 each, held by:

| | |
|---|---|
| F (son of E) | 60 |
| G | 40 |
| Total issued shares | 100 |

> The shareholders in Company X, other than Company Y, are all individuals and none are related or otherwise associated. No 'other shareholder' holds more than 50 shares.
>
> Control - the rights in the shares held by Company Y in Company X may be attributed to F who controls that company (Section 416(6) ICTA 1988).
>
> F is an associate of E but the rights attributed to F cannot be further attributed to E (Section 416(6) ICTA 1988).

No group of five participators or fewer can control Company X, nor do the director/participators control, and nor would the winding up test be of assistance here.

Company X is not a close company.

***Example 5***

The facts are the same as in Example 4 except that F is the holder of one share in Company X.

Control rights can be attributed to F as below.

| | |
|---|---|
| Shares held in own right | 1 |
| Shares held by E (an associate) | 40 |
| Shares held by Company Y (controlled by F) | 99 |
| | 140 |

Thus A, B, C, D and F hold (or have attributed to them) the rights in 540 shares and control the company.

Company X is a close company.

This example neatly illustrates the arbitrary nature of the rules. At the margin, there is obviously some scope for tax planning.

***Example 6***

Company X has authorised capital of £5,000 in £1 ordinary shares of which £3,000 is issued as below.

| | |
|---|---|
| A | 150 |
| B | 150 |
| C | 150 |
| D | 250 |
| E | 250 |
| F | 250 |
| 20 other shareholders (no one holder having over 100 shares) | 1800 |
| Total issued ordinary shares | 3000 |

The 20 other shareholders are individuals and none of the shareholders is an associate of any other. A, B and C are the directors. They each enter into a service agreement providing that they are to remain directors[41] for five years from 1 January 1992, and that on 31 December 1996, they shall each have the right to purchase 500 £1 shares in the company at par.

Control - A, B and C each exercises or is entitled to acquire rights in 650 shares (Section 416(2)(a) ICTA 1988 and Section 416(4) ICTA 1988).

Thus A, B, C, D and E (or A, B, C, D and F, or A, B, C, E and F) together constitute a group which is 'able to exercise or is entitled to acquire, control' of the company (with 2,450 shares out of 4,500, i.e. the 3,000 issued plus the 1,500 to be issued to the directors).

The company is a close company from 1 January 1992.

41 The right to remain directors is irrelevant to the tax analysis.

***Example 7***

The authorised and issued capital of an investment company is £33,000 and is owned equally by eleven individuals who are not associated. The loan creditors are:

| | |
|---|---|
| A (director and shareholder) | £35,000 |
| B (not a shareholder) | £13,500 |

Neither A nor B is a bank. B is not an associate of a director.
In a winding up, the value of the net assets distributable among members, including loan creditors, would be £120,000 as below.

| | | |
|---|---|---|
| Deposits with local authorities | | £30,000 |
| Market value of quoted investments (representing the remainder of the assets) | | £110,000 |
| | | £140,000 |
| Deduct sundry creditors | | |
| Management expenses | £300 | |
| Bank overdraft | £19,700 | £20,000 |
| Value of net assets | | £120,000 |

Control - the company cannot be shown to be controlled by five or fewer participators under Section 416(2)(a) or (b) ICTA 1988. In a liquidation, the assets would, however, be distributed as below.

| | |
|---|---|
| A as loan creditor | £35,000 |
| B loan creditor | £13,500 |
| Shareholders (£6,500 each) | £71,500 |
| Value of net assets | £120,000 |

More than half of this sum would be received by three persons, that is:

| | |
|---|---|
| A (£35,000 plus £6,500) | £41,500 |
| B | £13,500 |
| Any shareholder other than A | £6,500 |
| Distribution to three persons | £61,500 |

The company is therefore a close company by reference to Section 416(2)(c) ICTA 1988 because the inclusion of loan creditors as participators shows that it is controlled by three participators.

## 73.19 Close company condition B: winding-up test

Condition B provides for a case where the participators have rights which do not confer control. Section 439(3) CTA 2010 provides:

(3) Condition B is that 5 or fewer participators, or participators who are directors, together possess or are entitled to acquire—

(a) such rights as would, in the event of the winding up of the company ("the relevant company") on the basis set out in section 440, entitle them to receive the greater part of the assets of the relevant company which would then be available for distribution among the participators, or

(b) such rights as would, in that event, so entitle them if there were disregarded any rights which any of them or any other person has as a loan creditor (in relation to the relevant company or any other company).

The CT Manual provides:

**60320 Rights in a winding-up**

The tests so far considered in determining whether a company is a close company have depended on the question of control. With effect from 1 April 1989 there is a further test, in which control is irrelevant, based on rights in a winding-up. It is in Section 414(2) to (2D) ICTA 1988 and provides that a company ('the relevant company') is close if five or fewer participators, or participators who are directors, together possess or are entitled to acquire such rights as would, in the event of the winding-up of the company, entitle them to receive the greater part of the company's assets then available for distribution among the participators. By reason of Section 416(6) ICTA 1988 there is attributed to any participator all the rights of his associates.

This test is applied first on the basis that loan creditors are included as participators and then on the basis that they are disregarded. The company is close if it satisfies the test on either basis.

Section 440 CTA 2010 sets out the basis of the notional winding-up:

(1) This section applies for the purposes of section 439(3).

(2) In the notional winding up of the relevant company, the part of the assets available for distribution among the participators which any person is entitled to receive is the aggregate of—

(a) any part of those assets which the person would be entitled to receive in the event of the winding up of the relevant company, and

(b) any part of those assets which the person would be entitled to receive if—

(i) any other company which is a participator in the relevant company and is entitled to receive any assets in the notional winding up were also wound up on the basis set out in this section, and

(ii) the part of the assets of the relevant company to which the other company is entitled were distributed among the participators in the other company in proportion to their respective entitlement to the assets of the other company available for distribution among the participators.

(3) In the application of subsection (2)—

(a) to the notional winding up of the other company mentioned in paragraph (b) of that subsection, and

(b) to any further notional winding up required by that paragraph (or by any further application of that paragraph),

references to "the relevant company" are to be read as references to the company concerned.

Section 441 CTA 2010 provides:

(1) The following provisions apply for the purpose of determining whether under subsection (3) of section 439 five or fewer participators, or participators who are directors, together possess or are entitled to acquire rights such as are mentioned in paragraph (a) or (b) of that subsection.

(2) A person is to be treated as a participator in or director of the relevant company if the person is a participator in or director of any other company which would be entitled to receive assets in the notional winding up of the relevant company on the basis set out in section 440.

(3) No account is to be taken of a participator which is a company unless the company possesses or is entitled to acquire the rights in a fiduciary or representative capacity.

(4) But subsection (3) does not apply for the purposes of section 440.

CT Manual provides:

**60320 Rights in a winding-up**

If in the course of the deemed winding-up of the relevant company assets would be received by a participator which is a company, we proceed on the basis that the corporate participator is itself wound-up and that the assets it received from the winding-up of the relevant company are distributed to its own participators in proportion to their respective entitlement to the assets of that corporate participator. If in the course of that deemed winding-up assets would be received by a

further company the process is repeated. The process continues to be repeated until all of the assets of the relevant company are distributed to individuals (with the exception referred to below). The effect is that we 'look through' all participators which are companies.
The exception to this looking through is any company whose rights are possessed purely in a fiduciary or representative capacity. These stand with the individual participators in determining whether five or fewer participators would be entitled to receive the greater part of the assets available for distribution.
For the purposes of this test, then, the assets of the relevant company which would be distributed to any participator are the sum of what he would receive directly from the winding-up of that company plus what he would receive indirectly through the winding-up of participators which are companies.
For the purposes of this provision a person is treated as a participator in the relevant company if he is a participator in any company itself entitled to receive assets, directly or indirectly, in the winding-up of the relevant company.

## 73.20 Exceptions to close company test

### 73.20.1 *Non-resident company*

Section 442 CTA 2010 sets out three exceptions to the general rule:

> A company is not to be treated as a close company if—
> (a) it is non-UK resident

The rule that a non-resident company is not a close company is in practice often disapplied. As a matter of drafting technique, this is most often done by referring to a company "which would be close if UK resident"; sometimes the definition of close company is expanded to include a non-resident company. In this book I refer to such a company as **"a non-resident close company"**.

### 73.20.2 *Industrial & provident society or building society*

For completeness: s.442 CTA 2010 provides:

> A company is not to be treated as a close company if ...

(b) it is a registered industrial and provident society, or
(c) it is a building society.

### 73.20.3 *Company controlled by the Crown*

Section 443 CTA 2010 provides:

> (1) A company is not to be treated as a close company as a result of section 439(2) if it is controlled by or on behalf of the Crown.
> (2) A company is "controlled by or on behalf of the Crown", for the purposes of this section, if it is under the control of the Crown or of persons acting on behalf of the Crown, independently of any other person.
> (3) But a company is not controlled by or on behalf of the Crown, for the purposes of this section, if it is a close company as a result of being under the control of persons acting independently of the Crown.

EN CTA 2010 provides:

> 1340. The [words *as a result of section 439(2)*] leave it open for a company controlled by or on behalf of the Crown to be a close company if condition B in section 439(3) is met. Section 439(3) is based on section 414(2) of ICTA.
> 1341. The italicised words also leave it open for a company controlled by or on behalf of the Crown to be a close company if condition A in section 439(2) is satisfied by reference to persons acting independently of the Crown. See subsection (3).
> 1342. In short, section 414(1)(c) of ICTA is a qualified exception to section 414(1) of that Act but not an exception to section 414(2) of that Act.

The CT Manual provides:

> **60270 Control: By the Crown**
> A company is to be treated as controlled by or on behalf of the Crown (and therefore not a close company) if, and only if, it is by any of the control tests under the control of the Crown or of persons acting on behalf of the Crown, independently of any other person. If, however, it can be shown that under some other control test:
> - five or fewer participators, or
> - participators who are directors,

control the company and those participators (or director/participators) act independently of the Crown, the company is a close company.

The Crown for this purpose includes any Minister, Government Department or other person acting on behalf of the Crown.

**60280. Control: Overseas governments and local authorities**

A company should not be treated as a close company if the only persons who can be taken to have control of that company are any of the following:

- Overseas governments.
- The Crown Agents for Overseas Governments and Administrations.
- Local authorities or local authority associations exempt from tax under Section 519 ICTA 1988 (see CTM40850 onwards).

Nor should a company be treated as a close company if the only persons who can be taken to have control of that company are any of the above together with:

- a company or companies resident in the UK which are not close, or
- an overseas company or companies which, if resident in the UK, would not be close.

### 73.20.4 *Control by open company*

The next, important, exception concern companies controlled by open (ie non-close) companies. Section 444 CTA 2010 provides:

> (1) A company is not to be treated as a close company if condition A or B is met.
> (2) Condition A is that the company—
> (a) is controlled by one or more companies none of which is a close company, and
> (b) cannot be treated as a close company except by taking, as one of the 5 or fewer participators requisite for its being so treated, a company which is not a close company.
> (3) Condition B is that the company—
> (a) would not be a close company were it not for paragraph (a) of section 439(3) or paragraph (d) of section 450(3), and
> (b) would not be a close company if the references in those paragraphs to participators did not include loan creditors which are companies other than close companies.
> (4) References in subsections (2) and (3) to a close company include a company which, if UK resident, would be a close company.

The CT Manual provides:

**60290 Control: By another company**

A company is not to be treated as a close company where:

- the company is controlled ... by an open company, or by two or more open companies, and
- it cannot be treated as a close company ... except by including an open company in the group of five or fewer participators.

A company is also not to be treated as a close company where:

- the company can only be shown to be close under the control test in Section 416(2)(c) ICTA 1988 (entitlement to receive the greater part of the assets in a winding-up, etc), and
- the company would not be close under the control test if the reference to 'participators' in Section 416(2)(c) excluded loan creditors who are open companies.

Where, in considering the above, you have to take into account a company not resident in the UK, the non-resident company is to be treated as a close company if, were it resident in the UK, it would be such a company.

**60300 Open company loan creditor**

A company is not to be treated as a close company if:

i) it is only close by virtue of the control test in Section 416(2)(c) ICTA 1988 (see CTM60220) or the 'winding-up' test in Section 414(2)(a) ICTA 1988 (see CTM60320), and

ii) it would not be close if, for the purposes of those tests, open companies were not regarded as participators in respect of their interests in the company as loan creditors.

In arriving at the amount available for distribution among the participators, any amount due to an open company as a loan creditor (including any amount due to it as a holder of loan capital) may be disregarded if the result is that the company ceases to be close (Section 414(5)(b) ICTA 1988).

If the open company loan creditor also holds shares in the company, it will remain a participator in respect of that holding and any amount which would be distributed to it in respect of those shares should be taken into account for the purposes of Section 416(2)(c) and Section 414(2)(a).

## 73.21 Pension schemes

Section 445 CTA 2010 provides:

(1) If shares in a company ("C") are held on trust for a registered pension scheme, the persons holding the shares are to be treated, for the

purposes of section 444(2) and (3)—
(a) as the beneficial owners of the shares, and
(b) in that capacity, as a company which is not a close company.
(2) But subsection (1) does not apply if the scheme is established wholly or mainly for the benefit of—
(a) directors, employees, past directors or past employees of a company within subsection (3), or
(b) dependants of an individual within paragraph (a).
(3) The companies within this subsection are—
(a) C,
(b) an associated company of C,
(c) a company which is under the control of—
(i) a director of C,
(ii) an associate of a director of C, or
(iii) two or more persons each of whom is such a director or associate, and
(d) a close company.

The CT Manual summarises this and provides:

**60290 Control: By another company**
The broad effect of the above conditions is that the fund or scheme must be one established for the benefit of employees, etc, of an unrelated company which is not close. A joint fund for the benefit of employees of two or more companies is not disqualified if the majority of the beneficiaries are or were employees of qualifying companies or are dependants of such employees.

## 73.22 Quoted company exemption

Section 446 CTA 2010 provides:

(1) A company is not to be treated as a close company at a particular time if—
(a) shares in the company carrying at least 35% of the voting power in the company have been allotted unconditionally to, or acquired unconditionally by, and are at that time beneficially held by, the public, and
(b) any such shares have within the preceding 12 months been the subject of dealings on a recognised stock exchange, and the shares have within those 12 months been listed on such an exchange.
(2) But subsection (1) does not apply to a company at any time when the

total percentage of the voting power in the company possessed by all of the company's principal members exceeds 85%.

(3) For the purposes of this section, a person is a principal member of a company if the person possesses a percentage of the voting power in the company of more than 5% (but see subsection (4)).

(4) If there are more than 5 persons within subsection (3), a person is a principal member of the company only if—

(a) the person is one of the 5 persons who possess the greatest percentages, or

(b) in a case where there are no such 5 persons because two or more persons possess equal percentages of the voting power in the company, the person is one of the 6 or more persons (including those two or more who possess equal percentages) who possess the greatest percentages.

(5) In determining for the purposes of this section the voting power which a person possesses, there is to be attributed to the person any voting power which would be attributed to the person if section 451(3) to (6) applied for the purposes of this section.

(6) In this section "shares"—

(a) include stock, but

(b) do not include shares entitled to a fixed rate of dividend, whether with or without a further right to participate in profits.

The CT Manual provides:

**60310 35% or more voting power held by public**

... The total voting power for the purpose of (i) and (ii) above is that of all the issued shares (or stock) including that of shares, etc, entitled to a fixed dividend, etc, which are excluded under (i) above in determining the voting power in the hands of the public. ...

1. Where the company holding the shares loses its beneficial interest on commencement of winding-up (see CTM36125) you should not normally contend that a company which was not close before the commencement of that winding-up, thereby becomes a close company.
2. Shares beneficially held by an authorised unit trust (see CTM48200 onwards) are to be regarded as beneficially held by a company which is not a close company unless five or fewer persons hold more than half of the units issued by the trust. In determining the number of units held by a person, there should be attributed to him or her any units held by his or her associates (see CTM60150) or by his or her nominees or by any company (or companies) of which he/she has, or he/she and his associates have, control.

