TAXATION OF FOREIGN DOMICILIARIES

THIRD EDITION

by

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To my Jane

doch ohne die Liebe

Wäre die Welt nicht die Welt

(GOETHE)

INTRODUCTION

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

My book covers tax and tax planning. With care and foresight direct taxation in the United Kingdom may be largely avoided; or at least, a UK resident foreign domiciled individual need not pay much more tax than if he were not resident. The United Kingdom is tax friendly to the foreign domiciliary. It is sometimes called a tax haven but that is an exaggeration. A foreign domiciliary does not enjoy blanket tax exemption: there are convoluted paths to tax exemptions through the tangled jungle of UK tax legislation. To any problem there may be a choice of possible solutions with advantages and disadvantages. Tax avoidance in the strict sense is not covered, a foreign domiciliary should rarely have need of it.

A great deal has happened since the second edition. The most important developments are the following:

(1) Parliament has passed the Finance Act 2004. The new rules on pre-owned assets materially affect foreign domiciliaries.

(2) The Courts have decided *Slattery v Moore Stephens* (tax negligence) and *Vasili v Christensen* (joint ownership).

(3) The Revenue have published:
   (a) Tax Bulletin 64 (Who is a settlor);
   (b) the Employment Income Manual (which replaced the Schedule E Manual).

Bizarre first instance decisions in *Rysaffe* and *Grimm* (happily both corrected on appeal) well illustrate the uncertainties of law – or (which comes to the same thing) the lottery element in litigation. In tax planning matters, especially, it is not enough to explain the advisor's view of the law. One must identify a risk factor. Of course, this is true of life generally:

> dass eine preiswürdigere Wahrhaftigkeit in jedem kleinen Fragezeichen liegen dürfte, welches ihr hinter eure Leibworte und Lieblingslehren (und gelegentlich hinter euch selbst) setzt, als in allen feierlichen Gebärden und Trümpfen vor Anklägern und Gerichtshöfen![1]

I am very grateful to Peter Vaines my co-author on an earlier book on this topic, and to Robert Venables QC and Stephen Brandon QC for comments and discussions on many aspects of this book. Philip Baker QC kindly gave me the fruits of his research at the Public Records Office on the background to the transfer of asset provisions. I owe a great debt to Jane Hunt who typed and re-typed with patience and skill a manuscript as confusing and intractable as its subject matter.

Comments from readers would be of the greatest value and interest to the author. The pleasure in writing this book consists in the interest of the questions which it raises and the success which it may have achieved in answering them.

This book seeks to state the law as at 1 August 2004.

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

Trusts Discussion Forum

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

A note to the lay reader

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

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Statutes

FA	:	Finance Act
ICTA	:	Income and Corporation Taxes Act 1988
IHTA	:	Inheritance Tax Act 1984
ITEPA	:	Income Tax (Earnings and Pensions) Act 2003
PCA	:	Proceeds of Crime Act 2002
TCGA	:	Taxation of Chargeable Gains Act 1992
TLATA	:	Trusts of Land and Appointment of Trustees Act 1996
TMA	:	Taxes Management Act 1970

Periodicals

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

Other

A&M	:	Accumulation and Maintenance (Trust)
APR	:	Agricultural Property Relief (for IHT)
AUT	:	Authorised Unit Trust
BPR	:	Business Property Relief (for IHT)
CGT	:	Capital Gains Tax
CTO	:	Capital Taxes Office (reorganised into IR (Capital Taxes) in 2001)
DRs	:	Depository Receipts
DT	:	Discretionary Trust
ESC	:	Extra-Statutory Concession
GWR	:	Gift with Reservation of Benefit
IHT	:	Inheritance Tax
IOV	:	Instrument of Variation
IP	:	Interest in Possession (Trust)
IR20	:	Revenue Publication (Residence and Domicile)
IT	:	Income Tax
OEIC	:	Open-Ended Investment Company
OIG	:	Offshore income gain
PET	:	Potentially Exempt Transfer
POA	:	Pre-owned assets
PRs	:	Personal representatives
RI	:	Revenue Interpretation
SDLT	:	Stamp Duty Land Tax
SP	:	Statement of Practice

DISCLAIMER

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CHAPTER ONE

REFORM OF FOREIGN DOMICILIARY TAX AND PROTECTIVE ACTION IN ANTICIPATION

1.1 Policy issues in foreign domiciliary taxation[1]

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

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

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

In other areas where the UK faces international tax competition, those framing the law accept the need for pragmatism:

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1 For further discussion on policy issues, see Residence and Domicile: Response to Background Paper from STEP (16 June 2003); Reviewing the Residence and Domicile Rules (CIOT, 1 August, 2003); both accessible on *www.kessler.co.uk*.

> 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. This very rarely generates any significant yield, because UK assets still have to exceed the inheritance tax threshold ... before any tax is due. But it is a deterrent in marketing terms. Removing the potential inheritance tax charge will help UK managers compete on an equal footing with overseas fund providers.[2]

Another consideration is fairness. It seems fair that those whose links with the UK are less should be taxed less heavily on foreign source income. This is especially so bearing in mind that "residence" does not involve a very close connection to the UK – merely passing the 183 or 91 day tests. Further, a foreign domiciliary may not have had a fair opportunity to arrange his affairs with UK tax in mind; for instance creating settlements from which he was completely excluded. Another consideration is the impracticality (both for taxpayers and for the Revenue) of untangling ownership of assets, especially in family ownership arrangements which are common in third world countries.

There are counter-arguments:

(1) Unfairness as compared with UK resident and domiciled taxpayers.

(2) Loss of tax to UK Revenue.

(3) Unfair tax competition as against other countries.

Argument 1 is ultimately a political issue on which views may differ. Argument 2 is crucial but what will be the overall effect of any reforms is very hard to tell. Argument 3 assumes a level of international fiscal co-operation that does not yet exist, though it may come about in the future.

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2 Press Release 16th October 2002 (OEICs and AUTs) para 6. Another example: "The location of ownership, flagging (registration) and management activities is very 'footloose', since it can easily be transferred from one country to another. This makes it vital to have regard to the fiscal regimes in other countries if we want to maintain a successful shipping industry in the UK. The modern armoury in the battle for success invariably includes a virtually tax-exempt fiscal regime." (Independent Enquiry into a Tonnage Tax, Lord Alexander, HM Treasury 1999.)

Effective low tax is often achieved in other countries by formal or informal concession rather than by law, but the reality is that an individual domiciled in the UK who is prepared to move to find a favourable tax regime can normally find one. In short he is no worse off than the foreign domiciliary who moves from his original home country to the UK. The British system is largely based on the rule of law rather than informal practice.[3]

1.2 History of reforms of foreign domiciliary taxation

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

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

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

Both types of reform have been mooted.

It is certainly a fair criticism of the current system that the adhesive quality of a domicile of origin, and the restrictive rules for the acquisition of a domicile of choice, allow some fortunate individuals to enjoy foreign domicile tax treatment, despite very close UK links and only tenuous, historical and fortuitous links to their domicile of origin.