### 73.22.1 *"Held by the public"*

Section 447 defines "shares beneficially held by the public":

> (1) For the purposes of section 446, shares in a company (C) are beneficially held by the public if they are—
> (a) beneficially held by a UK resident company which is not a close company, or by a non-UK resident company which would not be a close company if it were UK resident,
> (b) held on trust for a registered pension scheme, or
> (c) not comprised in a principal member's holding.
> (2) But shares are not beneficially held by the public if they are held—
> (a) by a director of C,
> (b) by an associate of such a director,
> (c) by a company which is under the control of one or more persons each of whom is such a director or associate,
> (d) by an associated company of C, or
> (e) as part of a fund the capital or income of which is applicable or applied wholly or mainly for the benefit of any of individuals within subsection (3).
> (3) Those individuals are—
> (a) employees, directors, past employees or past directors of C or of any company within subsection (2)(c) or (d), and
> (b) dependants of any individuals within paragraph (a).
> (4) The reference in section 446(1) to shares which have been allotted unconditionally to, or acquired unconditionally by, the public is to be read in accordance with subsections (1) to (3).
> (5) For the purposes of subsection (1), a principal member's holding consists of the shares which carry the voting power possessed by him.
> (6) The reference in subsection (2) to shares held by any person includes shares the rights or powers attached to which would be attributed to the person if section 451(3) applied for the purposes of that subsection.
> (7) Subsections (3) to (5) of section 446 (meaning of "principal member" and determination of voting power possessed) apply for the purposes of this section as they apply for the purposes of that section.
> (8) In this section, "shares" includes stock.

The CT Manual par 60310 provides:

> Where a company in [s.315(5)(b)(c)] above loses its beneficial interest in the shares, etc, on commencement of winding-up (see CTM36125)

you should not normally accept that a company which was close before the commencement of that winding-up, thereby ceases to be close. ... For the purpose of (b)(iii) above, shares held in accordance with (b)(i) or (ii) above are deemed to be beneficially held by the public (provided that they are not excluded by (c) above) even if they are comprised in a principal member's holding.

The CT Manual para 60420 provides two simple examples of the quoted company exemption:

**60420 Examples**
*Example 8*
The issued ordinary capital of a trading company (other issued capital having no voting rights) is held as below.

| | |
|---|---|
| Company A (not a close company) | 280 |
| Company B (a close company) | 270 |
| Company C (not a close company) | 230 |
| D (director) | 40 |
| E (director) | 30 |
| F (an individual) | 30 |
| 20 others | 120 |
| Total issued ordinary shares | 1,000 |

Control - the requirements of Section 414(5)(a)(i) ICTA 1988 are regarded as satisfied because, upon one combination of shareholdings, control is in the hands of Company A and Company C, even though by other combinations a controlling group which includes only one of those companies may be established. The company is not a close company if the requirements of Section 414(5)(a)(ii) ICTA 1988 are also satisfied, that is, if none of the control tests enables control by five or fewer participators to be established without including a non-close company among those participators, and the company is not controlled by its directors and cannot be shown to be close on the [or][42] winding up test without including a non-close company among the five or fewer participators (see, however, Example 9 below).
*Example 9*
The ordinary shares are held as in Example 8. G, an individual, holds redeemable loan stock and would receive in a winding-up more than half of the assets available for distribution among the participators.
Control - as G is in control of the company by reference to Section

42 This word is in the original but seems to be a typographical error.

416(2)(c) ICTA 1988, the requirements of Section 414(5)(b) ICTA 1988 are not met and, irrespective of the control by open companies, the company is a close company.

CHAPTER SEVENTY FOUR

# PERMANENT ESTABLISHMENT AND BRANCH/AGENCY

## 74.1 Why does permanent establishment matter?

It is not practical to set out a complete list of the significance of PE for tax, but the following are the most important.

In the absence of a PE, a non-resident company trading in the UK is subject to income tax on its income. A company trading through a PE is subject to corporation tax. Section 5 CTA 2009 provides:

> (1) A UK resident company is chargeable to corporation tax on all its profits wherever arising.
> (2) A non-UK resident company is within the charge to corporation tax only if it carries on a trade in the UK through a permanent establishment in the UK.[1]

In the absence of a PE, a non-resident company is not subject to CGT. A company trading in the UK through a PE is subject to corporation tax on its chargeable gains. Section 10B TCGA provides:

> (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[2] 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

1 The drafting is based on article 7 of the OECD Model Convention.
2 For completeness, s.10B(4) TCGA defines "trade" to include an office, but in practice this will not often be significant.

> (b) assets situated in the UK and used or held for the purposes of the permanent establishment at or before the time the gain accrued or acquired for use by or for the purposes of the permanent establishment.
>
> (2) Subsection (1) does not apply unless the disposal is made at a time when the company is carrying on a trade in the UK through a permanent establishment there. ...

PE is relevant for double tax treaties. In particular, art. 7(1) OECD model treaty provides:

> The profits of an enterprise of a Contracting State shall be taxable only in that State unless the enterprise carries on business in the other Contracting State through a permanent establishment situated therein. If the enterprise carries on business as aforesaid, the profits of the enterprise may be taxed in the other State but only so much of them as is attributable to that permanent establishment.

Last but not least, PE of a corporate trustee is relevant to trust residence.

If a non-resident *individual* or trustee is carrying on a trade in the UK, their UK tax position is not affected whether or not they are carrying on their trade through a PE but the PE may be relevant for a DTA and will normally constitute a branch or agency.

PE and branch/agency (or very similar concepts) are also relevant for many non-tax purposes, such as civil jurisdiction.

### 74.1.1 *Carrying on business through a branch or agency*

The statutory provisions refer to a company carrying on a trade through a branch or agency, so one might think that there are two distinct questions:
(1) whether a PE exists
(2) whether the company is carrying on business through the PE.
However PE is defined as a fixed place of business through which the business of the company is carried on; so if a company owns (say) an office building which it does not use (or which it does not use for its business) then strictly the office building is not a PE at all.

### 74.1.2 *Extent of profits chargeable through PE*

Section 5(3) CTA 2009 identifies the amount on which CT is charged:

> A non-UK resident company which carries on a trade in the UK through a permanent establishment in the UK is chargeable to corporation tax on all its profits wherever arising that are chargeable profits as defined in section 19 (profits attributable to its permanent establishment in the UK)...

Section 19 CTA 2009 defines "chargeable profits":

> (1) This section applies if a non-UK resident company carries on a trade in the UK through a permanent establishment in the UK.
> (2) The company's chargeable profits are its profits that are—
> (a) of a type mentioned in subsection (3), and
> (b) attributable to the permanent establishment in accordance with sections 20 to 32.
> (3) The types of profits referred to in subsection (2)(a) are—
> (a) trading income arising directly or indirectly through or from the establishment,
> (b) income from property or rights used by, or held by or for, the establishment, and
> (c) chargeable gains falling within section 10B of TCGA 1992 (non-resident company with UK permanent establishment)—
> (i) as a result of assets being used in or for the purposes of the trade carried on by the company through the establishment, or
> (ii) as a result of assets being used or held for the purposes of the establishment or being acquired for use by or for the purposes of the establishment.

The question of how profits are attributed to a PE is not discussed here.

## 74.2 Meaning(s) of "permanent establishment"

The definition(s) of PE need a long book to itself.[3] This chapter is a relatively brief introduction.

The term "permanent establishment" is used in different places with different definitions. It is strictly necessary to distinguish between:

3 For further reading, there is a bibliography in Reimer, Urban and Schmid (ed), *Permanent Establishments* (2011), para 1.3. See too IFA, *Is there a Permanent Establishment?* Cahiers du Droit International, (Vol 94a, 2009); [2006] BTR at p.722.

(1) "**UK law PE**" (which the INT Manual calls domestic law PE), defined in s.1141 CTA 2010.
(2) "**OECD Model PE**" defined in the OECD Model. The INT Manual calls this "treaty PE" but I prefer the term "OECD Model PE" because different treaties have different definitions.[4]

There are two parts to the definition of PE: (a) fixed place of business and (b) agency PE. It is best to consider them separately.

For investment manager/broker PEs, see 39.1 (Investment manager exemptions - Introduction).

### 74.2.1 *Scope of UK law definition*

Section 1141 CTA 2010 provides:

> For the purposes of the Corporation Tax Acts a company has a permanent establishment in a territory if ...

Thus this definition applies only for the purposes of the corporation tax acts.

For CGT, s.288 TCGA provides:

> In this Act, unless the context otherwise requires—
> "permanent establishment", in relation to a company, is to be read in accordance with Chapter 2 of Part 24 of CTA 2010;

Similarly, for IT, s.989 ITA provides:

> The following definitions apply for the purposes of the Income Tax Acts—
> "permanent establishment", in relation to a company, is to be read in accordance with Chapter 2 of Part 24 of CTA 2010...

If we had a taxes-act-wide definition this cross referencing would not be necessary.

The statutory definition does not apply in relation to a non-company. If it were ever used in that context it would (subject to context) bear its

4 For instance, see 74.9 (PE in pre-OECD Model treaties).

normal meaning. If the view expressed here is right that domestic law PE should be construed to have the same meaning as OECD law PE, that would be the meaning to apply here too. But perhaps the term is only used in relation to companies, in which case the issue does not arise.

## 74.3 Fixed place of business

Section 1141 CTA 2010 provides:

> For the purposes of the Corporation 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 ...

OECD Model PE is substantially the same as UK law PE. Article 5(1) provides:

> For the purposes of this Convention, the term "permanent establishment" means a fixed place of business through which the business of an enterprise is wholly or partly carried on.

INTM para 264060 discusses UK law PE but that merely repeats and refers to the INTM discussion of OECD Model PE:

> **266050 Fixed place of business permanent establishment** [November 2004]
> [The manual refers to model treaty Article 5(1) and continues:]
> 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.

### 74.3.1 *Geographic condition*

INTM para 266060 provides:

> **Fixed place of business permanent establishment – Geographic condition** [November 2004]
> The words used in article 5(1) make it clear that there is a geographical condition within the fixed place of business treaty permanent establishment definition. There must be a distinct place of business being used for carrying on the business of the enterprise. The place could be premises, facilities, plant or machinery or even a site or installation. But equally the place of business could consist only of a space where premises are not necessarily required for the activities concerned. For example, a street vendor or market barrow enterprise could meet the geographic place condition where the business was carried out from appreciably one place whereas a French travelling salesman arriving in the UK and trading his French produce from door to door before returning to France would not meet the geographic condition and there would be no fixed place of business in the UK. For guidance on the scope for automated machinery to constitute a permanent establishment see INTM266090.
> A place of business of one enterprise could be situated in the business premises of a second enterprise, including possibly an affiliated company, if some space were put at the disposal of the first enterprise. In considering whether a place of business is 'at the disposal of' an enterprise it makes no difference whether that enterprise's use is exclusive or shared, whether the enterprise owns, rents or even occupies a place illegally. As an example of when premises would be considered to be 'at the disposal of an enterprise', a travelling salesman would not be considered to have the premises of each of his prospective customers at his disposal, but a parent company using an office in the headquarters of a subsidiary company to oversee that subsidiary for a period would have had that office space at its disposal. Other examples can be found in the commentary to Article 5.

### 74.3.2 *Degree of permanency*

INTM para 266070 provides:

> **Fixed place of business permanent establishment – Time condition – Degree of permanence of activities** [November 2004]
> The words used in article 5(1) make it clear that there is a time or degree of permanence condition inherent within the term 'fixed place of business' but it is not necessary that equipment or plant be physically fixed to the ground before it could constitute 'a fixed place of business'. There is no certain rule on the period that must pass before a place of business becomes 'fixed' and this can often depend on the nature of the activities. But it is immaterial how long an enterprise operates in another Country if it does not do so at a distinct place.

Since the place of business must be fixed, it also follows that a PE can be deemed to exist only if the place of business has a certain degree of permanency, i.e. if it is not of a purely temporary nature. A place of business may, however, constitute a PE even though it exists, in practice, only for a very short period of time. It is sometimes difficult to determine whether this is the case. Whilst the practices of the different Member States of the OECD are not necessarily consistent in so far as time requirements are concerned, experience has shown that PEs have normally not been considered to exist in situations where a business has been carried on in a country through a place of business that was maintained for less than six months. Conversely practice shows that there were many cases where a PE has been considered to exist where the place of business was maintained for a period longer than six months. One exception to the six month yardstick has been where the activities were of a recurrent nature; in such cases, each period of time during which the place is used needs to be considered in combination with the number of times during which that place is used (which may extend over a period of years). Another exception has been made where activities constituted a business that was carried on exclusively in that country; in this situation, the business may have short duration because of its nature but since it is wholly carried out in that country, its connection with that country is stronger. Temporary interruptions of business activities do not cause a PE to cease to exist.

Where a place of business which was, at the outset, designed to be used for such a short period of time that it would not have constituted a PE but it is in fact maintained for such a period that it can no longer be considered as a temporary one, it becomes a fixed place of business and [as brought out at para 6.3 of the commentary to model treaty article 5(1)] can thus retrospectively be a PE. A place of business can also constitute a PE from its inception even though it existed, in practice, for a very short period of time, if as a consequence of special circumstances, e.g. death of the taxpayer, investment failure etc, it was prematurely terminated.

A PE begins to exist as soon as the enterprise commences to carry on business through a fixed place of business. A period of preparation, as distinct from the real business activities, should not be treated as the business being carried out. The PE ceases to exist with the disposal of the fixed place of business or with the cessation of any activity through it.

A single place of business will generally be considered to exist where, in light of the nature of the business, a particular location within which the activities are moved may be identified as constituting a coherent whole commercially and geographically with respect to the business. For example, the market stall mentioned already if it moved position within a market area. Similarly, a painter who undertook under a single contract to paint a multi-occupied estate would have a single place of business and the duration of his activities at that place would be gauged accordingly. But if the painter entered into individual contracts with unrelated occupants of premises on an estate his activities should be considered separately rather than as a coherent whole.

## 74.3.3 *Personnel condition*

INTM para 266080 provides:

> **Fixed place of business permanent establishment – Personnel condition** [November 2004]
> For a fixed place of business to constitute a PE the business of the enterprise must have been carried on through that place, i.e. persons working in the business must have worked from that place. Those persons could be employees, the entrepreneur or proprietor themselves or any other persons receiving instructions from the enterprise e.g. self-employed consultants.

It would follow that property let out to third parties 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.
> **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).

### 74.3.4 *Items specifically included as PE*

Section 1141(2) CTA 2010 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,[5]
> (c) an office,
> (d) a factory,
> (e) a workshop,
> (f) an installation or structure for the exploration of natural resources,[6]
> (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 [November 2004] sets out a précis of the article and continues:

> The wording of article 5(2)[7] 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 of a fixed place of business, i.e. the geographic, period of duration and personnel conditions.

The point was less clear and it is helpful to see it in writing.

### 74.3.5 *Building site, construction or installation project*

This is the eighth item in the list in s.1141(2) CTA 2010:

> For this purpose a "fixed place of business" includes (without prejudice

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5 See 74.11.2 (Meaning of "branch or agency").
6 This is not in the OECD Model definition.
7 The text erroneously reads: 5(1).

> to the generality of that expression)— ...
> (h) a building site or construction or installation project.

The OECD Model moves this item into a paragraph of its own, and the wording is not quite the same. Article 5(3) provides:

> A building site or construction or installation project constitutes a permanent establishment only if it lasts more than twelve months.

This item, like the first seven in the list, is only a PE if it also meets the geographic, time and personnel conditions.

The INTM para 266130 provides:

> **Fixed place of business permanent establishment – Building sites or construction or installation projects** [March 2007]
> The model treaty article 5 includes specific provisions in para 3 that a building site or construction or installation project constitutes a treaty permanent establishment only where it lasts more than 12 months. The commentary makes it clear that this includes also the construction of roads, bridges or canals, the renovation (involving more than mere maintenance or redecoration) of buildings, roads, bridges or canals, the laying of pipes-lines and excavating and dredging. Additionally, the term 'installation project' is not restricted to an installation related to a construction project; it also includes the installation of new equipment, such as a complex machine, in an existing building or outdoors.
> The OECD member states have made this type of activity the subject of a specific rule because of the frequency with which it caused difficulties of interpretation. And, for clarity in the model treaty, 12 months duration has been taken to be a sufficient indication that the activity is a fixed place of business permanent establishment. Of course particular treaties may vary from the model in this respect and indeed different durations are included in many of the UK's treaties all of which can be referred to in full at DT2150 onwards. The UK domestic charging provisions in [s.1142(2)(h) CTA 2010] 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.

## 74.4 Agency PE

Section 1141 CTA 2010 provides:

> For the purposes of the Corporation Tax Acts a company has a permanent establishment 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*.

OECD Model PE is different. Article 5(5) provides:

> [a] Notwithstanding the provisions of paras 1 and 2, where a person — other than an agent of an independent status to whom para 6 applies — is acting on behalf of an enterprise and has, and habitually exercises, in a Contracting State an authority *to conclude contracts in the name of the enterprise*, that enterprise shall be deemed to have a permanent establishment in that State in respect of any activities which that person undertakes for the enterprise,
> [b] unless the activities of such person are limited to those mentioned in para 4 which, if exercised through a fixed place of business, would not make this fixed place of business a permanent establishment under the provisions of that paragraph.[8]

I refer to this as "**agency PE**" though the term "dependent agency PE" is sometimes used.

### 74.4.1 *Distinctions between OECD and domestic law PE*

Dawn Primarolo (then Paymaster General) explained why the wording of domestic law PE differs from OECD law PE:

8 See 74.7 (PE: preparatory and auxiliary activities).

**Dawn Primarolo**: ... the wording used in clause 147(1)(b) [FB 2003 now s.1142 CTA 2010] to define "dependent agent" varies from the exact wording in article 5(5) of the OECD model tax convention. Instead, it is based on guidance given in the commentary on article 5, which can be found in paragraphs 31 to 45, because article 5 refers to an agent who has the authority to conclude contracts in the name of the enterprise.

However, the OECD commentary on article 5 makes it clear that that phrase is not necessarily to be taken at face value. For instance, it covers contracts in the name of an enterprise, contracts binding on the enterprise but not in its name, and contracts recognised by the agent but signed by some other person, while excluding contracts that do not relate to the business proper of the enterprise, although concluded by the agent. The area is very complicated and there is an interaction between the commentary and the article itself.

UK legislation cannot be directly interpreted by reference to the commentary,[9] so the phrase used in clause 147 is intended to encapsulate the current OECD interpretation in respect of dependent agents. That would not have been achieved if the wording in article 5(5) were copied directly into UK domestic law.

**Mr. Burnett:** The Paymaster General will recall that one of the arguments used by me, the hon. Member for Eddisbury and one or two others who spoke on the matter was that the Inland Revenue confirmed that the reference to an agent in clause 147 is restricted to those persons who contractually can and do bind their principals and not to persons acting in some other representative capacity falling short of having such authority. The Paymaster General is obviously well aware of *Pepper v. Hart* and the reliance people may put on what she says in Committee. I would welcome her comments on that point raised by the Law Society.

**Dawn Primarolo:** I was coming to that important point, which was outlined in a letter to the Law Society and the Chartered Institute of Taxation on 8 May.

I was trying to explain that the article wording must be read in parallel with the commentary. The commentary needed to be part of the description that went into UK legislation in order to make that clear. In drafting the legislation, the importance of maintaining certainty on international understanding and practice on the OECD guidelines and model conventions while understanding how the commentary affects their operation was one of the major points, which was continually made

9 This is not correct, but fortunately no-one present reminded Ms Primarolo of (what is now) s.164 TIOPA (Application of OECD principles).

> to the Revenue and me. That is how we chose the clause's wording. Amendment No. 101 seeks to add to the definition of dependent agent used in clause 147(1)(b). It would mean that an agent would be a dependent agent of a foreign company as long as they had the authority to enter into arrangements on its behalf and had entered into contractually binding arrangements with it. That may not have been the amendment's intended effect, but I ask the Committee to reject it nevertheless. The suggested addition is unnecessary and the language used in clause 147(1)(b) already reflects the current OECD position on dependent agents. As such, no further clarification or definition is required.... The Bill does not extend the charge to tax on non-resident companies and there is no less certainty for an agent of a non-resident company on whether they are within the charge to corporation tax. The rules are set out in the OECD treaty and commentary and in UK law, which has had and will have specific rules to facilitate foreign investment in the City.[10]

Similarly, the INTM para 264050 provides:

> **Permanent establishment – Domestic law definition** [March 2007]
> The definition of domestic law permanent establishment is at [s.1141 CTA 2010]. This is similar to and has the same broad effect as the OECD model treaty article 5 definition of permanent establishment which is an important factor bearing in mind that treaty law takes precedence over domestic law. So it is unlikely that the application of a treaty that followed the model article 5 would cause any variance to the UK domestic charge to tax on a non-resident trading in the UK through a permanent establishment as defined under domestic law. Because of the similarities of wording and effect between PE under domestic law and under the OECD model treaty the guidance on interpretation of treaty PE at INTM266000 is understandably substantially applicable to domestic law PE as well.
> A lot of our interpretation of treaty PE is based on the Commentary to Article 5 of the OECD Model Treaty (INTM266030). Although the Commentary is not imported into UK domestic law the UK has contributed to and agreed the content except in specific instances where the UK has put on record either an observation or a reservation to a specific section of the Commentary. So, where the wording of the UK domestic law PE provisions are the same as those used in the OECD Model Treaty Article 5 then the commentary interpretation on those words will apply to those provisions and this guidance will contain cross-references into the guidance on treaty PE at INTM266000. If the

10 House of Commons Standing Committee B, accessible *www.publications.parliament.uk/pa/cm200203/cmstand/b/st030520/pm/part1/30520s06.htm*

> 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.

The simpler way to achieve the intention would have been to incorporate the OECD definition by reference, but it is considered that the UK law definition has reached that destination, even though by an less satisfactory route.[11] EN CTA 2010 agrees:

> 3253. This Chapter determines what constitutes a permanent establishment in a territory of a company which is not resident in that territory. ...
> 3254. The determination is in line with various internationally recognised characteristics commonly used in the UK's double tax agreements.

### 74.4.2 *OECD model agency PE*

The OECD Commentary provides:

> 31. It is a generally accepted principle that an enterprise should be treated as having a permanent establishment in a State if there is under certain conditions a person acting for it, even though the enterprise may not have a fixed place of business in that State within the meaning of paragraphs 1 and 2. [Article 5(5)] intends to give that State the right to tax in such cases. Thus paragraph 5 stipulates the conditions under which an enterprise is deemed to have a permanent establishment in respect of any activity of a person acting for it. The paragraph was redrafted in the 1977 Model Convention to clarify the intention of the corresponding provision of the 1963 Draft Convention without altering its substance apart from an extension of the excepted activities of the person.

The commentary then turns to the phrase *authority to conclude contracts in the name of the enterprise* which is at the heart of OECD model agency PE:

> 32. Persons whose activities may create a permanent establishment for the enterprise are so-called dependent agents i.e. persons, whether employees or not, who are not independent agents falling under para 6. Such persons may be either

11 If that is right, it answers the concerns expressed in Nias, "Taxation of non-resident companies and the meaning of agent" [2003] BTR 468.

individuals or companies. It would not have been in the interest of international economic relations to provide that the maintenance of any dependent person would lead to a permanent establishment for the enterprise. Such treatment is to be limited to persons who in view of the scope of their authority or the nature of their activity involve the enterprise to a particular extent in business activities in the State concerned. Therefore, para 5 proceeds on the basis that only persons having the authority to conclude contracts can lead to a permanent establishment for the enterprise maintaining them. In such a case the person has sufficient authority to bind the enterprise's participation in the business activities in the State concerned. The use of the term "permanent establishment" in this context presupposes, of course, that that person makes use of this authority repeatedly and not merely in isolated cases.

The commentary turns to the phrase *in the name of the enterprise*:

32.1 Also, the phrase "authority to conclude contracts in the name of the enterprise" does not confine the application of the paragraph to an agent who enters into contracts literally in the name of the enterprise; the paragraph applies equally to an agent who concludes contracts which are binding on the enterprise even if those contracts are not actually in the name of the enterprise.

The commentary turns to the phrase *authority to conclude contracts:*

Lack of active involvement by an enterprise in transactions may be indicative of a grant of authority to an agent. For example, an agent may be considered to possess actual authority to conclude contracts where he solicits and receives (but does not formally finalise) orders which are sent directly to a warehouse from which goods are delivered and where the foreign enterprise routinely approves the transactions.

33. The authority to conclude contracts must cover contracts relating to operations which constitute the business proper of the enterprise. It would be irrelevant, for instance, if the person has authority to engage employees for the enterprise to assist that person's activity for the enterprise or if the person were authorised to conclude, in the name of the enterprise, similar contracts relating to internal operations only.

It seems to me that "agent" can be used in three broad senses:

(1) A person who can *legally* enter into contracts which bind their principal

(2) A person who can *effectively decide whether* to enter into a contractual relationship which binds their principal and any further step to create a contract is a commercial formality or "rubber stamping".

(3) In a looser, colloquial sense, an intermediary, spokesperson, or

representative (who lacks that power).[12]

The meaning here is meaning (2). If in practice the agent can commercially give a commitment, they will be regarded as an agent even if they lack formal authority so that any contract strictly needs to be endorsed by the principal as a formality.[13]

The commentary then turns to the requirement that the authority must be exercised in the state concerned. What about arranging that the negotiating work is done by the agent in a state, but the contract is signed elsewhere? This does not work:

> Moreover the authority has to be habitually exercised in the other State; whether or not this is the case should be determined on the basis of the commercial realities of the situation. A person who is authorised to negotiate all elements and details of a contract in a way binding on the enterprise can be said to exercise this authority "in the State", even if the contract is signed by another person in the State in which the enterprise is situated or if the first person has not formally been given a power of representation. The mere fact, however, that a person has attended or even participated in negotiations in a State between an enterprise and a client will not be sufficient, by itself, to conclude that the person has exercised in that State an authority to conclude contracts in the name of the enterprise. The fact that a person has attended or even participated in such negotiations could, however, be a relevant factor in determining the exact functions performed by that person on behalf of the enterprise.

The article 5(4) exemption (auxiliary & preparatory work, etc)[14] applies to agents:

> Since, by virtue of paragraph 4, the maintenance of a fixed place of business solely for purposes listed in that paragraph is deemed not to constitute a permanent establishment, a person whose activities are restricted to such purposes does not create a permanent establishment either.

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12 "The use of the word 'agent' in any mercantile transaction is, of itself, wholly uninformative of the legal relationship between the parties and the use of the words 'independent agent' takes the matter no further. Either is consistent with a self-employed person acting either as a true agent who puts his principal into a contractual relationship with a third party or with such a person acting as a principal." See *Potter v CE* [1985] STC 45 at p.51 cited with approval in *Umbro International v HMRC* [2009] STC 1345 at [29].

13 The point has been decided the same way in relation to branch/agency: see 74.11.5 (Difference between branch/agency and PE).

14 See 74.7 (PE: preparatory and auxiliary activities).

The commentary comments on "habitually" (which echoes the requirement of "degree of permanency" for a place of business PE):

> 33.1 The requirement that an agent must "habitually" exercise an authority to conclude contracts reflects the underlying principle in Article 5 that the presence which an enterprise maintains in a Contracting State should be more than merely transitory if the enterprise is to be regarded as maintaining a permanent establishment, and thus a taxable presence, in that State. The extent and frequency of activity necessary to conclude that the agent is "habitually exercising" contracting authority will depend on the nature of the contracts and the business of the principal. It is not possible to lay down a precise frequency test. Nonetheless, the same sorts of factors considered in para 6 would be relevant in making that determination.

And lastly two general points:

> 34. Where the requirements set out in paragraph 5 are met, a permanent establishment of the enterprise exists to the extent that the person acts for the latter, i.e. not only to the extent that such a person exercises the authority to conclude contracts in the name of the enterprise.
> 35. Under paragraph 5, only those persons who meet the specific conditions may create a permanent establishment; all other persons are excluded. It should be borne in mind, however, that paragraph 5 simply provides an alternative test of whether an enterprise has a permanent establishment in a State. If it can be shown that the enterprise has a permanent establishment within the meaning of paragraphs 1 and 2 (subject to the provisions of paragraph 4), it is not necessary to show that the person in charge is one who would fall under paragraph 5.

The INTM provides:

> **266160. UK common law – Variance with civil law** [March 2007]
> The majority of European countries have civil law codes whereas the UK has a common law code. Any matters of interpretation of undefined terms used in article 5 or any other article of a treaty should be interpreted in the UK under UK law or at least common meaning. The civil law concept of agency is different from that under common law in that civil law will not usually regard the actions of an agent as though they were the actions of the principal. Civil law separates the relationship between the principal and the agent on the one hand and that between the agent and the third party (including a customer) on the other. Thus civil law countries do not, as the UK does, necessarily see the presence of the non-resident principal in the actions of the resident agent. In the UK, under common law, we interpret any actions carried out by an agent as having been performed for the principal and binding the principal in the same way as though they had carried out those actions themselves. For example, a contract arranged

by an agent in the UK to deliver goods owned by a foreign principal to a customer would be treated for UK tax purposes as though the foreign principal themselves had contracted in the UK for the delivery. This is the case, regardless of whether the contract is written in the name of the principal or in the name of the agent (commentary to model treaty article 5(5), para 32.1 of July 2005 version).

The former ITH provided:

**851.** Treaties following the example of the OECD Model are influenced by the civil law concept of agency. Para 5 of Article 5 of the Model deems an agent to be a permanent establishment if the agent has and habitually exercises an authority to conclude contracts in the name of the enterprise of the treaty partner state, unless the agent is an agent of independent status within para 6. There are two pointers here to civil law influence. One is 'contracts in the name of the enterprise', the other is 'agent of independent status'.

**852. In the name of principal**

The making of contracts in the name of the principal would be regarded by civil law countries as a characteristic of a dependent agent whereas contracts made in the agent's own name would be characteristic of independent status (though the wording of the Article does not preclude the possibility of independent status even if the contracts are in the name of the 'enterprise'). In our law, if the contracts are made on behalf of and with the authority of the principal the relationship of the agent to the principal is not affected by whether the contract is made in the name of the principal or in the agent's own name. So agents, who in all other respects would be dependent agents according to the OECD Model, could in our law make contracts in their own name. We would not wish such agents to be regarded as agents of independent status under a treaty and therefore resist the literal meaning of 'in the name of' and argue that the words should be interpreted as 'on behalf of', which is an acceptable translation of the words 'au nom de' which appear in the French version of the Model Convention. The commentary on Article 5 of the 1992 Model included a note of our view at para 45 and in 1994 a sentence was added to the commentary itself at para 32 confirming that this is now the accepted interpretation.

The INTM discussion of OECD Model PE at 266140 [March 2007] is a lightly adapted version of the OECD commentary, so is not set out here.

### 74.4.3 *USA DTA*

Article 6(5) UK/US DTA provides a definition of agency PE very similar to the OECD model.[15]

The US Department of the Treasury Technical Explanation of the Convention[16] provides:

> The OECD Model uses the term "in the name of that enterprise" rather than "binding on the enterprise". There is no substantive difference. As indicated in paragraph 32 to the OECD Commentary on Article 5, paragraph 5 of the Article is intended to encompass a person who "concludes contracts which are binding on the enterprise, even if those contracts are not actually in the name of the enterprise".
> The contracts referred to in paragraph 5 are those relating to the essential business operations of the enterprise rather than ancillary activities. For example, if the agent has no authority to conclude contracts in the name of the enterprise with its customers for the sale of the goods produced by the enterprise, but it can enter into service contracts in the name of the enterprise for the enterprise's business equipment used in the agent's office, this contracting authority would not fall within the scope of the paragraph, even if exercised regularly.

## 74.5 Independent agent

Section 1142(1) CTA 2010 provides:

> A company is not regarded as having a permanent establishment 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 the agent's business.

The OECD Model is slightly differently worded, but the differences do not seem material. Article 5(6) provides:

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15 "Notwithstanding the provisions of paragraphs 1 and 2 of this Article, where a person—other than an agent of an independent status to whom paragraph 6 of this Article applies—is acting on behalf of an enterprise and has and habitually exercises in a Contracting State an authority *to conclude contracts that are binding on the enterprise,* that enterprise shall be deemed to have a permanent establishment in that State in respect of any activities that the person undertakes for the enterprise, unless the activities of such person are limited to those mentioned in paragraph 4 of this Article that, 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."

16 Accessible *www.irs.gov/pub/irs-trty/temod006.pdf*

> 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 OECD Commentary summarises:

> 36. Where an enterprise of a Contracting State carries on business dealings through a broker, general commission agent or any other agent of an independent status, it cannot be taxed in the other Contracting State in respect of those dealings if the agent is acting in the ordinary course of his business (cf. paragraph 32 above). Although it stands to reason that such an agent, representing a separate enterprise, cannot constitute a permanent establishment of the foreign enterprise, paragraph 6 has been inserted in the Article for the sake of clarity and emphasis.

The view that the independent agent exception is only inserted for the avoidance of doubt is important in contexts (such as pre-OECD model treaties) where the exception is not found.

> 37. A person will come within the scope of paragraph 6, i.e. he will not constitute a permanent establishment of the enterprise on whose behalf he acts only if
> a) he is independent of the enterprise both legally and economically, and
> b) he acts in the ordinary course of his business when acting on behalf of the enterprise.

The requirements of independent status and “ordinary course of business” overlap slightly but it is best to consider them separately.