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

This suggests that the way forward should be or include an alteration of the definition of domicile, at least for tax purposes.

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

In 1987 the Law Commission published recommendations for mild reforms of the general law of domicile but despite initial acceptance by the

3 But see 7.52 (Forward tax agreements).

Government, there was no change in the law. In 1996 the proposals were formally abandoned.[4]

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

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

> It seems more likely than not that, apart from tinkering changes, the present regime will continue for the foreseeable future. But "the major distinguishing feature of the British tax system is its instability".[5] There is also the possibility of EU pressure for reform.[6] 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.

Since then a newspaper campaign has indeed emerged[7] and which has pressed the Government into action, or at least into the appearance of action. The Budgets of March and November 2002 promised, and the Budget of April 2003 has delivered, a "background paper" called "Reviewing the Residence and Domicile Rules as they affect Taxation". Its content[8] is less interesting than what it does not contain:

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4 Law Com. No. 168: The Law of Domicile; Hansard, 16 January 1996: "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 decision for the right reason.

5 *Taxation and Democracy*, Sven Steinmo, Yale University Press, 1993, p.44.

6 See for instance the EU Code of Conduct for Business Taxation *www.europa.eu.int/comm/taxation_customs/taxation/law/primarolo.htm*.

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

8 An outline of the present law (a rehash of IR20 but why reinvent the wheel?); one paragraph summaries of the law of 29 other countries (of insufficient detail to be of any use and generally said to be misleading).
See *www.inlandrevenue.gov.uk/budget2003/residence_domicile.pdf*.

(1) It recites the principles that taxation of foreign domiciliaries:

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

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

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

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

In the depth of the Budget Report 2004 is this paragraph:

> The Government is continuing to review the residence and domicile rules as they affect the taxation of individuals, and is considering various aspects of this issue in the light of the responses to the paper published at Budget 2003. The Government remains determined to proceed on the basis of evidence and in keeping with its key principles. It would welcome further contributions to the debate, which will then be taken forward by the publication of a consultation paper setting out possible approaches to reform.[9]

If it were the case that the Government is inclined to do little or nothing, but wished to postpone announcing that decision for political reasons, this is what one might expect to see.

9 Para. 5.103. The pre-Budget Report (December 2003) contains a virtually identical paragraph in the obscurity of page 121.

1.3 Protective steps in anticipation of law reform

It is impossible to know what will come out of the Government's present review of the taxation of foreign domiciliaries. It is also impossible to know what transitional rules there might be or when the new rules (whatever they are) will take effect.

The worst case scenario is no transitional relief and:

(1) abolition[10] of the remittance basis for foreign income and capital gains accruing to United Kingdom resident foreign domiciled individuals, so these would be taxed on an arising basis;

(2) abolition of the foreign domicile defence to section 660A ICTA 1988, so that a settlor would be taxed on income accruing to the trustees if he had an interest in the settlement;

(3) abolition of the foreign domicile defence to section 86 TCGA 1992, so that a settlor would be taxed on gains accruing to the trustees (or underlying companies) if he had an interest in a non-resident settlement;

(4) abolition of the foreign domicile defence to section 87 TCGA 1992, so that capital payments from a trust to United Kingdom resident beneficiaries would give rise to CGT to the extent that the trust has realised "trust gains";

(5) abolition of the foreign domicile defence to sections 739 and 740 ICTA 1988. This would probably not affect trusts to which the tax motive defence in section 741 applies;

(6) abolition of the foreign domicile defence to section 13 TCGA 1992, so a UK resident foreign domiciled individual would be subject to tax on gains of non-resident close companies in which he is a participator.

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

The best case scenario is tightening the Schedule D Case V remittance basis by:

(1) abolition of the source ceasing rule;

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

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

1.4 Planning in anticipation of reforms

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

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

Trustees of non-resident trusts should consider making capital payments to foreign domiciled UK resident beneficiaries equal to the outstanding trust gains of the trust.[11]

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

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

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

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

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

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

income.

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

All these steps would ideally take place before the next Budget. If there is insufficient time, it would be possible to arrange that a disposal takes place before the Budget by entering into an unconditional contract. The date of disposal is of course the date of the contract: section 28 TCGA 1992. The contract would need to be drafted so that it was unconditional and did not fall within the scope of *Marren v Ingles* 54 TC 76.

CHAPTER TWO

DOMICILE

2.1 Why does domicile matter?

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

(1) Income tax on foreign source income; see 6.1 (Schedule D) and 8.1 (Employment income).

(2) Capital gains tax on foreign situate assets; see 17.1 (CGT).

(3) IHT on foreign situate assets; see 22.1 (IHT).

Domicile is also important for many non-tax purposes.

2.2 The concept of domicile

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

The reader seeking a full discussion of the general law of domicile is advised to turn to Dicey and Morris, *Conflict of Laws*, 13th edition, 2000 ("Dicey"). This is the book that the Revenue always cite. The discussion of domicile in IR20 is brief and sketchy so as to be not worth setting out here.

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

(1) the French or German *Domicil*; or

(2) the meaning of "domicile" in ordinary English usage, which is broader.[1]

2.3 Domicile of origin

Dicey states:

> Rule 9 – (1) Every person receives at birth a domicile of origin:
> (a) A legitimate child born during the lifetime of his father has his domicile of origin in the country in which his father was domiciled at the time of his birth;
> (b) A legitimate child not born during the lifetime of his father, or an illegitimate child, has his domicile of origin in the country in which his mother was domiciled at the time of his birth; ...
> (2) A domicile of origin may be changed as a result of adoption, but not otherwise.
>
> (*Conflict of Laws*, 13th ed., para. 6R-025).

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.
>
> 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.
> (2) When a domicile of choice is abandoned, either
> (i) a new domicile of choice is acquired; or
> (ii) the domicile of origin survives.
>
> (*Conflict of Laws*, 13th ed., paras. 6R-033 and 6R-074).

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

2.5 Acquisition of a United Kingdom domicile of choice

The concern of the person with a foreign domicile of origin will usually be that he might acquire a domicile of choice in the UK. The key to the acquisition of a domicile of choice is the combination of two factors, physical and mental:

(1) the individual must reside in England, Scotland or Northern Ireland; and

(2) he must also form the intention to live there permanently or indefinitely, having no real intention to live anywhere else.

The first condition is easily satisfied, but the second condition is very strict indeed. In *IRC v Bullock* [1976] STC 409 the taxpayer resided in England for 40 years but he always hoped to return to his home of Nova Scotia (to which his wife objected) should he survive her or persuade her to change her mind.

This contingency had sufficient substance to represent a real determination to return home rather than a vague hope or aspiration. Mr Bullock did not acquire a UK domicile of choice but retained his domicile of origin. A similar conclusion was reached in *Buswell v IRC* [1974] STC 266 where Mr Buswell, despite residing in the UK for periods totalling nearly 30 years, retained ties of sufficient substance with his country of origin to avoid acquiring a UK domicile of choice.