## 74.5.1 *Independent status*

The OECD comment on “independent status”:

> 38. Whether a person is independent of the enterprise represented depends on the extent of the obligations which this person has vis-a-vis the enterprise. Where the person’s commercial activities for the enterprise are subject to detailed instructions or to comprehensive control by it, such person cannot be regarded

as independent of the enterprise. Another important criterion will be whether the entrepreneurial risk has to be borne by the person or by the enterprise the person represents.
38.1 In relation to the test of legal dependence, it should be noted that the control which a parent company exercises over its subsidiary in its capacity as shareholder is not relevant in a consideration of the dependence or otherwise of the subsidiary in its capacity as an agent for the parent. This is consistent with the rule in paragraph 7 of Article 5. But, as paragraph 41 of the Commentary indicates, the subsidiary may be considered a dependent agent of its parent by application of the same tests which are applied to unrelated companies.
38.2 The following considerations should be borne in mind when determining whether an agent may be considered to be independent.
38.3 An independent agent will typically be responsible to his principal for the results of his work but not subject to significant control with respect to the manner in which that work is carried out. He will not be subject to detailed instructions from the principal as to the conduct of the work. The fact that the principal is relying on the special skill and knowledge of the agent is an indication of independence.
38.4 Limitations on the scale of business which may be conducted by the agent clearly affect the scope of the agent's authority. However such limitations are not relevant to dependency which is determined by consideration of the extent to which the agent exercises freedom in the conduct of business on behalf of the principal within the scope of the authority conferred by the agreement.
38.5 It may be a feature of the operation of an agreement that an agent will provide substantial information to a principal in connection with the business conducted under the agreement. This is not in itself a sufficient criterion for determination that the agent is dependent unless the information is provided in the course of seeking approval from the principal for the manner in which the business is to be conducted. The provision of information which is simply intended to ensure the smooth running of the agreement and continued good relations with the principal is not a sign of dependence.
38.6 Another factor to be considered in determining independent status is the number of principals represented by the agent. Independent status is less likely if the activities of the agent are performed wholly or almost wholly on behalf of only one enterprise over the lifetime of the business or a long period of time. However, this fact is not by itself determinative. All the facts and circumstances must be taken into account to determine whether the agent's activities constitute an autonomous business conducted by him in which he bears risk and receives reward through the use of his entrepreneurial skills and knowledge. Where an agent acts for a number of principals in the ordinary course of his business and none of these is predominant in terms of the business carried on by the agent legal dependence may exist if the principals act in concert to control the acts of the agent in the course of his business on their behalf.

The INTM comments at para 264080:

**Independent agents do not create a permanent establishment** [March 2007] [The INTM summarises s.1142(1) 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.[17] 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.

17 See 74.6 (Controlled companies and group companies).

INTM discusses the OECD Model wording. It partly duplicates the text of the discussion on domestic law agency PE. The other parts provide:

> **266150. Agent of independent status – Article 5(6)** [March 2007]
> ... The work done by an agent, where that work was all done for one non-resident client, is unlikely to be viewed as the conduct of his 'own business' but more likely that of the non-resident's business. An exception to that view might be where the concentration on one client was an unusual occurrence within a settled continuous trade involving several clients. ...

## 74.5.2 *"Ordinary course of business"*

The OECD comment on "ordinary course of business:"

> 38.7 Persons cannot be said to act in the ordinary course of their own business if, in place of the enterprise, such persons perform activities which, economically, belong to the sphere of the enterprise rather than to that of their own business operations. Where, for example, a commission agent not only sells the goods or merchandise of the enterprise in his own name but also habitually acts, in relation to that enterprise, as a permanent agent having an authority to conclude contracts, he would be deemed in respect of this particular activity to be a permanent establishment, since he is thus acting outside the ordinary course of his own trade or business (namely that of a commission agent), unless his activities are limited to those mentioned at the end of paragraph 5.
> 38.8 In deciding whether or not particular activities fall within or outside the ordinary course of business of an agent, one would examine the business activities customarily carried out within the agent's trade as a broker, commission agent or other independent agent rather than the other business activities carried out by that agent. Whilst the comparison normally should be made with the activities customary to the agent's trade, other complementary tests may in certain circumstances be used concurrently or alternatively, for example where the agent's activities do not relate to a common trade.
> 39. [This deals with insurance companies and is not discussed here].

## 74.5.3 *USA DTA*

Article 4(6) UK/US DTA is similar to the OECD model.[18]

The US Department of the Treasury Technical Explanation of the

18 "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 person is acting in the ordinary course of his business as an independent agent."

Convention[19] provides:

> Whether the agent and the enterprise are independent is a factual determination. Among the questions to be considered are the extent to which the agent operates on the basis of instructions from the enterprise. An agent that is subject to detailed instructions regarding the conduct of its operations or comprehensive control by the enterprise is not legally independent.
>
> In determining whether the agent is economically independent, a relevant factor is the extent to which the agent bears business risk. Business risk refers primarily to risk of loss. An independent agent typically bears risk of loss from its own activities. In the absence of other factors that would establish dependence, an agent that shares business risk with the enterprise, or has its own business risk, is economically independent because its business activities are not integrated with those of the principal. Conversely, an agent that bears little or no risk from the activities it performs is not economically independent and therefore is not described in paragraph
>
> Another relevant factor in determining whether an agent is economically independent is whether the agent has an exclusive or nearly exclusive relationship with the principal. Such a relationship may indicate that the principal has economic control over the agent. A number of principals acting in concert also may have economic control over an agent. The limited scope of the agent's activities and the agent's dependence on a single source of income may indicate that the agent lacks economic independence. It should be borne in mind, however, that exclusivity is not in itself a conclusive test; an agent may be economically independent notwithstanding an exclusive relationship with the principal if it has the capacity to diversify and acquire other clients without substantial modifications to its current business and without substantial harm to its business profits. Thus, exclusivity should be viewed merely as a pointer to further investigation of the relationship between the principal and the agent. Each case must be addressed on the basis of its own facts and circumstances.

### 74.5.4 *Broker and general commission agents*

The precise meanings of broker and general commission agent in the OECD Model PE definition do not greatly matter since both terms are

19 Accessible *www.ustreas.gov/offices/tax-policy/library/teus-uk.pdf*

subsumed into "other agent of independent status".

For completeness, "broker" is discussed at 39.5.2 ("Broker"). The former ITH explained "general commission agent" in a passage too amusing to omit:

> **935. General commission agent**
> ... Although the words general commission agent appear in the legislation, nobody really knows what a general commission agent is and textbooks on agency make no reference to such a character; the expression is indeed used in our Double Taxation Agreements but it is not a term that our treaty partners are familiar with. They say it has no particular meaning for them and think that it is there because the British were rather insistent about it.
> **936. London Produce case**
> The one case to which we most often turn for guidance on who may or may not be a general commission agent is the London Produce case [*Fleming v London Produce Co Ltd* 44 TC 582]. The London Produce company acted as agents in importing meat from New Zealand and selling it for commission on the London market. 95 per cent of its business was carried out for one principal. It claimed to be a general commission agent.
> Megarry J enjoyed himself with the expression saying that he found it puzzling and unidentified. He wondered whether he might get at a meaning by looking at the words general, commission and agent separately and then adding the constituent parts together. He felt, however, that that was not a good idea because one could not arrive at the meaning of a particular high office by adding together the separate words lord, privy and seal. He came to the conclusion that a general commission agent must have broker-like qualities as it is included in the term 'broker' in the Section and that it is someone who holds himself out as being ready to work for clients generally. In his view Section 82(1) [TMA] (then Section 373(1) ITA 1952) could not be relevant if 'in substance what is done is that (the non-resident) carries on business within the UK through the medium of an agent who is virtually a sole agent running the entire business for him and merely sending him remittances on request'. London Produce lost the case.
> The only other case is the earlier one of *Boyd v Stephen* [10 TC 698] (concerned with bacon) when Rowlatt rather summarily dismissed the suggestion that the agents were general commission agents on the grounds that they did much more than such an agent would normally do. What the words are probably getting at is somebody like an import commission agent. That is someone, probably more common in 1915, who, acting for a non-resident producer, will sell goods through a broker on the market in return for a commission. It is unlikely that the authors of the Section had in mind the smaller domestic markets such as meat and bacon.

## 74.6 Controlled companies and group companies

Article 5(7) OECD Model provides:

> The fact that a company which is a resident of a Contracting State controls or is controlled by a company which is a resident of the other Contracting State, or which carries on business in that other State (whether through a permanent establishment or otherwise), shall not of itself constitute either company a permanent establishment of the other.

The OECD commentary provides:

> 40. It is generally accepted that the existence of a subsidiary company does not, of itself, constitute that subsidiary company a permanent establishment of its parent company. This follows from the principle that, for the purpose of taxation, such a subsidiary company constitutes an independent legal entity. Even the fact that the trade or business is carried on by the subsidiary company is managed by the parent company does not constitute the subsidiary company a permanent establishment of the parent company.
> 41. A parent company may, however, be found, under the rules of paragraphs 1 or 5 of the Article, to have a permanent establishment in a State where a subsidiary has a place of business. Thus, any space or premises belonging to the subsidiary that is at the disposal of the parent company (see paragraphs 4, 5 and 6 above) and that constitutes a fixed place of business through which the parent carries on its own business will constitute a permanent establishment of the parent under paragraph 1, subject to paragraph 3 and 4 of the Article (see for instance, the example in paragraph 4.3 above). Also, under paragraph 5, a parent will be deemed to have a permanent establishment in a State in respect of any activities that its subsidiary undertakes for it if the subsidiary has, and habitually exercises, in that State an authority to conclude contracts in the name of the parent (see paragraphs 32, 33 and 34 above), unless these activities are limited to those referred to in paragraph 4 of the Article or unless the subsidiary acts in the ordinary course of its business as an independent agent to which paragraph 6 of the Article applies.
> 41.1 The same principles apply to any company forming part of a multinational group so that such a company may be found to have a permanent establishment in a State where it has at its disposal (see paragraphs 4, 5 and 6 above) and uses premises belonging to another company of the group, or if the former company is deemed to have a permanent establishment under paragraph 5 of the Article(see paragraphs 32, 33 and 34 above). The determination of the existence of a permanent establishment under the rules of paragraphs 1 or 5 of the Article must, however, be done separately for each company of the group. Thus, the existence in one State of a permanent establishment of one company of

> the group will not have any relevance as to whether another company of the group has itself a permanent establishment in that State.
>
> 42. Whilst premises belonging to a company that is a member of a multinational group can be put at the disposal of another company of the group and may, subject to the other conditions of Article 5, constitute a permanent establishment of that other company if the business of that other company is carried on through that place, it is important to distinguish that case from the frequent situation where a company that is a member of a multinational group provides services (e.g. management services) to another company of the group as part of its own business carried on in premises that are not those of that other company and using its own personnel. In that case, the place where those services are provided is not at the disposal of the latter company and it is not the business of that company that is carried on through that place. That place cannot, therefore, be considered to be a permanent establishment of the company to which the services are provided. Indeed, the fact that a company's own activities at a given location may provide an economic benefit to the business of another company does not mean that the latter company carries on its business through that location: clearly, a company that merely purchases parts produced or services supplied by another company in a different country would not have a permanent establishment because of that, even though it may benefit from the manufacturing of these parts or the supplying of these services.

There is no equivalent of art 7(5) in UK domestic law PE, but it is considered that the same rules should be implied.

## 74.7 PE: preparatory and auxiliary activities

Section 1143 CTA 2010 provides:

> (1) If the condition in subsection (2) is met, 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.
>
> (2) The condition is that, in relation to the business of the company as a whole, the activities carried on are only of a preparatory or auxiliary character.
>
> (3) 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, and
(d) purchasing goods or merchandise, or collecting information, for the company.

This is a slight rewrite of OECD Model but the differences in wording do not seem significant.

INTM para 264050 discusses this, but need not be set out as it only refers to (and repeats some material from) the INTM discussion of OECD Model PE:

> **266120 Fixed place of business permanent establishment – Activities specifically excluded from the definition of permanent establishment** [March 2007]
> Model treaty Article 5(4) lists certain activities that are not to be treated as permanent establishments even if they are carried on through a fixed place of business.

The Manual sets out a précis of the article and continues:

> In deciding whether or not a fixed place of business of a non-resident enterprise is used for activities of a preparatory or auxiliary nature, consider the following factors:
> a. Are the services it performs so remote from the actual realisation of profits by the enterprise that it would be difficult to allocate any part of the profit to the fixed place of business? If they are, then the fixed place of business will not be a permanent establishment. The benchmark to gauge the activities against are those of the trade as a whole entity. So, for example, if the UK activities are no different to the essence of the trade, e.g. the UK personnel collect market research information and the non-resident company's main trade is concerned with market research, then the activities in the UK would not be preparatory or auxiliary and there could be a permanent establishment in the UK.

An example is a research division of a trading or manufacturing company.

> b. Does the activity of the fixed place of business form an essential and significant part of the enterprise as a whole?

This sentence is from the OECD commentary but with respect it cannot be a correct or helpful test since all the activities specified as auxiliary are significant and some of them are essential.

> A fixed place of business whose general purpose is identical to the general purpose of the enterprise is not used for activities of a preparatory or auxiliary nature. Examples of this are fixed places of business used for the purpose of managing an enterprise, or where a fixed place of business is maintained to supply spare parts of machinery supplied by the enterprise to customers and to service such machinery.
> Note that the exclusion of activities of a preparatory or auxiliary nature from the definition of a permanent establishment only applies if these activities are solely for the non-resident enterprise. If the activities are performed not only for the enterprise but also for other enterprises, including other companies in the same group, then the fixed place of business will not be within the scope of the exclusion.

I find the last paragraph rather surprising though it is in the OECD Commentary. The OECD Commentary explains the reason for the exemption for collecting information:

> The reference to the collection of information in subpara d) is intended to include the case of the newspaper bureau which has no purpose other than to act as one of many "tentacles" of the parent body; to exempt such a bureau is to do no more than to extend the concept of "mere purchase".

## 74.8 Alternative finance arrangements

Section 1144 CTA 2010 deals with alternative finance arrangements, and is not discussed here.

## 74.9 PE in pre-OECD Model treaties

Article 2(1) of the UK/Jersey DTA 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.

To what extent is this different from OECD Model PE? It is suggested that the Courts ought to have regard to the general international law understanding of PE (that is, OECD Model PE) and construe it in the same way. Notwithstanding the multiplicity of definitions, a multiplicity of concepts should be avoided or minimised so far as possible. Otherwise we will never know much about the meaning of this definition as there is will not be the litigation to answer all the puzzles which could arise.

It would be a significant simplification if the old-style treaties could be amended to adopt standard OECD model wording, though, obviously, that cannot be achieved by the UK unilaterally, and the point is not likely to have much priority in the agendas of tax simplification or treaty negotiation.

## 74.10 Why does branch/agency matter?

It is not possible to give a full list, but a branch/agency is important to an individual or trust for the following purposes:

(1) The branch/agency gives rise to a liability to CGT: see 43.8 (Non-resident traders with UK branch).
(2) IT and CGT may be collected from the branch/agency.[20]
(3) The branch/agency may affect the residence of non-corporate trustees.

Lastly, the branch or agency is likely to be a PE, which is relevant for DTAs.

Branch/agency is not relevant to companies. In theory one can envisage a situation where a non-resident company does not have a UK PE but does have a UK branch or agency, and such a company would be within the scope of CGT under s.10 TCGA. In practice, this does not happen, or if it does, no-one takes any notice.[21]

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20 See 38.1 (Collection of tax from UK representatives).

21 See for instance the HMRC trustee residence guidance which states conveniently (if not strictly accurately):
"This is in line with section 10B Taxation of Chargeable Gains Act 1992 *which has the effect that an overseas company is not taxed on the gains made by a UK branch or agency, but only on those made by a permanent establishment here*." (Emphasis added).

## 74.11 Meaning of "branch or agency"

### 74.11.1 *The statutory (non-)definition*

Section 10(6) TCGA provides:

> In this Act, unless the context otherwise requires,
> [a] "branch or agency" means any factorship, agency, receivership, branch or management, but
> [b] does not include any person within the exemptions in section 82 of the Management Act (general agents and brokers).

For the purposes of UK representatives rules[22] the term is likewise defined to mean "any factorship, agency, receivership, branch or management". The definition here does not include the restriction for general agents and brokers but these categories are taken out of the UK representative rules by other provisions.

The definition in s.10(6)[a] TCGA is completely useless, since it incorporates both words being defined, merely adding three further obscure or archaic terms which seem to mean "agent" if they mean anything.[23] The INTM expresses the same point more tactfully:

> **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

22 See 38.1 (Collection of tax from UK representatives).

23 The former ITH explained 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 assessable and chargeable in the name of the factor, agent, receiver, branch or manager."

1988 thus – "any factorship, agency, receivership, branch or management".[24] This is not particularly helpful so we must look for authority elsewhere including case law.

### 74.11.2 *Meaning of "branch"*

The former ITH stated at para 842:

> There is very little guidance on the meaning of 'branch'. We have been advised that the presence of a principal (in the case of a sole trader or partnership) or of employees on a more or less regular basis is likely to be an essential ingredient of a branch (though employees may also be agents).

That repeats the personnel condition in the definition of PE. The INTM discusses the meaning of branch at para 264090 [March 2007]:

> 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.

### 74.11.3 *Meaning of "agency"*

The INTM continues:

> **264100. Agency – Common law concept** [November 2004]
> Practical experience will have introduced all of us to the idea of agency.

24 [Author's Note.] The reference should be s.126(8) FA 1995. However, the definition there is the same, so it does not matter.

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.

### 74.11.4 *Exception for general agents*

Section 10(6)[b] TCGA provides that branch or agency:

> does not include any person within the exemptions in section 82 of the Management Act (general agents and brokers).

The reference is to s.82 TMA 1970 which was repealed in 1995! This provided:

> [a] Nothing in this Part of this Act shall render a non-resident person chargeable in the name of a broker or in the name of an agent not being an authorised person carrying on the regular agency of the non-resident person, in respect of profits or gains arising from sales or transactions carried out through such a broker or agent:
>
> [b] Provided that where sales or transactions are carried out on behalf of a non-resident person through a broker in the ordinary course of his business as such and the broker

(a) is a person carrying on bona fide the business of a broker in the UK, and
(b) receives in respect of the business of the non-resident person which is transacted through him remuneration at a rate not less than that customary in the class of business in question,

then, notwithstanding that the broker is a person who acts regularly for the non-resident person as such broker, the non-resident person shall not be chargeable in the name of that broker in respect of profits or gains arising from those sales or transactions.

In this subsection, "broker" includes a general commission agent.

There are two exceptions here. The exception at [a] applies only to cases where there is no regular agency.[25] This is similar to the rule that casual agents do not constitute an agency PE.[26] The exception at [b] is similar to the broker exemption. There is no statutory exemption for investment managers or other independent agents. This is, I think, an oversight. It is considered that the exemption (or something like it) should be held to be implied.[27] As far as investment managers are concerned, in practice it does not matter much, as individuals or trusts are not likely to be trading in securities (and if they were, I do not expect that anyone would take any notice).

### 74.11.5 *Difference between branch/agency and PE*?

It is considered that "branch" should have (more or less) the same meaning as place of business PE, and "agency" should have (more or less) the same meaning as agency PE, so the composite expression has a very similar meaning to PE.

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25 The phrase "not being an authorised person carrying on the regular agency of the non-resident person" governs "broker" as well as "agent", ie the section means:
"Nothing in this Part of this Act shall render a non-resident person chargeable
[I] in the name of a broker *not being an authorised person carrying on the regular agency of the non-resident person*, or
[ii] in the name of an agent not being an authorised person carrying on the regular agency of the non-resident person,
in respect of profits or gains arising from sales or transactions carried out through such a broker or agent..."

26 See 38.5 (Agents not treated as UK representatives).

27 See 74.5 (Independent agent) citing the OECD Model commentary:
"... it stands to reason that such an agent, representing a separate enterprise, cannot constitute a permanent establishment of the foreign enterprise, paragraph 6 has been inserted in the Article for the sake of clarity and emphasis."

HMRC agree. The SALF Manual provides:

> **704 UK representatives of non-residents chargeable under Case I and II Schedule D** [February 2011]
> *Definition of UK representative*
> Branch or agency has the statutory definition at Section 126(8) FA 1995 of 'Any factorship, agency, receivership, branch or management' but it is interpreted on broadly equal lines to 'permanent establishment'...[28]

In *Brackett v Chater*,[29] the Special Commissioners treated the term "branch or agency" as composite phrase containing a single concept. They did not think it correct to consider separately whether there was a branch, and whether there was an agent. The difficulty with this approach is that it is far from clear what the single concept is, if it is distinct from the concepts of branch, agency or PE. (The statutory definition, as noted, does not help.) The Special Commissioners' solution is to ignore the wording altogether.[30] It is not necessary to go that far, even when dealing with these 19th century fossils, and at a time when more emphasis is placed on a purposive approach. What might be said is that the two concepts can overlap and a branch will often constitute an agency. It may not be necessary to decide whether a person is a branch or an agent, as long as they are clearly one or the other.

The Special Commissioners continued:

> Mr. Brackett represents Drishane in this country and is in sole charge of the day to day conduct of the trading operations other than the formation of contracts. It is not straining language, in our opinion, to say that by entrusting those operations to his care Drishane has established at least a branch in this country. Alternatively Mr. Brackett can properly be described as the manager of those operations, because he personifies them. Nor can we accede to Mr. Brackett's argument that it is

28 Similarly the HMRC trustee residence guidance: "The examples all relate to non-UK resident companies that are trustees. The same principles would apply for other non-UK resident persons who are trustees (and for whom the relevant UK-based entity would be a branch or agency rather than a permanent establishment)."

29 60 TC 134 & 639, at p.646.

30 "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."

> 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 agreed 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.

### 74.11.6 *Can you trade in the UK without a branch/agency or PE?*

In *Brackett v Chater* the judge said:

> ... 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.[31]

This is *obiter*, but given the breadth of the expression it seems right as a general rule but not as an absolute rule. This applies to a PE as well as to a branch/agency.

The former ITH at 846 took the view that trading in the UK without a branch or agency was 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.

31 60 TC 134 at p.149.

> 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.

### 74.11.7 *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.[32]

This was a good reason to change corporation tax, and it is an equally good reason to bring IT and CGT into line. We do not need both concepts. The term PE should be extended to replace "branch or agency" altogether. This would be a worthwhile and trouble-free simplification in the law. It would make no difference whatsoever in practice, because in practice the two terms come to much the same thing, and no-one takes any notice of such differences as there may be, but it would remove some puzzles and complexity in the law.

32 REV BN 25 para 8 (17 April 2002).

CHAPTER SEVENTY FIVE

# DISCLOSURE AND COMPLIANCE

## 75.1 Standards of disclosure and mistake

### 75.1.1 *Standards of care: culpability of mistakes*

It is helpful first to define some terminology and draw some distinctions. Errors may be classified by certain standards:

"**An honest error**" is one where the maker meets the standard of honesty.

"**A non-careless error**" is one where the maker meets the standard of reasonable care.

"**A reasonable-excuse error**" is one for which the maker has a reasonable excuse. This is similar to a non-careless error, but perhaps it reflects a higher standard: it is perhaps possible to envisage an error which is not careless but for which one still cannot find a reasonable excuse. But the difference (if any) is only a matter of nuance and for most purposes they are the same.

The minimum level of care required is that of reasonable care, ie if there is a mistake in a return (or any other document given to HMRC) the error is honest and non-careless.

### 75.1.2 *Standards of disclosure*

Taxpayers disclosure may be classified by various standards:

"**Minimum disclosure**" – the minimum required by statute.

"**Above-minimum disclosure**" meeting some higher standard above that minimum. This is a (deliberately) loose expression since (in the absence of context) a variety of standards might be applied. One particular standard (discussed below) I call "**Veltema-disclosure**" but there can be other standards.

"**Full disclosure**" (in the absence of context) is not an apt expression, and

I prefer to avoid it, because one cannot disclose *everything*: that is not practical. Indeed even to try would swamp HMRC with information so they could not identify what is relevant. HMRC are themselves aware of this. SP 1/06 provides:

> 9. A taxpayer can further restrict the opportunity for discovery [assessments] by providing enough information for an HMRC officer to realise within the enquiry period that the self-assessment is insufficient. However taxpayers are encouraged to submit the minimum necessary to make disclosure of an insufficiency. The Veltema judgement does not require the provision of enough information to quantify the effect on the assessment. Information will not be treated as being made available where the total amount supplied is so extensive that an officer 'could not have been reasonably expected to be aware' of the significance of particular information and the officer's attention has not been drawn to it by the taxpayer or taxpayer's representative.

## 75.2 Self-assessment tax return: minimum disclosure

This section discusses general principles. See also 29.45 (Tax return: disclosure of motive defence).

A tax return is a series of questions, and the statutory duty of taxpayers (and advisers) is simply to answer them. The answers should be honest and non-careless. That is, one cannot necessarily avoid errors, but any errors in the return should be honest and non-careless.

The standard of honesty is the ordinary standard of reasonable and honest people.[1] In practice debate normally focuses on neglect.

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1 But what is that standard? It ultimately depends on the view of the judge or jury as finders of fact. Did Pepys reflect those standards when he wrote in his diary for 10 December 1660:

> "This afternoon there was a Couple of men with me, with a book in each of their hands, demanding money for polemony; and I overlooked the book and saw myself set down *Samuel Pepys, gent.,* 10*s* for himself and for his servants 2*s*. Which I did presently pay without any dispute; but I fear I shall not escape so, and therefore I have long ago laid by 10*l:* for them; but I think I am not bound to discover myself"?

The point of the entry is that he was liable to pay £10 under the Act (12 Car. II c.9) as an esquire. Pepys' good fortune continued under the next poll tax: The entry of 20 March 1667 reads:

> "I ... assessed by the late Pole-bill, where I am rated at an Esquire; and for my office, all will come to about 50*l* – but not more then I expected, nor so much by

## 75.3 Carelessness

### 75.3.1 *Significance of carelessness*

Carelessness is relevant to time limits of assessment and to penalties.

As far as time limits are concerned, it is convenient to read s.34(1) and 36(1) TMA together:

> **34(1)** Subject to the following provisions of this Act, and to any other provisions of the Taxes Acts allowing a longer period in any particular class of case, an assessment to income tax or capital gains tax may be made at any time not more than 4 years after the end of the year of assessment to which it relates. ...
> **36(1)** An assessment on a person in a case involving a loss of income tax or capital gains tax brought about carelessly by the person may be made at any time not more than 6 years after the end of the year of assessment to which it relates (subject to subsection (1A) and any other provision of the Taxes Acts allowing a longer period)....
> (1B) In subsections (1) and (1A), references to a loss brought about by the person who is the subject of the assessment include a loss brought about by another person acting on behalf of that person.

In short, there is normally an (approximately) 4-year limit on assessments. In the case of carelessness, assessments may be made up to 6 years, and in other specified cases up to 20 years.

The taxpayer may be subject to penalties if they are guilty of carelessness. In penalty matters the carelessness must (in short) be personal carelessness of the taxpayer, not of their agents (though it is of course possible for both taxpayer and agent to be guilty of carelessness).[2]

### 75.3.2 *Meaning of "carelessness"*

A note on terminology. Enquiry Manual correctly provides:

> **5125 Culpability: Neglect, Negligence and Negligent Conduct** [August 2009]
> The terms are interchangeable.

a great deal as I ought to be for all my offices – so I shall be glad to escape so."

2 Para 18(3) Sch 24 FA 2007.

Modern drafting uses the word "careless", defined to mean "failure to take reasonable care".[3] This is just a Plain English synonym of "negligence" or "neglect". HMRC agree. Compliance Handbook provides:

> **53400. What is careless behaviour?** [November 2010]
> The 6-year time limit applies where income tax, capital gains tax or corporation tax has been under-assessed or over-repaid due to the careless behaviour of
> - the person, see CH51600, or
> - a person acting on their behalf, see CH53200.
>
> "Careless" means a failure to take reasonable care in relation to your tax affairs.
> Carelessness can be likened to the longstanding concept in general law of "negligence".
> In the 1856 case of *Blyth v Birmingham Waterworks Co*,[4] Baron Alderson said
>
> > 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 prudent and reasonable person would have done, or did that which a person taking reasonable care would not have done.
>
> There is no question of whether or not the person intended to make the inaccuracy or fail to comply with the obligation. If they did that would be deliberate, see CH53700. It is simply a question of examining what the person did or failed to do and asking whether a prudent and reasonable person taking reasonable care would have done that or failed to do that in those circumstances.
> Repeated inaccuracies may form part of a pattern of behaviour which suggests a lack of care by a person in developing adequate systems for the recording of transactions or preparing tax returns. Similarly, repeated failures in relation to the relevant obligations in CH53900 to CH54100 inclusive may suggest a lack of care. It is, however, important to keep a sense of proportion. For example, repetition of the same inaccuracy would not always, of itself, indicate a failure to take reasonable care.
> People do make mistakes. We do not expect perfection. We are simply

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3 See s.29(4) and s.118 TMA as amended; similarly the penalty provisions in Sch 24 FA 2007.

4 (1856) 11 Ex 781, p784.

> seeking to establish whether the person has given the care and attention that could be expected from a reasonable person taking reasonable care in similar circumstances....

This definition will do as well as any other.

The question must be decided in the light of the position as it was at the relevant time without the benefit of hindsight. The fact that a view later turns out to be mistaken does not show that it was careless to form that view. Otherwise any judge whose decision is reversed on appeal would be guilty of carelessness and how often does that happen! The onus of proof generally rests on HMRC to prove carelessness. An allegation of carelessness is a serious one and it should not be lightly made. I stress these points because HMRC ignore them and allege neglect as a matter of course, whenever carelessness is necessary to justify out of time assessments.[5]

Depending on which statutory provision is in point, it may be necessary to ascertain:

(1) whether the taxpayer is guilty of carelessness; or
(2) whether the taxpayer's agent is guilty of carelessness.

### 75.3.3 *The standard of care: taxpayers*

A taxpayer who is not an expert in taxation must leave technical tax issues to their professional advisers. When tax law is complicated a properly represented taxpayer cannot be expected to identify their advisers mistakes. So where there are technical errors of law, the issue is normally whether the taxpayer's professional advisers have been guilty of carelessness. HMRC agree (if grudgingly):

> A taxpayer who
> [1] goes to an ostensibly competent professional adviser,
> [2] provides a full and accurate account of the facts,
> [3] checks that advice to the limit of his or her ability and competence,

5 See eg International Manual which contains this revealing and extraordinary statement:

> "**268520 Assessing time limits** [February 2008]
> … If we come to the reasonable conclusion that there is a PE, or that the company is resident in the UK, prima facie there has been negligent conduct in the failure to notify."

[4] and then follows the agent's advice (or signs the return prepared on that basis)

has not been negligent. He or she has taken reasonable care. If it turns out that the agent has made a careless error in giving the advice or in preparing the tax return the taxpayer who has taken reasonable care will not be penalised.[6]

This wording is somewhat overfavourable to HMRC, at [2] and [3] which (depending on what nuance one puts on the expressions used) do seem to exceed a requirement of reasonable care. But the basic point made is correct.

An interesting question is what the taxpayer should do if their advisers disagree. A safe course then (if the amounts involved make this reasonable) is to seek the advice of counsel, or more senior counsel, or a QC, but what is to be done if two tax QCs disagree or if the amounts do not justify that expense? It is suggested that the correct course is as follows:

(1) The individual must ask himself whether one view or the other is obviously or glaringly wrong. However it is not to be expected that this will often provide a solution.
(2) Subject to that, the individual can in principle follow whichever view suits them, provided that the person whose advice is adopted is suitably experienced, has seen the contrary advice and maintains their view. Then (even if the practitioner whose view is adopted turns out to be wrong) any error is non-careless and a reasonable-excuse error.

### 75.3.4 *The standard of care: tax practitioners*

The question then is what reasonable tax practitioners should do in advising or completing a tax return for a client. The standard of care is that to be expected of a reasonable practitioner.[7]

A solicitor or accountant is entitled to rely on advice given by an

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6 "Modernising Powers, Deterrents and Safeguards: Working with Tax Agents" 22 April 2009, accessible *www.hmrc.gov.uk/budget2009/tax-agent-6440.pdf*

7 Of course, the adviser's duty is not merely (merely?) to understand the law. He/she must explain it, record it in writing, and identify the risk factors to the client. Is this so obvious that it is unnecessary to say? It is not: *Chandrasekaran v Deloitte & Touche Wealth Management* [2004] EWHC 1378 at [72].

appropriate expert counsel (provided it is not obviously or glaringly wrong). A person who acts in this way is not careless.[8] This rule applies in the completion of a tax return. So where counsel has advised, HMRC would normally need to allege that counsel is guilty of carelessness in order to make an out of time assessment.

What should a practitioner do if the law is so unclear that they are unable to form a view? Common examples include residence and the source of interest: in many cases the only honest answer to the question of how a court would decide is "I don't know" or "toss a coin". In such cases the proper course is to complete the tax return on whichever view best suits the client.

A trickier question is where professional views differ between view A and view B, the practitioner prefers view A, but view B suits the client. It is suggested the practitioner can advise the client to fill in their return on view B. Take, for example, the old chestnut problem of GWR and trusts. In my view there is no IHT charge on the death of a deemed domiciled individual who has a GWR in an excluded property trusts. Some practitioners (I think, a minority) take the view that there is a charge. Should they really advise their clients to complete the return on that basis? I would have thought not. If that were wrong, then the best advice one could give would be to change advisers, which can hardly be right.