This may be contrasted with *Furse v IRC* [1980] STC 596 in which the taxpayer expressed his intention to live in the UK for the rest of his life save only for a contingency that he would return to America in the event that he were to become physically incapable of taking an active interest in his UK farm. This was said to be so vague that it presented no reasonable limit on his intentions and accordingly Mr Furse acquired a domicile of choice in England.

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

It is sometimes said that an individual who has taken up residence in the

UK need only have the intention to reside in this country "indefinitely" to acquire a domicile here. That is correct only if *indefinitely* is understood to mean that the individual intends to reside in this country for the foreseeable future. To put it another way, he may not have the positive intention to reside here permanently, but he has no positive intention of leaving.

In *IRC v Bullock* 51 TC 522 at page 540, Buckley LJ commented on an earlier dictum that:

> A domicile of choice is acquired when a man fixes voluntarily his sole or chief residence in a particular place with an intention of continuing to reside there for an unlimited time.

He said:

> 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.

2.6 Proof of intention

The Courts regard the acquisition of a foreign domicile as a very serious step which is only to be imputed to a person upon clear and unequivocal evidence. If the Inland Revenue wish to show that an individual has acquired a UK domicile of choice the burden lies on them to prove it. In the event of a dispute the Court would have regard to every conceivable factor which might shed light on an individual's true intentions – except registration and voting as an overseas elector (which will be ignored unless the individual wishes otherwise).[2]

"The importance of onus of proof is easily exaggerated. While the burden of proof always exists, few substantial cases turn upon it and in making his factual findings the judge is usually expressing his considered

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2 See s.200 FA 1996. This unprincipled provision was intended to encourage UK expatriates to vote without imperiling their claim to be non-UK domiciled.

judgment as to what in truth occurred."[3] If that is right, then reforms proposed of amending the burden of proof will have little practical effect.

2.7 Retaining a foreign domicile while United Kingdom resident

Suppose an individual comes to the UK and wishes to retain his foreign domicile (and its associated tax privileges). The primary advice to be given to him is clear: he may live in the UK as long as he wishes from year to year but he should not form the intention to settle here permanently. Unless he does so, the essential condition for the acquisition of a new domicile will not be satisfied. But the individual should not be content with this mental step unless his stay here is also a short one. He should also take such practical steps as are possible to broadcast the absence of any intention of residing here permanently and to manifest the 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 has conducted his affairs while in the UK.

The individual should if possible retain ties with his country of origin. There are many ways by which he might do so and he 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 and the execution of a Will taking effect under local law. The Will should include a declaration that the individual intends to return home in due course or the circumstances in which that is to occur. The Will might also express a desire to be buried in that country if possible. Thought should be given to the drafting of this section of a Will in accordance with the individual's own circumstances; a simple declaration of domicile is inadequate.[4]

For the same reasons the individual's social and business commitments in the UK should be minimised. The purchase of a home in this country could indicate a degree of permanence which would not be the case with rented accommodation – but this is not a necessary inference; purchasing

3 Tom Bingham, "The Judge as Juror", *Current Legal Problems* (London: Stevens & Sons, 1985) p.2; reprinted in The *Business of Judging*, 2000, OUP p.2.

4 A UK will may also be appropriate to deal with UK property. See James Kessler, *Drafting Trusts & Will Trusts* Sweet & Maxwell, 6th edn, 19.18 (Best form of will for foreign domiciled testator).

a property may be no more than a financial judgment implying nothing more than an intention of medium-term residence. Involvement in domestic politics or the development of other commitments to the community, such as changing his name (or its spelling) to accord with UK usage, are to be avoided.

Much is often written about burial plots but their importance should not be overstated. The purchase of a burial plot does provide some indication of an intention to be buried in that territory at the time of purchase. If that is the territory of residence it might indicate an intention to remain in that country for the rest of his life. If the burial plot is in the country of origin it provides some evidence of an intention to return home in due course. However, this is not necessarily a matter which deserves much weight.

The assembling of evidence of an intention to return to the country of origin, whilst obviously helpful, is not strictly necessary and in some cases will be unnecessary, maybe even inappropriate. The retention of the foreign domicile of origin is not dependent on establishing a positive intention to return home; rather, it is determined negatively by the absence of an intention to stay in the UK. Accordingly 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.

2.8 Coming to the United Kingdom

The effect that coming to the UK will have on an individual's domicile will depend upon the nature of his domicile immediately before his arrival. A number of possibilities arise. He may have:

(a) a domicile of choice in (say) France (displacing his UK domicile of origin).

(b) a domicile of origin in (say) France.

(c) a domicile of choice in (say) France (displacing his domicile of origin in (say) Italy).

In (a) the question is whether by taking up UK residence his foreign domicile of choice will be lost, causing the UK domicile of origin to revive. His domicile of choice will be lost if he ceases to reside in France with the intention of ceasing to reside there permanently. It may be that the UK residence is intended only to be temporary (for example for the purpose of settling his children safely at school or to be close to aged parents) and there is a positive and clearly evidenced intention to return to France. In that case there would be no intention to cease to reside in France and the domicile of choice would continue.

In (b) an entirely different question arises. The position here is not one of *abandonment* of a domicile of choice but the possible *acquisition* of a domicile of choice. This is decided simply by reference to whether when he comes to the UK the individual resides here with the intention of residing here permanently or indefinitely and with no real wish or expectation of returning to live in his country of origin. Only in these circumstances would the domicile of origin be lost and a UK domicile of choice be acquired.

The third example presents another set of possibilities. When the individual leaves France, the first question will be whether he has ceased to reside there and ceased to intend to reside there permanently. If not, his domicile of choice in France will continue, just as in (a) above. If he does cease to reside there and ceases to intend to reside there permanently, his domicile of choice in France will be lost. However, that is not enough by itself to determine where he will then be domiciled; it will only determine where he is not domiciled. On abandoning his domicile in France he would only acquire a domicile of choice in the UK if he takes up residence here with the intention of permanent or indefinite residence; unless he does so, his domicile of origin in Italy will revive.

It should be noted that in each of these examples there is a common theme – the existing domicile in the foreign country is not abandoned until the individual has actually ceased to reside there. Accordingly, whatever may be his intentions, his domicile will not be lost until physical departure so all necessary or desirable planning which depends for its effectiveness on a foreign domicile can safely be undertaken prior to departure from the other country.

An interesting slant on this issue was provided by *Plummer v CIR* 60 TC 452 in which Miss Plummer failed in her claim to have lost her domicile of origin in England and to have acquired a domicile of choice in Guernsey. It was held that a person who retains a residence in his domicile of origin can only acquire a domicile of choice elsewhere if the residence established in the other country is his chief residence. The case contains passages which suggest that a domicile of choice can be lost whilst continuing to intend to reside in that territory and furthermore that the same applies to the loss of a domicile of origin. In the author's view both propositions are open to question and in the case of the loss of a domicile of origin it is difficult to see how it can be correct.

The suggestion that a domicile of choice in a country can be lost whilst continuing to intend to reside there is directly contrary to the established rule (Dicey: Rule 13):

> 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.

Plummer seeks to replace this rule or to interpret it so that a domicile of choice is lost where the individual has merely established a more important residence elsewhere, irrespective of his intentions. This conclusion is explained thus:

> Rule 13(1) of Dicey & Morris, if read literally, appears to go too far.... 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 formed with dual residence in mind.
> (60 TC 452, at 463, 464)

However, there seems to be scant authority for this proposition, in contrast to the weight of authority to the contrary. The Court sought to rely on *Udny v Udny* (1869) 1 Sc & Div App 441 which indicated that loss of a domicile of choice is not inconsistent with the retention of a place of residence in that country if the chief residence had been established elsewhere. The earlier case of *Forbes v Forbes* [1854] Kay 341 lends some support to this limited proposition in the following terms:

> If a person has two homes in different countries he is in the absence of a contrary intention domiciled in the country in which he has his permanent home.

But this is some way from the proposition that a person can lose his domicile of choice in a country despite retaining a place of residence in that country. As long ago as 1860 in *Maxwell v McLure* 8 WE 370 Lord Cranworth made it quite clear that:

> When a residence is retained in a place where a party has been domiciled, it is a circumstance, and a very cogent circumstance, to show that that party does not mean to change his domicile.

In *Fielden v IRC* 42 TC 501 the taxpayer who had lost his UK domicile of origin on the acquisition of a domicile of choice in Michigan subsequently returned to the UK where he lived for 22 years to run the family business. Despite his chief residence obviously being in the UK, he retained his domicile of choice until such time as his intention to return to the USA became too vague and uncertain.

Again in *Ross v Ross* [1926] SLT 689 it was held in the clearest terms that the intention to abandon the domicile of choice is an essential element, and in *Huntly v Gaskell* [1906] AC 56 the suggestion that the chief residence should be conclusive was rejected firmly by the House of Lords as a “monstrous proposition”.

It is even more difficult to see how this reasoning can apply to a domicile of origin. Domiciles of origin and choice are lost in entirely different ways. A domicile of origin is lost only by the positive act of taking up permanent residence in a new territory. Ceasing to reside or intending to reside in the country of origin is not relevant on its own – the domicile of origin will continue unless and until the positive conditions of residence and the intention of permanent residence in the new country are satisfied. By contrast, a domicile of choice is lost in exactly the opposite way, by ceasing to reside in the chosen territory without any positive intention of residing permanently anywhere else. For it to be suggested that the establishment of a chief residence, which may be taken to mean the predominant place of residence (perhaps being one of a number of possible choices) can be the relevant test for both these conflicting tests seems to be impossible.

It could be said that the commentary to Dicey’s Rule 6 provides a reconciliation, stating as it does that where a person has two homes in different countries he will be domiciled in the territory in which he has his principal home. However, that seems entirely appropriate to select one from two competing domiciles of choice; it seems inadequate on its own as a reason to override the express terms of Dicey’s Rule 13 which sets out the specific conditions which need to be satisfied for the loss of a domicile.

2.9 Refugees

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

2.10 Acquisition of UK citizenship

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

The Inland Revenue in practice accept that a naturalised citizen may retain a foreign domicile.[5] However, the foreign domiciliary who applies for UK citizenship would be well advised to consider his domicile position, and it may be appropriate to take other steps to manifest his ultimate intention to return home in due course.

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

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

An individual cannot shed his UK domicile of origin without acquiring a domicile of choice in another territory; it is not enough to demonstrate the clearest intention to leave the UK permanently, never to return. The

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

domicile of origin is not lost by abandonment but by replacement. His departure from the UK must therefore be accompanied by permanent residence in the chosen territory. Accordingly, as little time as possible should thereafter be spent in the UK and good reasons given for any subsequent visits; certainly the time spent in the UK should not be sufficient to cause the individual to be UK resident.

The deemed domicile rules for inheritance tax must also be borne in mind; for three years after a change of domicile the individual is deemed to remain domiciled in the UK for inheritance tax purposes: see 22.3 (Deemed UK domicile).

The acquisition of a foreign domicile which is motivated purely by tax considerations is fraught with difficulty because the intention to reside in the other territory permanently may become confused with the desire merely to reap the tax benefits. In such circumstances the intention to live in the territory may prove to be insufficiently firm to support the acquisition of a domicile there. The story of the late Sir Charles Clore may serve as an example. It is recorded that the last two years of his life were saddened by his move to Monaco (where he had taken up residence with the intention of losing his UK domicile of origin) and he often thought of returning to England which he called "home". In such circumstances he was not surprisingly held to have remained domiciled in the UK: see *Re Clore (No. 2)* [1984] STC 609.

On the other hand, if a UK domiciliary has plans of a business or personal nature which already take him abroad for a lengthy period, then the further step of acquiring a foreign domicile may become feasible.

2.12 Married women

Until 1 January 1974, a married woman had the domicile of her husband. This was called a domicile of dependancy. 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.

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 taken as evidence of an intention to reside in the UK permanently, but of course that depends on all the facts.

The position regarding women who married before 1st January 1974 is more complex. Section 1(2) of the Act provides:

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

On the effect of this see *IRC v The Duchess of Portland* 54 TC 648.

2.13 Revenue ruling on domicile

2.13.1 *Statutory rulings and appeals procedures: 2002/03 and onwards*

Sections 42 and 43 ITEPA 2003 provide a ruling procedure for employment income:

> **42 Board to determine dispute as to domicile or ordinary residence**
> (1) This section applies if, in connection with any of the provisions listed in subsection (3), there is a dispute as to whether a person is or has been ordinarily resident or domiciled in the United Kingdom.
> (2) The question whether the person is or has been so resident or domiciled is to be referred to and decided by the Board of Inland Revenue.
> (3) The provisions referred to in subsection (1) are —
> [*List not printed here; it appears to include every relevant provision in the ITEPA: sections 15, 21, 22, 23, 25, 26, 341, 342, 355, 376, 390*]
> **43 Appeal against Board's decision on domicile or ordinary residence**
> (1) A person who has been given notice of the Board's decision on a question under section 42 may, if aggrieved by that decision, appeal to the Special Commissioners.
> (2) The notice of appeal must be given to the Board within 3 months after the date on which the person is given notice of the Board's decision.

Section 9(2) TCGA 1992 applies the same procedure for CGT purposes. A formal ruling for IHT will be made by a notice of determination, see s.221 IHTA 1984; or for other IT purposes by means of an assessment.

It is difficult to see the need for a special procedure of rulings and appeals on residence. The sections could be repealed so that ordinary assessment and appeals principles would apply consistently; but they do no particular harm.