## 75.4 Significance of reasonable excuse

It is not possible to give a full list. The most important is s.59C TMA which imposes a 5% surcharge on tax paid more than 28 days late and another 5% on tax paid more than 6 months late. It is not a requirement that the taxpayer or their agent be guilty of carelessness. (This is no doubt why the term used is "surcharge" and not "penalty".) Instead there is a defence for a taxpayer with a "reasonable excuse".

## 75.5 Advantages of above-minimum disclosure

This section considers whether a tax return should contain more than the

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8 *Locke v Camberwell Health Authority* [1991] 2 Med LR 249 accessible *www.kessler.co.uk*.

minimum disclosure of answering the questions asked. The "white box" section of a tax return "Any other information" is designed for this purpose, or material may of course be put in a covering letter.

Any such disclosure is strictly voluntary. Everyone who is responsible for completing tax returns has to ask questions and decide on the answers. If an answer is reached, there is in general no obligation to disclose this process of reasoning to HMRC. Failure to do so does not render answers in the return (even if they turn out to be wrong) to be dishonest or careless errors.

The CIOT used to say that expressly:

> *In the preparation of a tax return, there is no duty to provide more information to the tax authorities than the return requires simply because some pieces of information known to the member might support a different tax treatment from that which the member, after due consideration of all the information available to him, honestly considers to be the tax treatment.*[9]

That continues to be the law, and the CIOT have not changed their view, but in the 2011 version of the code they no longer have the confidence to express it in clear and uncompromising terms:

> A tax return must contain at least the minimum information required by law.[10]

That sentence is a truism, and not in any meaningful sense guidance, for the question is to identify the information which is "required by law". However one can infer from what follows that the CIOT view has not changed, as the passage goes on to identify reasons for *voluntary* disclosure:

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9 CIOT, *Professional Conduct in Relation to Taxation* (2004), para 3.10.
The Keith Committee recommended that taxpayers' doubts should be disclosed to HMRC but the recommendation was rightly rejected as impractical: see Committee on Enforcement Powers of Revenue Departments (1983) Cmnd 8822 para 7.3.6 and HMRC consultation papers "The Inland Revenue and the Taxpayer" and "Keith: Further Proposals" (1988).

10 CIOT, *Professional Conduct in Relation to Taxation* (4 Jan 2011), para 3.9 [2011] STI p.215, accessible *www.tax.org.uk*.

> In general it is likely to be in a client's own interests to ensure that factors relevant to his tax liability are adequately disclosed to HMRC ... In addition, it may be desirable to make fuller disclosure than is strictly necessary.[11]

The fact that there is a possibility that the courts might disagree with an adviser's view does not in itself require any disclosure. The law could not sensibly take any other view, as that possibility almost always exists, even if the law seems clear: decisions such as *Rysaffe* and *Grimm v Newman* (happily corrected on appeal) and *Phizackerley* (not appealed) illustrate the uncertainties – or (which comes to the same thing) the lottery element in litigation.

The same of course applies both ways. When HMRC assess tax to the best of their judgement, they disclose what tax they consider due, but not their reasoning.

Voluntary disclosure (in the words of the CIOT, "fuller disclosure than is strictly necessary") may be desirable for any one or more of the following reasons:

(1) It may curtail HMRC's enquiry period.
(2) It may facilitate good relations with HMRC.
(3) It may help avoid allegations of misconduct, which might later arise if the view taken turns out to be in error, and tax is due:
    (a) Allegations of dishonesty (based on a suspicion that the taxpayer might be relying on HMRC not finding out the facts).
    (b) Allegations of carelessness.
    (c) Allegations of no reasonable excuse.

## 75.6 Voluntary disclosure to curtail enquiry period

### 75.6.1 *IT and CGT enquiry*

HMRC usually have 12 months in which to begin an enquiry into a tax return. However, s.29 TMA provides an extension of time in certain cases:

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11 CIOT, *Professional Conduct in Relation to Taxation* (4 Jan 2011), para 3.10, 3.11 [2011] STI p.215, accessible *www.tax.org.uk*.

> (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 was brought about carelessly or deliberately by the taxpayer or a person acting on his behalf.

The first condition will not be satisfied in the absence of fraud or carelessness. 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

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12 Section 29(6) TMA provides:
"For the purposes of subsection (5) above, information is made available to an officer of the Board if—
(a) it is contained in the taxpayer's return under section 8 or 8A of this Act in respect of the relevant year of assessment (the return), or in any accounts, statements or documents accompanying the return;
(b) it is contained in any claim made as regards the relevant year of assessment by

situation mentioned in subsection (1) above.

The advantage of voluntary disclosure is that HMRC cannot (after the one-year period has passed) make any further enquiries into the return. If a taxpayer wants security that the matter is closed after one year, therefore, it would be necessary to disclose relevant facts. I refer to disclosure which meets the requirements of s.29(5) as "***Veltema*-disclosure**".

Taxpayers are entitled to weigh up the advantages of *Veltema*-disclosure (curtailing the enquiry period) against the disadvantages (possible costs).

### 75.6.2 *Veltema standard of disclosure*[13]

The Enquiry Manual provides:

> **3260 Discovery in SA years - Made Available** [August 2009]
>
> ...
>
> In *Langham v Veltema* 76 TC 259, Auld LJ considered two issues relating to s 29(6).
>
> The first issue was 'whether awareness or inference of actual insufficiency is required to negative the condition, or would awareness that it was questionable do'.
>
> The second issue was 'what is the relevant information before the Inspector on the basis of which he could be said to have been reasonably expected to be aware of an insufficiency'.
>
> ***First issue***
>
> In addressing this Auld LJ concluded:

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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; or

(d) it is information the existence of which, and the relevance of which as regards the situation mentioned in subsection (1) above—

(i) could reasonably be expected to be inferred by an officer of the Board from information falling within paras (a) to (c) above; or

(ii) are notified in writing by the taxpayer to an officer of the Board."

13 See Keith Gordon, "Discovery Assessments– The Consequences of the Decision in *Corbally v Stourton*" 12 PTPR 45.

> '.. it is plain from the wording of the statutory test in s 29(5) that it is concerned ... with what he could have been reasonably expected to be aware of. It speaks of an Inspector's objective awareness, from the information made available to him by the taxpayer, of 'the situation' mentioned in s 29(1), namely an actual insufficiency in the assessment. ...
> It is a mark of the way in which the subsection provides an objective test of awareness of insufficiency, expressed as a negative condition in the form that an officer 'could not have been reasonably expected ... to be aware of the insufficiency. It also allows as s 29(6) expressly does, for constructive awareness of insufficiency, that is, for something less than an awareness of an insufficiency, in the form of an inference of insufficiency '.

***Second issue***

Auld LJ considered:

> 'It seems to me that the key to the scheme is that the Inspector is to be shut out from making a discovery assessment under the section only when the taxpayer or his representatives, in making an honest and accurate return or in responding to a Section 9A enquiry, have clearly alerted him to the insufficiency of the assessment in question.'

There is more HMRC guidance in SP 1/06. This comments on valuation and accountancy issues (not discussed here) and then provides:

***Taking a Different View***

18. It is open to a taxpayer properly informed or advised to adopt a different view of the law from that published as HMRC's view. To protect against a discovery assessment after the enquiry period, the return or accompanying documents would have to indicate that a different view had been adopted. This might be done by comments to the effect that the taxpayer has not followed HMRC guidance on the issue or that no adjustment has been made to take account of it. This would offer an opportunity to HMRC to take up the return for enquiry. It is not necessary to provide all the documentation that HMRC might need to quantify that insufficiency if an enquiry into the Return is made.

19. Provided the point at issue is clearly identified and the stance adopted is not wholly unreasonable, the existence of an under-assessment or insufficiency is demonstrated by the statement that a different view of the law has been followed. In these circumstances the taxpayer achieves finality if no enquiry is opened within the statutory time limit.

In *R v HMRC ex p Pattullo*[14] the taxpayer entered into a CGT tax avoidance scheme. In his return he put the following:

> Capital Redemption Contract
> 1. On 24 February 2004 I settled an interest in possession trust with £6,000.
> 2. The trust is called 'The Pattullo 2004 Life Interest Settlement'.
> 3. I had borrowed on commercial terms a sum of £2,665,000 from Investec Bank UK Limited and settled this amount into the trust.
> 4. The trustees 'Nexus Trustee Company Limited' used the funds to acquire a number of capital redemption contracts to me on 4 March 2004.
> 5. I surrendered the Capital redemption contracts on 8 March 2004 and received redemption proceeds of £2,600,000.
> 6. This has given rise to a capital loss as a consequence of Section 37(1) TCGA 1992 amounting to £2,665,000.

I would have thought this made it obvious to any competent inspector exactly what had happened. However the Court of Session held that this did not reach the Veltema standard. Lord Bannatyne said:

> [114] ...the white space does not contain the following:
> 1. A statement that Mr Pattullo was a participant in the CRC Mark II tax avoidance scheme.
> 2. A statement that the petitioner and his advisers had adopted a different view of the law from that published as HMRC's namely: they had taken a view in respect of the tax treatment of Capital Redemption Contracts which is the opposite of that taken by HMRC Capital Gains Tax Manual at CG69004 dated 2 September 2003 (production 7/3) is not contained within the white space.[15] ...

The judge erroneously continues:

> The necessity to make such a declaration in order to comply with the duty to clearly alert has been held to exist in *HMRC v Household Estate Agents Ltd* where it was held as follows:

14 [2009] CSOH 137. Note incidentally that the Latin tag *ex parte* which has been rejected in English law usage seems to have survived in Scotland.

15 This may be factually incorrect, the judge does not set out the relevant text of the Manual, but that does not affect the point of principle.

> "Taxpayers who adopt a different view of the law from that published as HMRC's can protect against a discovery assessment after the enquiry period. The return and accounts would have to indicate that a different view had been adopted by entering comments to the effect that they did not follow HMRC guidance on the issue or that no adjustment had been made to take account of it."

This is a reference to a paragraph in the Special Commissioners decision. The paragraph merely records a submission made by HMRC, which did not form any part of the Commissioners decision in favour of the taxpayer.[16]

> 3. There is no explanation as to how Mr Pattullo contends that Section 37 operates in order to produce the capital loss.
> 4. The details other than the basics of the transactions which have been entered into are not contained within the white space.

The judge wisely does not seek to identify what details were missing.

> 5. There is no indication of any doubt in the disclosure that the petitioner is entitled to the loss. I accept ... that the taxpayer does not require in order to clearly alert to say there is an insufficiency as of course that is not his position. However, in circumstances such as this a reference to doubt or as I have said to the fact that it is, a position contrary to HMRC's would be necessary to comply with the duty incumbent upon him.
> In the absence of information of the type as above described an inspector of the skill and knowledge as I have earlier defined it could not in my judgment have been aware of actual insufficiency. ...

The judge does not say whether it is generally necessary to indicate a doubt. It is suggested that this should not be necessary except in special cases. There must always be a doubt when there is a white box disclosure, for if there is no doubt, what is the point of disclosure?

One can, I think, expect some back-tracking, refinement or qualification from the Courts for taxpayers they regard as more meritorious than Mr. Pattullo.

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16 78 TC 705 at [10]. For completeness, the Commissioners decision was reversed on other grounds on appeal.

### 75.6.3 *IHT: voluntary disclosure to curtail enquiry*

The IHT rules are differently worded (and much more concise) but the standard of disclosure is similar. A certificate of discharge discharges "all persons from any further claim for the tax on the value transferred by the chargeable transfer concerned". See s.239(3) IHTA. However, s.239(4) provides:

> A certificate under this section shall not discharge any person from tax in case of fraud or failure to disclose material facts. ...

## 75.7 Above-minimum disclosure for sake of good relations with HMRC

CIOT Professional Conduct in Relation to Taxation used to provide:

> *It may be in the client's best interest to furnish more information than he is strictly required to do because this is likely to lead to a more reasonable approach by the tax authorities, thereby saving money and time in the long run ...*

In the 2010/11 edition of this work I commented:

> The CIOT are tentative (note the *may*) and the validity of the point is not easy to assess: it may vary from client to client[17] and from time to time. It seems to me that the only tangible incentive for above-minimum disclosure is to curtail the enquiry period, and obtaining "a more reasonable approach by the tax authorities" is uncertain, unquantifiable, unenforceable and ultimately chimerical. But readers who deal directly with HMRC on a daily basis will be in a better position than I am to form a view on this issue, and this is (understandably) an attitude that HMRC wish to encourage.[18]

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17 The trade-off may be different for large businesses who have a "client relationship manager", where HMRC expressly offer the carrot of "far fewer interventions" in return for behaviour which meets the HMRC low risk criteria; and, conversely, the stick of "more intensive scrutiny" for "high risk customers": see HMRC Approach to Compliance Risk Management for Large Business, March 2007, accessible *www.hmrc.gov.uk/budget2007/large-business-riskman.pdf.*

18 See comments on the "enhanced relationship" in the OECD Study into the Role of Tax Intermediaries, 2008, *www.oecd.org/dataoecd/28/34/39882938.pdf* and the OECD's "Engaging with High Net Worth Individuals on Tax Compliance" (May

The CIOT may agree, since in 2011 they watered down this passage which now reads:

> In general it is likely to be in a client's own interests to ensure that factors relevant to his tax liability are adequately disclosed to HMRC because:
> • His relationship with HMRC is more likely to be on a satisfactory footing if he can demonstrate good faith in his dealings with them ...[19]

This debate should be seen in the context of a broader fundamental controversy concerning the relationship between the Revenue and the taxpayer. The traditional view has been that:
(1) The relationship is adversarial: the interests of HMRC and taxpayer are distinct.
(2) The relationship should be characterised by adherence to legal rules (substantive tax rules determining the amount of tax due supplemented by procedural rules such as courtesy, honesty and efficiency).
A rival (and more recent[20]) view is the opposite:
(1) The relationship should be a mutual one, taxpayer and state working together in harmony towards a common goal, to ascertain the proper amount of tax.
(2) The proper amount of tax is defined only partly in legal rules but also discernable from a more insubstantial spirit of the rules.[21] (Perhaps HMRC

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2009); *www.oecd.org/dataoecd/5/25/42798312.pdf.*

19 CIOT, *Professional Conduct in Relation to Taxation* (4 Jan 2011), para 3.10, 3.11 [2011] STI p.215, accessible *www.tax.org.uk.*

20 It is difficult to identify a specific date when this school of thought emerged, but I think it reflects a change of administration around the beginning of the second term of the Labour Government (2001). Contrast the discussion on the term "compliant" in 39.6.4 (Investment manager condition E: customary remuneration).

21 The prime example is the Code of Practice on Taxation for Banks, December 2009 which prescribes that banks should "not undertake tax planning that aims to achieve a tax result that is contrary to the intentions of Parliament; ... not engage in tax planning other than that which supports genuine commercial activity... Remuneration packages for bank employees ... should be structured so that the bank reasonably believes that the proper amounts of tax and national insurance contributions are paid... Relationships with HMRC should be transparent and constructive, based on mutual trust [adding with jarring realism: "wherever possible"]. The features of this relationship should include disclosing fully the significant uncertainties in relation to tax matters... engaging in a co-operative, supportive and professional manner in all interactions ... working collaboratively...."

consider themselves the arbiter of this spirit, or perhaps no arbiter is needed: since the point is not governed by law, the question can be fudged.)[22]

The controversy raises empirical questions of whether HMRC and taxpayers actually regard the later model as their relationship, or pretend to do so, and political and moral questions of whether they should do so, or the extent to which they should do so. These are important questions. They are not legal questions[23] and they lie beyond the scope of this book, but they will not go away. For a recent restatement of the traditional view, see the first speech of Anthony Thomas, president of the CIOT:

> We need to return to the "healthy tension" between HMRC and the tax profession that existed ten to 20 years ago: no special relationships, no cosy conferences; no favours, deals and understandings; no inside tracks and private access. ... Senior tax officials did not subject directors, businesses and the professions to the kind of lectures one would expect from a politician. The job of civil servants is, and always has been, to apply the rule of law in an even handed manner.[24]

## 75.8 Above-minimum disclosure to avoid allegation of misconduct

Disclosure may be sensible to avoid allegations of misconduct, which might later arise if the view taken turns out to be in error, and tax is due: that is, allegations of dishonesty, carelessness or absence of "reasonable excuse". Cases where disclosure is needed for this reason are rare, but examples are:

(1) Where the taxpayer has carried out a complex, artificial, and aggressive tax avoidance scheme. In such a case (even though it is reasonably considered the scheme should succeed) full disclosure of the transactions should be made so HMRC have a proper opportunity to review the matter. In practice such cases will generally be caught by the tax avoidance scheme disclosure rules so the issue of disclosure

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22 HMRC say: "Any disagreements arising under the Code will be dealt with using existing processes." See "A Code of Practice on Taxation for Banks - Consultation Response Document" December 9, 2009.