2.13.2 *Statutory procedure before 2002/03*

Paragraph 12 Sch 7 ITEPA 2003 provides:

> *Disputes as to domicile or ordinary residence*
> 12 (1) Nothing in sections 42 and 43 (disputes as to domicile or ordinary residence) has effect where the dispute relates to the amount of income charged to tax for the tax year 2002 - 03 or any earlier tax year.
> (2) Nothing in those sections—
> (a) as applied by section 645(4C) of ICTA (earnings from pensionable employment) or section 76(6E) of FA 1989 (non-approved retirement benefits schemes) has effect where the dispute relates to the amount of income charged to tax for the tax year 2002 - 03 or any earlier tax year, or
> (b) as applied by section 9(2) of TCGA 1992 (residence, including temporary residence) has effect where the dispute relates to the amount of capital gains tax charged for the tax year 2002 - 03 or any earlier tax year.
> (3) Accordingly, section 207 of ICTA (disputes as to domicile or ordinary residence) continues to apply to the disputes mentioned in sub-paragraphs (1) and (2) whether they arise before or after 6th April 2003.

The differences between the old rules and the new rules are minor ones: see ITEPA Explanatory Notes Annex 1 changes 8 and 9.

2.13.3 *Obtaining a Revenue ruling on domicile*

The practice of the Inland Revenue is not to comment on an individual's domicile unless it is immediately relevant to the determination of a current tax liability. (See Employment Income Manual paragraph 42806 and Inspector's Manual 1635). In practice, where domicile is relevant, the

Revenue usually give informal rulings; their view is obviously important as it will form the basis of their approach to an individual's tax affairs.

To obtain the Revenue opinion on a question of domicile some positive steps should therefore be taken, for example:

(1) A UK resident individual might invest so as to receive significant foreign source income and retain the income outside the UK.

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

(3) A resident or non-resident individual might transfer foreign property of an amount in excess of the inheritance tax nil rate band plus available exemptions to a discretionary settlement.[6]

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

In case (3) the individual strictly has no tax return to submit but the transfer to the discretionary settlement would be a chargeable transfer on which inheritance tax would arise if he were domiciled in the UK. If he were domiciled outside the UK the transfer would be of excluded property and no tax would arise. The Inland Revenue would therefore need to consider the individual's domicile to determine whether any tax arises on this transfer.

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6 Other possibilities which the Revenue contemplate are:
(1) A claim for UK tax relief in respect of contributions to a non-UK pension scheme or retirement benefit plan which are incurred out of remuneration received from an employer who is not resident in the UK.
(2) A claim in respect of costs in travelling between the country in which the individual normally lives and the UK which have been borne or reimbursed by the employer.
(3) Unremitted overseas chargeable earnings.

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

2.13.4 *Are the Revenue bound by their ruling?*

It is an interesting question how far the Inland Revenue would be bound by any informal ruling they may give on domicile. In principle they would not be precluded from taking a different view at a later date even if the individual's circumstances had remained entirely unchanged. However, it would be most unusual (and possibly the subject of a successful application for judicial review) if they were to resile from their earlier ruling, unless it could be suggested that the individual had not disclosed all relevant information or there had been some change in circumstances.

2.13.5 *Revenue practice*

The Revenue practice is as set out in Tax Bulletin 29 (June 1997) as follows:

> Domicile
> Initial non-domicile claims may be made on form DOM1, form P86[7] or in the SA [Self Assessment] tax return. We will continue to deal with initial non-domicile claims which are made before we have received the return for the year in which the claim is made. And we will let claimants know how their claim to be non-domiciled in the United Kingdom has been treated. But we may ask questions to check the validity of the claim as part of a formal Taxes Management Act 1970, s9A enquiry into the SA tax return.
>
> Advice, Guidance and Enquiries
> ...
> With domicile it is likely that ticks in boxes 9.5 and 9.28 on the "NON-RESIDENCE ETC" pages of a return will prompt a review of an individual's domicile which may lead to the issue of a Taxes Management Act 1970, s9A enquiry. And we may issue a form DOM1 as part of a Taxes Management Act 1970, s9A enquiry into the

7 Entitled "Arrival in the UK".

return. But where, for example, an individual:

- has a domicile of origin outside the United Kingdom; and
- has come to the United Kingdom only for the purpose of employment; and
- intends to resume residence abroad when the employment ceases; and
- has given such information on a form P86

we are unlikely to issue an enquiry into the domicile position.

A tick in box 9.29 of the "NON-RESIDENCE ETC" pages is also likely to prompt a review of an individual's domicile and the issue of a Taxes Management Act 1970, s9A enquiry. At that stage we will review the individual's domicile from the date of any change in circumstances. In line with current practice, but depending on the circumstances of any particular case, we may only change the basis of assessment from 6th 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 6th April following the date our enquiries are concluded.

If an individual completes and files the supplementary "NON-RESIDENCE ETC" pages fully disclosing all the relevant information with his or her tax return then, after the statutory period for enquiring into the return has expired, the Revenue would not be able to challenge the individual's residence status or domicile for the purposes of calculating the tax liabilities shown on that return. That is, unless we subsequently receive or find information enabling us to make a discovery on the grounds of inadequate disclosure or fraudulent or negligent conduct on the part of the individual.

2.14 Inheritance tax deemed domicile

For the IHT deemed domicile rules, see 22.2 (Three classes of domicile for IHT).

2.15 Domicile of company

The domicile of a company is its place of incorporation.[8] Domicile of a company is only rarely important for tax purposes.

8 *Gasque v IRC* 23 TC 209; Dicey & Morris *Conflict of Laws*, 13th ed, para 30-002.

CHAPTER THREE

RESIDENCE OF INDIVIDUALS

3.1 Why does residence matter?

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

(1) The charge to income tax on foreign investment and employment income which applies to residents; see 6.1 (Investment income) and 8.1 (Employment income).

(2) The exemption for certain UK source income of non-residents: s.128 FA 1995.

(3) Capital gains tax; see 17.1 (CGT).

3.2 Source materials

There is nothing like a definition of "residence" in the legislation, but five statutory provisions impinge on the subject. Residence has also been discussed in a fair number of decisions by the Courts. Much more important in practice is Revenue booklet IR20 supplemented in minor respects by the Inland Revenue Manuals, Tax Bulletin 52 and "Notes on Non-Residence" (Revenue leaflet NRN1).

3.3 The statutory provisions

Three separate provisions relate specifically to Schedule D, employment income and CGT.

3.3.1 *Schedule D and employment income residence rules*

Section 336(1) ICTA 1988) provides:

> A person shall not be charged to income tax under a charge to which subsection (1A) applies[1] as a person residing in the United Kingdom, in respect of profits or gains received in respect of possessions or securities out of the United Kingdom, if—
> (a) he is in the United Kingdom for some temporary purpose only and not with any view or intent of establishing his residence there, and
> (b) he has not actually resided in the United Kingdom at one time or several times for a period equal in the whole to six months in any year of assessment,
>
> but if any such person resides in the United Kingdom for such a period he shall be so chargeable for that year.

I call this the "Schedule D residence rule".

The "employment income residence rule" is in s.336(2):

> For the purposes of determining taxable earnings from an employment under Chapters 4 and 5 of part 2 of ITEPA 2003 (employment income: charge to tax), a person who is in the United Kingdom for some temporary purpose only and not with the intention of establishing his residence there shall not be treated as resident in the United Kingdom if he has not in the aggregate spent at least six months in the United Kingdom in the year of assessment, but shall be treated as resident there if he has.

The question of residence may arise for some other income tax purpose. In particular it may arise for Schedule F or D III.[2] It is suggested that these provisions should be regarded as laying down a rule which applies to income tax generally. This is the Revenue view. Inspector's Manual paragraph 43 provides:

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1 Subsection 1A applies to the charge under Schedule D and certain classes of pension income charged under Schedule D before ITEPA. There is no point setting this out here in full as the details are irrelevant.

2 s.128 FA 1995.

In practice, however, ICTA 1988, s 336 is applied to other Schedules and cases as its language has an 'illustrative value' (see Rowlatt, J, in *Lysaght v CIR* 13 TC 511 at 515) on all questions of residence.

3.3.2 *CGT residence rule*

Section 9 TCGA 1992 provides that for the purposes of the TCGA:

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

The drafter was understandably unsure whether this would incorporate the Schedule D and employment income residence rule, so he provided a CGT residence rule to the same effect:

> (3) ... an individual who is in the United Kingdom for some temporary purpose only and not with any view or intent to establish his residence in the United Kingdom shall be charged to capital gains tax on chargeable gains accruing in any year of assessment if and only if the period (or the sum of the periods) for which he is resident in the United Kingdom in that year of assessment exceeds 6 months.

3.3.3 *Occasional residence rule*

Section 334 ICTA 1988 provides:

> Every Commonwealth citizen or citizen of the Republic of Ireland—
> (a) shall, if his ordinary residence has been in the United Kingdom, be assessed and charged to income tax notwithstanding that at the time the assessment or charge is made he may have left the United Kingdom, if he has so left the United Kingdom for the purpose only of occasional residence abroad, and
> (b) shall be charged as a person actually residing in the United Kingdom upon the whole amount of his profits or gains, whether they arise from property in the United Kingdom or elsewhere, or from any allowance, annuity or stipend, or from any trade, profession, employment or vocation in the United Kingdom or elsewhere.

I call this the "occasional residence rule". This adds nothing substantial to the Schedule D, employment income and CGT residence rules.[3] Thus it is of no practical importance that the section applies only to Commonwealth and Irish citizens and not to others. There is probably no other area of tax where so many statutory words are used to so little effect! Perhaps the tax law rewrite will be bold enough to tidy up this mess.

3.3.4 *Accommodation in the UK*

Section 335(1) ICTA 1988 provides:

> **Residence of persons working abroad**
> Where—
> (a) a person works full-time in one or more of the following, that is to say, a trade, profession, vocation, office or employment; and
> (b) no part of the trade, profession or vocation is carried on in the United Kingdom and all the duties of the office or employment are performed outside the United Kingdom;
> the question whether he is resident in the United Kingdom shall be decided without regard to any place of abode maintained in the United Kingdom for his use.

Likewise s.336(3):

> The question whether—
> *(a)* a person falls within subsection (1)(a) above, or
> *(b)* for the purposes of subsection (2) above a person is in the UK for some temporary purpose only and not with the intention of establishing his residence there,
> shall be decided without regard to any living accommodation available in the UK for his use.

In fact, IR20 contains several references to owning, buying or leasing accommodation, para. 2.8, 3.7, 3.9, 3.11, 3.13. IR20 can (just) be reconciled with the law because the statutory disregard is of

3 This section is discussed in *Reed v Clark* 58 TC 528; see 3.17 (*Reed v Clark*). It was held that the section was a "substantive charging provision" rather than a "procedural section". I have never been able to understand what was meant by this. More significantly, the judge concluded that the section had "little scope in practice" for any operation.

"accommodation *available* for use" whereas IR20 is concerned not with availability for use but with *ownership*. This was in fact the Revenue's intention when enacting s.336(3).[4]

3.3.5 *Dual residence*

Inspector's Manual paragraph 36 correctly states:

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

3.4 The 183 day rule

These three statutory residence rules employ slightly different language to say the same thing. The Schedule E residence rule states that a person who has spent at least six months in the UK "shall be treated as resident there". The Schedule D residence rule says that such a person shall be "charged to income tax under Schedule D as a person residing in the UK". That seems to be a roundabout way of saying, or equivalent to saying, that such a person shall be regarded as resident here.

The Revenue state:

> You will always be resident if you are here for **183 days** or more in the tax year. **There are no exceptions to this**. You count the total number of days you spend in the UK – it does not matter if you come and go several times during the year or if you are here for one stay of 183 days or more.
>
> IR20, para.1.2 (emphasis original)

This is straightforward and soundly based on the statutory provisions.[5] I refer to it as "the 183 day rule".

4 Press Release 1993 commenting on what is now s.376(3). See too John Avery Jones [1993] BTR 286 and Philip Baker OTPR Vol 3 p.143.

5 Except that one may dispute the case where an individual spends 183 days here during a leap year. Inspector's Manual para.50 shows that the Revenue apply the 183 day rule whether or not the year is a leap year.

3.5 Other tests

3.5.1 *The statute*

The Schedule D, employment income and CGT statutory residence rules all make it plain that an individual is resident unless:

(1) he is in the UK for some temporary purpose only, and

(2) not with any view or intent to establishing his residence there.

For good measure, the occasional residence rule makes the same point again. This is of limited help to the poor taxpayer, since:

(1) "temporary purpose only" is vague; and

(2) the definition (defying logic) uses the term "residence" which is sought to be defined.

3.5.2 *The case law*

The case law is quite considerable but does not help very much. It is clear that a person who does not meet the six month test may still be resident here, but in what circumstances? The leading cases are *Levene v IRC* and *Lysaght v IRC*, both in 13 TC. They reflect conditions of life in the 1920s. Viscount Cave said in 13 TC at 505:

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

> Glasgow where his wife and family lived, and to which he returned during the intervals between his sea voyages, was held to reside there, although he actually spent the greater part of the year at sea. Similarly a person who has his home abroad and visits the UK from time to time for temporary purposes without setting up an establishment in this country is not considered to be resident here...
>
> But a man may reside in more than one place. Just as a man may have two homes – one in London and the other in the country – so he may have a home abroad and a home in the UK, and in that case he is held to reside in both places and to be chargeable with tax in this country. Thus, in *Cooper v Cadwalader* (5 TC 101) an American resident in New York who had taken a house in Scotland which was at any time available for his occupation, was held to be resident there, although in fact he had only occupied the house for two months during the year; and to the same effect is the case of *Loewenstein v de Salis* (10 TC 424).
>
> 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 The Commissioners*, 10 TC 673). If for instance such a man is a foreigner who has never resided in this country, there may be great difficulty in holding that he is resident here. But if he is a British subject the Commissioners are entitled to take into account all the facts of the case.