23 HMRC rightly say (under the heading "The Rule of Law"): The Code is not law. See "A Code of Practice on Taxation for Banks - Consultation Response Document" December 9, 2009.

24 "We need Trust", Taxation (2 June 2011) p.7.

on a tax return does not arise.

(2) Where the taxpayer is taking a view which is contrary to a HMRC view which has been formally published in a SP or RI. The same applies if the HMRC view is clearly known from more informal sources, such as the HMRC Manuals, or informally published correspondence, unless the HMRC view expressed is fairly clearly wrong.

(3) Where the adviser is following a view in the profession which they themselves do not share.

That should be regarded as best practice rather than a requirement.

## 75.9 IHT reporting requirement on creation of settlement

Section 218(1) IHTA provides:

> Where any person, in the course of a trade or profession carried on by him, other than the profession of a barrister,[25] has been concerned with the making of a settlement and knows or has reason to believe—
> (a) that the settlor was domiciled in the UK, and
> (b) that the trustees of the settlement are not or will not be resident in the UK,
> he shall, within three months of the making of the settlement, make a return to the Board stating the names and addresses of the settlor and of the trustees of the settlement.

The duty of disclosure rests on a person ("the practitioner") acting in the course of their trade or profession. The duty rests on the firm or company acting and not directly on its employees.

Barristers are exempt. The reason must be that they will usually be instructed by others who are subject to the duty.

The practitioner must be concerned with the making of a settlement. This would include not only solicitors who might draft the settlement but other advisers who advise in relation to the creation of a settlement, even if the actual execution of the settlement were delegated to foreign advisers.

The practitioner might advise on the matter generally, leaving the client to take whatever action they wish in light of the advice, perhaps in

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25 Section 272 IHTA provides: "barrister" includes a member of the Faculty of Advocates.

conjunction with the trustees; in such circumstances they are probably not "concerned with the making of a settlement"; this presupposes the settlement had been established. What if the client had decided against a non-resident settlement after all or wanted to think about it? The practitioner may not know what the client eventually decided to do. The obligation under s.218 must be restricted to those who are able to provide the relevant information.

The practitioner must know or have reason to believe that the settlor is domiciled in the UK. A settlement may have more than one settlor.[26] Suppose one settlor is domiciled in the UK but the other is not. Does the reporting requirement arise? On a literal construction one could not say "the settlor" is UK domiciled and the reporting requirement would not arise. A purposive construction suggests that the duty does arise. That is the better view at least if the foreign domiciled settlor only provides a nominal amount. A practitioner should err on the side of caution.

A question also arises about the time when the settlor's domicile is relevant. Section 218 merely says that it applies if the settlor *was* domiciled in the UK. Does this mean domiciled in the UK at the time the settlement was made? Or does it mean that the settlor had at any time been domiciled in the UK? Context and common sense dictate that the provision is referring to the domicile of the settlor at the time the settlement was made because that is the date that matters for IHT.

IHT Manual para 42993 [April 2010] correctly provides:

> **42993 Section 218 notices** [April 2010]
> ***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'[27]

26 "Settlor" for this purpose has the usual IHT meaning: see 69.1 (Who is the settlor?). The separate settlements fiction does not apply for this purpose: see 55.4 (The separate settlements fiction).

27 The text is 30 years out of date, since the reference should now be to Sch. 1 Interpretation Act 1978, but the point is still valid.

- In general a company is domiciled where it is registered – *Gasque v IRC* [1940] 2 KB 80.

So where a non-UK resident [Employee Benefit Trust] is established by a company registered in the UK a s.218 notice is mandatory.

The person must know or have reason to believe that the trustees of the settlement are not or will not be resident in the UK

In marginal cases the practitioner may be placed in difficulty. It may be necessary in some cases to disclose the creation of the settlement to HMRC out of caution.

There is no requirement under s.218 to notify the amount or nature of the settled property. However, HMRC have power in s.219 IHTA to require information to be provided by "any person" and they would know from the notification to whom further enquiries could be directed.

Sch. 5A TCGA imposes overlapping reporting requirements relating to non-resident settlements. But s.218 IHTA is wider in some respects. It applies to settlements which are not necessarily non-resident under the CGT rule.[28] Thirdly, the CGT duty is imposed on the settlor. The IHT duty is on the professional advisers.

For the position where IHT DTA relief applies see 63.9 (Claims for foreign IHT credit relief).

### 75.9.1 *Non-resident practitioner*

It is suggested that no duty will arise on foreign practitioners who have no UK connection; the usual territorial limitation must apply: see *Clark v Oceanic* 56 TC 183. At first sight the requirement that the settlor is domiciled in the UK is sufficient to meet the territorial requirement so that no further territorial limitations should be implied. But the domicile connection may be a faint one. Suppose an individual leaves the UK in 2000 and settles in the USA, and in 2003 he makes a settlement. The individual may still be deemed domiciled in the UK, but it is not realistic to expect the US practitioner to file a s.218 return (particularly having regard to the fact that the USA IHT DTA provides some IHT exemption).

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28 For IHT Trust residence, see 4.14 (Trustee residence for IHT). This is quite different from the IT/CGT definition.

### 75.9.2 *Penalty for failure to disclose*

Failure to make the return gives rise only to a nominal penalty.[29] 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.

### 75.9.3 *The future*

A consultation paper was published 9 December 2009.[30] I predict substantially increased penalties for HMRC's customers and their advisors will arrive in due course.

## 75.10 Reporting on death of foreign domiciled individual

I consider here the reporting duty of personal representatives on the death of an individual not domiciled in the UK. The legislation draws a distinction between:

(1) "**excepted estates**"; and
(2) "**ordinary estates**"; I use this term to describe an estate which is not an "excepted estate".

For the position where IHT DTA relief applies see 63.9 (Claims for foreign IHT credit relief).

### 75.10.1 *Ordinary estates*

Section 216(1) IHTA provides (so far as relevant):

> Except as otherwise provided by this section or by regulations under section 256 below, the personal representatives of a deceased person ... shall deliver to the Board an account specifying to the best of his knowledge and belief all appropriate property...and the value of that property.

29 Section 245A(1) IHTA 1984.
30 "Modernising Powers, Deterrents and Safeguards: Tackling Offshore Tax Evasion".

"Appropriate property" is defined in s.216(3) IHTA which provides (so far as relevant):

> Subject to subsections (3A) and (3B) below,[31] where an account is to be delivered by personal representatives ... the appropriate property is—
> (a) [i] all property which formed part of the deceased's estate immediately before his death
> [ii] (or would do apart from s.151A(3)(b) or 151C(3)(b) above),
> [iii] other than property which would not, apart from section 102(3) of the Finance Act 1986, form part of his estate; and
> (b) all property to which was attributable the value transferred by any chargeable transfers made by the deceased within seven years of his death.

Excluded property does not form part of a person's estate immediate before death, so there is no statutory duty to disclose details of excluded property in a person's estate on death. Nevertheless Question 22 of HMRC form IHT 401 asks:

> Did the deceased leave any assets outside the UK? If yes give approximate value.

There is no legal duty to supply this information.[32] But refusal to answer the question may give rise to further enquiries.

There is no statutory duty to disclose details of gifts of excluded property which the deceased made before death. (The gifts do not fall within s. 216(3)(b) IHTA since a gift of excluded property is not a transfer of value.) However the IHT Account (form IHT 400 April 2010) Question 30 provides:

> **Gifts and other Transfers of Value:** Did the deceased make any lifetime gifts or other transfers of value on or after 18 March 1986?

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31 Subsections (3A) and (3B) are not relevant here.

32 HMRC form D2 (Notes, 12/05) tacitly recognised this:

"*If the deceased was domiciled outside the UK when they died, any assets they owned abroad will not be liable to inheritance tax. Even so, you can help us to deal with this estate more quickly if you can give us a rough idea of the value of all of the deceased's estate outside the UK.*"

I have not found a similar comment in the current forms which were revised in 2008.

It is considered that the reference in the question to "gifts" means gifts which are transfers of value so that it is proper to answer "no" even if the deceased made gifts of excluded property. The guidance in IHT 400 Notes (April 2010) shows that the question is not read literally:

> **Gifts and other transfers of value**
> You can enter 'No' and do not need to provide any details if the only gifts made by the deceased were:
> - to their husband, wife or civil partner and spouse or civil partner exemption applies
> - outright gifts to any individual which do not exceed £250 in any one year. (These will be covered by the small gifts exemption.)
> - outright gifts to any individual of money or listed stocks and shares that are wholly covered by the annual exemption
> - outright gifts made regularly from income that did not exceed £3,000 in total each year.
>
> These exemptions are detailed on page 72 of this guide. If the deceased had made any other gifts or 'transfers of value' since 18 March 1986, including transfers into trust, payment of insurance premiums for the benefit of another person, advances out of a trust fund or any assets that were taken out of a trust before death, you must fill in Schedule IHT403 *Gifts and other transfers of value*. In general, a 'transfer of value' is any transaction where the deceased did not receive full value in exchange.

Question 45 IHT 400 provides:

> **Assets held in trust**: Did the deceased have any right to benefit from any assets held in trust (including the right to receive assets held in a trust at some future date)? No/Yes – Use Schedule IHT418.

The word "right" only includes fixed interests, it is not apt to describe discretionary trusts. But it appears that "right to benefit" here is used (confusingly) to mean a right to an estate interest in possession. IHT 400 Notes (April 2010) provides:

> ***Schedule IHT418 Assets held in trust***
> You must complete Schedule IHT418 if the deceased had an interest in possession and the trust is one of the following.
> - A trust that was set up before 22 March 2006 from which the deceased was entitled to benefit.

- An immediate post-death interest.
- A disabled person's interest.
- A transitional serial interest.

This would include an excluded property trust where the deceased had an estate interest in possession. In such a case the answer to Question 45 is, "yes". However only limited information needs to be disclosed in form IHT 418. IHT 400 Notes (April 2010) provides:

> **Foreign trusts** If the deceased had a right to benefit from settled property where the assets are overseas and the person who set up the trust was domiciled outside the UK when the trust was created, please answer questions 2 to 5 only.

75.10.2 *Excepted estates*

The IHT (Delivery of Accounts) (Excepted Estates) Regulations 2004 provides different rules for so-called "excepted estates". Regulation 4(1) provides:

> An excepted estate means the estate of a person immediately before his death in the circumstances prescribed by paras (2), (3) or (5).

Thus there are three categories of excepted estate. The first two apply to a person who dies domiciled in the UK.[33] 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

33 It is doubtful whether a person who is deemed domiciled qualifies under these categories. Reg. 4(5)(b) distinguishes between someone domiciled and someone treated as domiciled in the UK. However, it would be absurd if the estate of a deemed UK domiciliary can never be an excepted estate so it is suggested that the reference to "domiciled in the UK" includes someone deemed domiciled for IHT purposes. But HMRC may disagree. IHT Manual 6020 states that a deemed domiciliary's estate cannot qualify as an excepted estate regardless of the value. The Manual is out of date (as it often is) and is here considering the 2002 Regulations, but the point is the same.

alternatively secured pension fund provisions[34] applies; and

(c) the value of that person's estate situated in the UK is wholly attributable to cash[35] 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.[36]

However, while a so-called excepted estate is not required to put in an account *under s.216 IHTA* it is required to deliver more or less the same information set out in reg.6(2):

> The information specified for the purpose of para (1) is—
> (a) the following details in relation to the deceased—
> (i) full name;
> (ii) date of death;
> (iii) marital or civil partnership status;
> (iv) occupation;
> (v) any surviving spouse or civil partner, parent, brother or sister;
> (vi) the number of surviving children, step-children, adopted children or grandchildren;
> (vii) national insurance number, tax district and tax reference;
> (viii) if the deceased was not domiciled in the UK at his date of death, his domicile and address;
> (b) details of all property to which the deceased was beneficially entitled and the value of that property;
> (c) details of any specified transfers, specified exempt transfers and the value of those transfers;
> (d) the liabilities of the estate; and
> (e) any spouse, civil partner or charity transfers and the value of those transfers.

34 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)."

35 IHT Manual 6018 shows that HMRC sensibly construe "cash" widely, so as to include a bank account.

36 See reg.4(5).

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 their estate for IHT purposes immediately before their 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.

### 75.10.3 *Territorial limitations*

The statutory provisions (as recast in 2004) utterly fail to provide any territorial limitation on the duty to disclose. They merely provide two regimes of disclosure, one for ordinary estates and one for excepted estates. The Courts must devise some territorial limitation, as they have on occasion done elsewhere: *Clark v Oceanic* 56 TC 183. The question is, what should it be? It is suggested that no duty applies to foreign personal representatives of excepted estates. But disclosure in one form or another will be required in all cases where the personal representatives need a UK grant of probate.

### 75.10.4 *Commentary*

The 2004 Regulations impose a significant burden on (primarily) small estates which would not formerly have had to provide these details. Whether this is a necessary burden is a matter on which views may differ. However, the chutzpah in the explanatory notes still deserves to be recorded:

> 7. **Impact**
> 7.1 These Regulations do not impose new costs on business or charities.

### 75.10.5 *Conclusion*

Disclosure is required for an excepted estate even though no tax is payable on the death (eg because the property falls within the nil rate band). How well observed this requirement is in practice is another matter. However, if a foreign domiciled individual wishes to ensure that their personal representatives are under no duty to put in UK returns on their death, they must not have any UK situate property at the time of their death and should appoint foreign executors. Then there is no duty to disclose the assets of the estate.

## 75.11 Proceeds of Crime Act 2002 and disclosure of tax avoidance schemes

These topics require books to themselves and are outside the scope of this book.

APPENDIX ONE

# SOME COMMON STATUTORY TERMS

## App. 1 Introduction

This appendix considers some ubiquitous statutory terms: United Kingdom, Spouse and Civil Partner.

## App. 1.1 "United Kingdom" and related expressions

### App. 1.1.1 *"United Kingdom"*

Interpretation Act 1978 Sch 1 provides that "United Kingdom" means Great Britain and Northern Ireland.

The Isle of Man and the Channel Islands do not form part of the UK.

### App. 1.1.2 *"Great Britain"*

"Great Britain" means England, Wales and Scotland: s.1 Union with Scotland Act 1706 provides:

> That the two Kingdoms of England and Scotland shall upon the First day of May which shall be in the year One thousand seven hundred and seven and forever after be united into one Kingdom by the name of Great Britain …

### App. 1.1.3 *"England"*

The definition of "England" is not usually an issue for tax. However, for completeness, para 5(a) Sch 2 Interpretation Act 1978 provides:

> in any Act passed before 1st April 1974, a reference to England includes

> Berwick upon Tweed and Monmouthshire and, in the case of an Act passed before the Welsh Language Act 1967, Wales.

### App. 1.1.4 *Territorial sea*

"Territorial sea" extends 12 nautical miles from shore, further defined in the United Nations Convention on the Law of the Sea.

Section 1013 ITA provides:

> The territorial sea of the UK is treated for the purposes of the Income Tax Acts as part of the UK.

Section 276 TCGA and s.830 ICTA make the same point for CGT and corporation tax. Section 172 SSCBA makes the same point for NIC.

There is no equivalent provision in the IHT legislation so the territorial sea is not part of the UK for IHT purposes (though this will not often be important).

## App. 1.2 Meaning of "spouse"

The word "spouse" is used frequently in tax legislation so its meaning is important. The IHT Manual provides:

> **11032 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

1 See CG Manual:
> **22070 Definitions** [March 2006]
> A polygamous marriage may be recognised as valid in UK law if it was valid in the country in which the ceremony occurred and, broadly, it was contracted by persons domiciled in that country.

IHTA84/S18. Where the IHTA84/S18 (2) limit applies because of the spouses' foreign domicile (IHTM11033), the total exemption (including any similar lifetime exemptions) may not exceed the IHTA84/S18 (2) limit.

The following are not spouses

- persons who are living together but not lawfully married, however long the relationship may have lasted (England, Wales and Northern Ireland)
- In Scotland the only form of irregular marriage now recognised by Scots law is that by cohabitation with habit and repute. Basically this arises where a man and woman cohabit together at bed and board as husband and wife and behave towards each other as such for a considerable length of time so as to produce a general belief in the society and neighbourhood in which they live, and among their friends and relatives that they are married. They are then presumed to be so in fact although it is impossible to state with any precision a place and a time when they exchanged the consent which is essential for marriage. If it is claimed that this common law style of marriage entitles the parties to the exemption under IHTA84/S.18(1) in either a death or lifetime situation you should refer the file to TG (IHTM1081).[2]
  **(This text has been withheld because of exemptions in the Freedom of Information Act 2000)**
- parties to a bigamous marriage
- persons who were formerly lawfully married but divorced before the date of death/transfer

The argument that discrimination between married and unmarried couples is in breach of Art. 14 ECHR (Prohibition of discrimination) has failed, though only narrowly.[3]

## App. 1.3 Meaning of "civil partner"

Schedule 1 Interpretation Act 1978 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.