The case law is unsympathetically but not unfairly 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.[6]

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

3.6 IR20 categorisation in outline

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

(1) those leaving the UK; and

(2) those coming to the UK.

These are subdivided as follows:

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

   (a) the working abroad practice;

   (b) the three years abroad practice;

   (c) a third category not mentioned in IR20 which I call the *Reed v Clark* "year out" route.

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

   (a) the three years in the UK practice;

   (b) visitors to the UK, i.e. those not within (a), a category divided into:

      (i) short-term visitors:

         [A] undecided short term visitors;

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

[B] fixed intention short term visitors;

(ii) longer term visitors.

3.7 Short absences

IR20 provides:

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

This is obviously correct.

3.8 The working abroad practice

IR20 continues:

> **Working abroad**
> 2.2 If you leave the UK to work full-time abroad under a contract of employment, you are treated as not resident and not ordinarily resident if you meet **all** the following conditions
> - your absence from the UK and your employment abroad both last for at least a whole tax year;
> - during your absence any visits you make to the UK:
>
> (i) total less than 183 days in any tax year, and
> (ii) average less than 91 days a tax year. ...
> [See para. 3.11 (calculating annual average visits).]
> 2.3 If you meet all the conditions in paragraph 2.2, you are treated as not resident and not ordinarily resident in the UK from the day after you leave the UK to the day before you return to the UK at the end of your employment abroad. You are treated as coming to the UK permanently on the day you return from your employment abroad and as resident and ordinarily resident from that date.
>
> If there is a break in full-time employment, or some other change in your circumstances during the period you are overseas, we would have to review the position to decide whether you still meet the conditions in paragraph 2.2. If at the end of one employment you returned temporarily to the UK, planning to go abroad again after a very short

stay in this country, we may review your residence status in the light of all the circumstances of your employment abroad and your return to the UK.

If you do not meet all the conditions in paragraph 2.2, you remain resident and ordinarily resident unless paragraphs 2.8, 2.9 apply to you. Special rules apply to employees of the European Community (see paragraph 2.14).

2.4 The treatment in paragraph 2.3 will also apply if you leave the UK to work full-time in a trade, profession or vocation and you meet conditions similar to those in paragraph 2.2.

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

If you have several part-time jobs overseas at the same time, we may be able to treat this as full-time employment. That might be so if, for example, you have several appointments with the same employer or group of companies, and perhaps also where you have simultaneous employment and self-employment overseas. But if you have a main employment abroad and some unconnected occupation in the UK at the same time, we will consider whether the extent of the UK activities was consistent with the overseas employment being full-time.[7]

I refer to this as "the working abroad practice".

3.9 The accompanying spouse concession

IR20 provides:

7 RI 40 gives further comment on the meaning of "full time".

> **Accompanying spouse**
> 2.6 If you are the husband or wife of someone who leaves the UK within the terms of paragraph 2.2 or 2.4 and you accompany or later join your spouse abroad, you may also by concession (extra-statutory concession A78) be treated as not resident and not ordinarily resident from the day after your departure to the day before your return, even if you are not yourself in full-time employment abroad. This applies where:
> - you are abroad for a complete tax year, and
> - during your absence any visits you make to the UK
>   (i) total less than 183 days in the tax year, or
>   (ii) average less than 91 days a tax year.
>   [see para. 3.11 (calculating annual average visits).]

I refer to this as "the accompanying spouse concession".

3.10 The three years abroad practice

IR20 continues:

> **Leaving the UK permanently or indefinitely**
> 2.7 If you go abroad permanently, you will be treated as remaining resident and ordinarily resident if your visits to the UK average 91 days or more a year – see paragraph 2.10. ... [See para. 3.11 (calculating annual average visits.]
>
> 2.8 If you claim that you are no longer resident and ordinarily resident, we may ask you to give some evidence that you have left the UK permanently, or to live outside the UK for three years or more. This evidence might be, for example, that you have taken steps to acquire accommodation abroad to live in as a permanent home, and if you continue to have property in the UK for your use, the reason is consistent with your stated aim of living abroad permanently or for three years or more. If you have left the UK permanently or for at least three years, you will be treated as not resident and not ordinarily resident from the day after the date of your departure providing:
> - your absence from the UK has covered at least a whole tax year, and
> - your visits to the UK since leaving
>   (i) have totalled less than 183 days in any tax year, and
>   (ii) have averaged less than 91 days a tax year.
>   [See para. 3.11 (calculating annual average visits.]

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

The heading "leaving the UK permanently or indefinitely "is not a very accurate label. I refer to this as "the three years abroad practice".

3.11 Calculating annual average visits

This calculation is carried out in the same way for:

(1) the working abroad practice;

(2) the accompanying spouse concession; or

(3) the three years abroad practice.

3.11.1 *Illness and exceptional circumstances*

IR20 provides in each place in the same words:

> Any days spent in the UK because of exceptional circumstances beyond

> your control, for example the illness of yourself or a member of your immediate family, are not normally counted for this purpose.

SP 2/91 expands on this:

> **SP 2/91 (19 March 1991) Residence in the UK—visits extended because of exceptional circumstances**
> 1 Under TA 1988 s 336, an individual is not regarded as resident in the UK in a year of assessment if, broadly,
> (a) he is in this country for some temporary purpose only and without the intention of establishing his residence here, and
> (b) he has not, in the aggregate, spent at least six months in the UK in that year.
> 2 In applying the first condition, one of the considerations is that an individual is regarded as resident in the UK if visits to the UK average at least three months in a tax year; the average is calculated over a maximum of four years. Where this rule applies, any days which are spent in the UK because of exceptional circumstances beyond an individual's control, for example, illness, will be excluded from the calculation.
> 3 Each case where this relaxation of the normal rules may be appropriate will be considered in the light of its own facts. The statutory condition in paragraph 1(a) above must of course continue to be met, and the relaxation does not apply for the purposes of calculating the six months in paragraph 1(b) above.

This recognises that a person may spend up to 182 days present in the UK for medical care and still be non-resident. It omits the word "normally", though para. 3 ("each case considered in the light of its own facts") has a similar effect. The practice is merciful to the non-resident and important to the success of the private medical industry. The only situation I can envisage where it would not apply is in cases of abuse, e.g. if a UK resident individual "left" the UK knowing he would need to return shortly for extended medical treatment; or if the "illness" did not actually cause the individual to stay here.

3.11.2 *Day of arrival and departure*

IR20 para. 1.2 states:

> The normal rule is that days of arrival in and departure from the UK are ignored in counting the days spent in the UK, in all the various cases where calculations have to be made to determine your residence position – see for example paragraphs 2.2, 3.3 and 3.4 and the examples in 2.10 and 3.6.