> "Civil partnership" means a civil partnership which exists under or by virtue of the Civil Partnership Act 2004 (and any reference to a civil partner is to be read accordingly).

This takes us to s.1(1) Civil Partnership Act 2004 which provides:

> A civil partnership is a relationship between two people of the same sex ("civil partners")—
> (a) which is formed when they register as civil partners of each other—
> (i) in England or Wales (under Part 2),
> (ii) in Scotland (under Part 3),
> (iii) in Northern Ireland (under Part 4), or
> (iv) outside the United Kingdom under an Order in Council made under Chapter 1 of Part 5 (registration at British consulates etc. or by armed forces personnel), or
> (b) which they are treated under Chapter 2 of Part 5 as having formed (at the time determined under that Chapter) by virtue of having registered an overseas relationship. ...

Thus there are two types of civil partnership: those made under UK law, and overseas relationships.

App. 1.3.1 *Overseas relationships treated as civil partnerships*

Section 212(1) CPA 2004 provides:

> For the purposes of this Act an overseas relationship is a relationship which—
> (a) is either
> [i] a specified relationship or
> [ii] 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 and schedule 20 CPA 2004 defines "specified relationships":

| Country or territory | Description |
|---|---|
| Andorra | unió estable de parella |
| Australia: Tasmania | significant relationship |
| Belgium | cohabitation légale, wettelijke samenwoning or gesetzliches zusammenwohnen" |
| Belgium | marriage |
| Canada | marriage |
| Canada: Nova Scotia | domestic partnership |
| Canada: Quebec | union civile or as civil union |
| Denmark | registreret partnerskab |
| Finland | rekisteröity parisuhde or as registrerad partnerskap |
| France | pacte civile de solidarité |
| Germany | Lebenspartnerschaft |
| Iceland | staðfesta samvist |
| Luxembourg | partenariat enregistré or eingetragene partnerschaft |
| Netherlands | geregistreerde partnerschap |
| Netherlands | marriage |
| New Zealand | civil union |
| Norway | registrert partnerskap |
| Spain | marriage |
| Sweden | registrerat partnerskap |
| USA: California | domestic partnership |
| USA: Connecticut | civil union |
| USA: Maine | domestic partnership |
| USA: Massachusetts | marriage |
| USA: New Jersey | domestic partnership |
| USA: Vermont | civil union |

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 includes:

- USA: Hawaii
- Switzerland: Cantons of Genève and Zurich.

I would be interested if a reader could identify a website which provides up to date lists of the general conditions.

### App. 1.3.2 *Pre-2000 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 may be the norm) these terms are not so widely construed, and "spouse" will not include civil partner, etc.

APPENDIX TWO

# MEMBERS OF PARLIAMENT

## App. 2.1 Residence & domicile of MPs and members of House of Lords

Section 41 Constitutional Reform and Governance Act 2010 provides special rules for MPs and members of the House of Lords ("MLs"):

> (1) Subsection (2) applies if a person is for any part of a tax year[1]—
> (a) a member of the House of Commons, or
> (b) a member of the House of Lords.[2]
> (2) The person is to be treated for the purposes of the taxes listed in subsection (3) as resident, ordinarily resident and domiciled in the UK for the whole of that tax year.
> (3) The taxes are—
> (a) income tax,
> (b) capital gains tax, and
> (c) inheritance tax.

In practise this means MPs and MLs are deemed UK resident and

---

1 IHT does not use the concept of tax years, so s.41(9) CRGA 2010 provides:
"In this section, in relation to inheritance tax—
(a) 'tax year' means a year beginning on 6 April and ending on the following 5 April, and
(b) 'the tax year 2010-11' means the tax year beginning on 6 April 2010."

2 Section 41(5)(10) CRGA 2010 defines ML:
For the purposes of this section and section 42 a person is a member of the House of Lords if the person is entitled to receive writs of summons to attend that House....
(10) In determining for the purposes of this section and section 42 whether a person is entitled to receive writs of summons to attend the House of Lords, ignore—
(a) section 2 of the Forfeiture Act 1870;
(b) sections 426A and 427 of the Insolvency Act 1986.

domiciled for almost all tax purposes, though minor taxes such as NICs slip through the net. EN CRGA provides:

> 269. The section provides that MPs and peers are deemed ROD [resident ordinarily resident and domiciled] for the whole of each tax year in which they are a member of either House (including those tax years in which they are a member for only part of the year). This means that they will be deemed ROD from the start of the tax year in which they become a member of that House and to the end of the tax year in which they cease to be a member.

DT relief may apply where a treaty has a suitable tie-breaker.

Section 41(4) CRGA 2010 defines when a person becomes or ceases to be a MP or a ML:

> For the purposes of this section a person—
> (a) becomes a member of the House of Commons when (having been elected to that House) the person makes and subscribes the oath required by the Parliamentary Oaths Act 1866 (or the corresponding affirmation), and
> (b) ceases to be a member of that House when—
> (i) the Parliament to which the person was elected is dissolved, or
> (ii) the person's seat is otherwise vacated.

Since a person will know the exact date when they become an MP or ML, they will have an opportunity for pre-appointment planning. Note that when a person ceases to be a ML or MP, they will continue to be deemed IHT domiciled for another three or four years. Sinn Fein MPs do not take their seats at Westminster so happily escape deemed UK residence and domicile.

Section 41(6) CRGA 2010 excludes judges[3] and bishops (the section is after all only a *political* exercise). This level of micro-detail cannot sensibly be covered even in this book which seeks to be comprehensive: it would be surprising if there are more than one or two individuals concerned (if indeed there are any at all).

3 This makes sense, as a ML who holds a disqualifying judicial office is disqualified from sitting or voting in the House of Lords: s.137(7) Constitutional Reform Act 2005.

## App. 2.2 Members of the European Parliament

The rules do not apply to MEPs. EN CRGA 2010 para 275 discusses the position of a MEP who is also a member of the House of Lords but as far as I am aware no-one falls in this category.

## App. 2.3 Commentary

The Financial Secretary to the Treasury (Stephen Timms) said:

> This is how the vast majority of the UK population is taxed, so it seems right to me ... that MPs and Members of the House of Lords should be taxed on that basis and should not have access to the remittance basis. It is helpful that there is now clear, albeit rather belated, cross-party support for action, following the Conservative's change of position to supporting the principle that MPs and Members of the House of Lords should be required to pay tax in full on their overseas income, gains and assets.[4]

A great deal more could be said about the policy issues relating to these provisions. They were not debated in Parliament: the clauses were a late amendment to the CRGA, which was enacted in a breathless ping pong procedure just before the dissolution of Parliament. But the context of the rules is wholly political - the scrabble for public approval and to knock the opposition - so it would be unrealistic to expect cool and considered reflection. The debate is long-standing.[5]

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4 Hansard, 5 Jan 2010, Column 52WH.

5 There was a comparable debate in relation to Lord Vestey who (though resident and domiciled when ennobled) had shortly before been a tax exile: see the TFD archive on *www.kessler.co.uk*.

APPENDIX THREE

# VISITING FORCES

## App. 3.1 The treaty background

The taxation of visiting forces is based on article X of the Agreement Between the Parties to the North Atlantic Treaty Regarding the Status of Their Forces dated 19 June 1951. This provides:

> 1. [a] Where the legal incidence of any form of taxation in the receiving State depends upon residence or domicile, periods during which a member of a force or civilian component is in the territory of that State by reason solely of his being a member of such force or civilian component shall not be considered as periods of residence therein, or as creating a change of residence or domicile, for the purposes of such taxation.

A period of residence would not normally create a change of domicile (except for IHT deemed domicile) but the drafter also had in mind civil law conceptions of domicile which is a concept more like habitual residence. The article continues:

> [b] Members of a force or civilian component shall be exempt from taxation in the receiving State on the salary and emoluments paid to them as such members by the sending State or on any tangible movable property the presence of which in the receiving State is due solely to their temporary presence there.
> 2. Nothing in this Article shall prevent taxation of a member of a force or civilian component with respect to any profitable enterprise, other than his employment as such member, in which he may engage in the receiving State, and, except as regards his salary and emoluments and the tangible movable property referred to in paragraph I, nothing in this Article shall prevent taxation to which, even if regarded as having his residence or domicile outside the territory of the receiving State, such a

member is liable under the law of that State.
3. Nothing in this Article shall apply to 'duty' as defined in paragraph 12 of Article XI [customs duties and other taxes payable on importation or exportation].
4. For the purposes of this Article the term 'member of a force' shall not include any person who is a national of the receiving State.

## App. 3.2 Residence for IT and CGT

Section 833 ITA provides:

(1) This section applies to an individual who—
(a) is a member of a visiting force of a designated country or of a civilian component of such a force,
(b) is in the UK, but only because of being a member of the force or the civilian component, and
(c) is not a British citizen, a British overseas territories citizen, a British National (Overseas) or a British Overseas citizen.
(2) For the purposes of subsection (1)—
(a) members of the armed forces of a designated country who are attached to a designated allied headquarters[1] are treated as a visiting force of that country, and
(b) whether an individual is a member of a civilian component of such a force is to be determined accordingly.
(3) This section also applies to an individual who—
(a) is of a category for the time being agreed between Her Majesty's Government in the UK and the other members of the North Atlantic Council,
(b) is employed by a designated allied headquarters,
(c) is in the UK, but only because of being employed by the designated allied headquarters, and
(d) is not a British citizen, a British overseas territories citizen, a British National (Overseas) or a British Overseas citizen....
(6) Subsections (1) to (3) are to be interpreted as if—
(a) they were in Part 1 of the Visiting Forces Act 1952, and

---

1 Defined in subsection (7):
" In this section—
"allied headquarters" means an international military headquarters established under the North Atlantic Treaty, and
"designated" means designated for the purpose in question by or under an Order in Council made for giving effect to an international agreement."

(b) references in that Act to a country to which a provision of that Act applies were references to a designated country.

I refer to a person within (1) as visiting forces. Section 833 continues:

> (4) If this section applies to an individual throughout a period, the period is not treated for income tax purposes as—
> (a) a period of residence in the UK, or
> (b) creating a change of the individual's residence or domicile.

Section 833(5) ITA contains an exception:

> Subsection (4) does not affect the operation of section 56 or 460 of this Act (residence etc of claimants) in relation to an individual for any tax year.

EN ITA explains:

> 2498. Subsection (5) ensures that an individual to whom this section applies has the benefit of the personal reliefs to which the individual would be entitled if resident in the UK. Such reliefs will, accordingly, be available in calculating the individual's liability to UK income tax on such income as, for example, UK bank interest, dividends from UK resident companies and UK-based earnings which are not exempt under section 303 of ITEPA.

Section 11(1) TCGA extends the rule to CGT:

> If section 833 of ITA 2007 (visiting forces and staff of designated allied headquarters) applies to an individual throughout a period, the period is not treated for capital gains tax purposes as—
> (a) a period of residence in the UK, or
> (b) creating a change of the individual's residence or domicile.

HMRC TDSI Guidance Notes provide:

> **4.47 Visiting armed forces**
> Members of visiting armed forces are treated as NOR ... but the residence status of their spouses is determined according to the normal rules.
> A person is a member of a visiting force if he or she is a member of the armed forces of Belgium, Greece, Norway, Germany, France, Canada, Italy, Portugal, Netherlands, United States, Denmark, Luxembourg, Turkey, and is based in the

UK, or attached to:

Allied Command Atlantic Headquarters; Channel Command; The Channel Committee; Eastern Atlantic Area Command; Supreme Headquarters Allied Forces Europe; North Atlantic Treaty Organisation.

**4.48 Civilian component of visiting armed forces**

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

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

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

## App. 3.3 Employment income

Section 303 ITEPA provides:

(1) No liability to income tax arises in respect of earnings if—

(a) they are paid by the government of a designated country to a member of a visiting force of that country or of a civilian component of such a force, and

(b) that person is not a British citizen, a British overseas territories citizen, a British National (Overseas) or a British Overseas citizen.

(2) [*This is a definition provision identical to s.833(2) set out above]*

(3) No liability to income tax arises in respect of earnings if they are paid by a designated allied headquarters to an employee of a category for the time being agreed between Her Majesty's government in the UK and the other members of the North Atlantic Council.

(4) But where the employee is a British citizen, a British overseas territories citizen, a British National (Overseas) or a British Overseas citizen, subsection (3) only applies if it is necessary for it to do so to give effect to an agreement between parties to the North Atlantic Treaty.

(5) & (6) [*These are definition provisions identical to s.833(6)(7) set out above]*.

## App. 3.4 Excluded property

Section 155(1) IHTA provides

> 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 UK is due solely to the presence in the UK of such a person while serving as a member of the force.

This takes us to s.6(4) which provides:

> Property to which this subsection applies by virtue of section 155(1) below is excluded property.

In short, emoluments and tangible movable property of visiting forces qualify as excluded property for IHT purposes.

## App. 3.5 Deemed domicile

Section 155(2) IHTA provides

> A period during which any such member of a visiting force as is referred to in subsection (1) above is in the UK 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 UK or as creating a change of his residence or domicile.

Thus (in short) 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). 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).

APPENDIX FOUR

# STUDENTS

## 4.1 Introduction

In general a student is taxed in the same way as any other individual. There is a special rule for ordinary residence; see 3.39 (Students).

## 4.2 DT relief

Article 20 OECD Model Convention provides:

> Payments which a student or business apprentice who is or was immediately[1] before visiting a Contracting State a resident of the other Contracting State and who is present in the first-mentioned State solely for the purpose of his education or training receives for the purpose of his maintenance, education or training shall not be taxed in that State, provided that such payments arise from sources outside that State.

The OECD commentary provides:

> 3. The Article covers only payments received for the purpose of the recipient's maintenance, education or training. It does not, therefore, apply to a payment, or any part thereof, that is remuneration for services rendered by the recipient and which is covered by Article 15 (or by Article 7 in the case of independent services). Where the recipient's training involves work experience, however, there is a need to distinguish between a payment for services and a payment for the recipient's

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1 The OECD commentary provides: "2. The word "immediately" was inserted in the 1977 Model Convention in order to make clear that the Article does not cover a person who has once been a resident of a Contracting State but has subsequently moved his residence to a third State before visiting the other Contracting State."

maintenance, education or training. The fact that the amount paid is similar to that paid to persons who provide similar services and are not students or business apprentices would generally indicate that the payment is a remuneration for services. Also, payments for maintenance, education or training should not exceed the level of expenses that are likely to be incurred to ensure the recipient's maintenance, education or training.

4 For the purpose of the Article, payments that are made by or on behalf of a resident of a Contracting State or that are borne by a permanent establishment which a person has in that State are not considered to arise from sources outside that State.

DTR manual provides:

**1930 Visiting students and apprentices**

Most double taxation agreements provide that students and business apprentices who visit the UK solely for the purpose of their education or training and who, immediately before coming here, were residents of the other country shall be exempt from UK tax on payments which they receive from outside the UK for their maintenance, education or training. Some agreements also provide that certain remuneration which a student or business apprentice receives from employment in this country shall be exempt from UK tax. Various limitations are imposed in particular agreements, often relating to monetary limits, the student's need to supplement grant income, or the type of employment. In every case when an agreement provides an exemption of this type, details of any limitations are given in Part IV of this volume.

Claims for exemption under a students'Article are dealt with in the District which, but for the agreement, would have dealt with any tax on such payments or remuneration. In examining claims, refer to the relevant double taxation agreement to ensure that the conditions for exemption are fulfilled. The following notes give some guidance on matters to be taken into account in considering whether exemption is due

(a) The exemption does not extend to income or capital gains derived by a student or business apprentice from his own investments or from trust income to which he is absolutely entitled.
(b) Whether payments or remuneration are for the student's etc. maintenance, education or training, or for supplementing his resources, or are reasonably necessary, is a question of fact and the onus is on the claimant to provide the evidence. The figures quoted in Statement of Practice SP4/86 (see SE1314) can be used as a guide. Where the payments or remuneration seem to be unreasonably high,

refer the case to Personal Tax Division (Schedule E), Sapphire House, Solihull.

(c) If the payments or remuneration exceed the amount needed for the student's etc. maintenance, education or training, the whole amount is taxable and not merely the excess.

(d) Where the Article provides that remuneration is to be exempted up to a certain monetary limit and the student or business apprentice is resident in the UK under UK domestic law, that amount is additional to the personal allowances available under UK law. For example, if the monetary limit in the agreement is 1,000 and the claimant is entitled to a personal allowance in the relevant year of 3,445, earnings of 4,445 or less will be exempt.

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