When will the "normal" rule not apply? An example is an individual who commutes weekly to the UK arriving Monday morning and leaving Wednesday evening. The individual may be present in the UK for 150 days but excluding arrival and departure reduces this to 50. This is a clear case where the "normal" rule may reasonably be disapplied. But where does the dividing line come? What if an individual has (say) 60 days of arrival and departure? Or 40? If the normal rule is not applied, does one count all the days of arrival and departure or only some? Modern travel facilities have made this a real issue and it is very unsatisfactory that the position is so unclear; but there it is.

3.11.3 *Method of calculating average*

IR20 states:

> 2.8 ... The average is taken over the period of absence up to a maximum of four years – see paragraph 2.10...
> 2.10 If it is necessary to calculate your annual average visits to the UK, the method is as follows:
>
> $$\frac{\text{Total visits to the UK (in days)}}{\text{Total period since leaving (in days)}} \times 365 = \text{annual average visits}$$
>
> For this purpose, days spent in the UK in the tax year before the date of your original departure are excluded.
>
> Suppose, for example, you leave the UK on 5 October 1997. The first review of the average of your visits is made after 5 April 1999, and takes account of your visits between those two dates. If you visited the UK for 30 days between 6 October 1997 and 5 April 1998 and for 50 days in 1998-99, the annual average is
>
> [(30 + 50)/(182+365)]x365 = 53.38 days
>
> If you continue to remain outside the UK, the annual average is

calculated as follows in reviews after 5 April in subsequent years

- after 5 April 2000 – include visits from 5 October 1997 to 5 April 2000
- after 5 April 2001 – include visits from 5 October 1997 to 5 April 2001
- after 5 April 2002 – include visits from 6 April 1998 to 5 April 2002.

After the third review the year of departure is dropped from the calculation. At each subsequent review the oldest year is dropped, so that there is a rolling period of four years being reviewed.

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

3.12 The three years in the UK practice

While Chapter 2 of IR20 (Leaving the UK) is satisfactory, Chapter 3 (Coming to the UK) is confused and confusing. IR20 provides:

> **3 Coming to the UK**
> **Coming to the UK permanently or indefinitely**
> 3.1 You are treated as **resident and ordinarily resident** from the date you arrive if your home has been abroad and you intend:
> [1] to come to the UK to live here **permanently**,[8] or
> [2] to come and remain here for three years or more.
>
> [Emphasis original but paragraph numbering added.]

I refer to this as "the three years in the UK practice". (The label is not completely accurate.)

This practice is roughly the converse of the three years abroad practice.

8 It is hard to see what the words in [1] add, since anyone within [1] (who intends to come to the UK to live here permanently) will usually be within [2] (he intends to come and remain here for three years or more). But that does not matter.

A person who "remains" in the UK in the IR20 sense will almost certainly satisfy the 183 day rule. So the main relevance of this category is to establish residence in the tax years of arrival and departure (when the 183 day rule may not be satisfied).

3.12.1 *Meaning of "remain"*

IR20 para 3.1 provides:

> You 'remain' in the UK if you are here on a continuing basis and any departures are for holidays or short business trips. (The same applies for the other references in this Chapter to 'remaining' in the UK.)[9]

3.13 Categories of "visitors" to the UK

IR20 continues:

> **Visitors to the UK**
>
> 3.2 If you come to the UK other than to live here permanently [*or to remain here for three years or more*][10] as in paragraph 3.1, the guidelines in the rest of this Chapter will govern your residence and ordinary residence position in the UK.
>
> The Chapter deals in turn with two main groups coming to this country—
> [1] short term visitors (where you visit the UK for only limited periods in one or more tax years, without any intention to remain for an extended period);
> [2] longer term visitors (where you come to the UK intending to remain indefinitely or for an extended period, perhaps stretching over several tax years).
> You may at first fall within one of these categories and later move to the other, depending on your precise circumstances.

I refer to these as "short term" and "longer term" visitors.

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9 This essential paragraph is missing (I think, accidentally) in some electronic versions of IR20.

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

3.14 Short term visitors rules

There are two categories of short term visitors.

3.14.1 *Undecided short term visitors*

IR20 continues:

> **Short term visitors – residence**
>
> 3.3 You will be treated as **resident** for a tax year if
> - you are in the UK for 183 days or more in the tax year (see paragraph 1.2), or
> - you visit the UK regularly and after four tax years your visits during those years average 91 days or more a tax year – see paragraph 3.6. You are treated as resident from the fifth year.

I refer to these as "undecided short term visitors". "Undecided short term visitors" is not an entirely accurate label for this category of UK residence, but "those who come regularly for more than 91 days average over a five year period without intending to do so at the outset" is somewhat of a mouthful. Undecided short term visitors are treated as UK resident from the fifth year.

3.14.2 *Fixed intention short term visitors*

IR20 continues:

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

I refer to those who will fall in this category as "fixed intention short term visitors". This category seems to have the most extraordinary status of contingent or uncertain residence. Suppose T intends to average 91 days over 5 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 3 he unexpectedly changes his intention and leaves the UK, he retrospectively finds that he is not resident in years 1 and 2 after all! (But possibly one is only expected to calculate the days here up to the year in question, not over a longer average?) In practice no problems seem to arise, perhaps because taxpayers take the view that "intention" requires a firm, fixed and irrevocable intention and in practice few if any form such an intention (unless they fall within the three years in the UK practice).

IR20 continues with some straightforward examples:

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

The Inspector's Manual adds a gloss on this (para.45):

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

individual is resident, he is also ordinarily resident.

[Emphasis added]

3.14.3 *Calculating annual average visits for short term visitors rules*

The method of computation for the short term visitors rules is slightly different from the method used for those leaving the UK. IR20 provides at 3.3(i):

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

This contrasts with the practice in relation to those leaving the UK where the word "normally" is added: see 3.11.1 (Illness and exceptional circumstances). *Quære* whether this is accidental or deliberate? IR20 also states:

> 3.6 Where it is necessary to calculate your annual average visits, the method is as follows:
>
> $$\frac{\text{Total visits to the UK (in days)}}{\text{Relevant tax years (in days)}} \times 365 = \text{annual average visits}$$
>
> For example, suppose you visited the UK for 80 days in 1995–96, 100 days in 1996–97, 85 days in 1997–98 and 105 days in 1998–99. The annual average is
>
> $$\frac{80+100+85+105}{366+365+365+365} \times 365 = 92.44 \text{ days}$$

3.15 Longer term visitors

IR20 continues:

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

for at least two years.

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

This category overlaps unhappily with the three years in the UK practice. A person who intends to remain three years is in that category. A person who comes for a purpose (whatever that means) and intends to remain two years is in this category. For the same reasons as mentioned in para. 3.12 (Three years in the UK practice) this only matters for the year of arrival and departure.

IR20 continues:

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

At first sight this is alarming. In what circumstances does a person become resident just because he owns or leases accommodation? But I think this comment refers only to "longer term visitors", i.e. those who come to the UK intending to "remain" here in the IR20 sense [i.e. not leave the UK except for short holidays or business trips]. I take "you own" literally. This statement is not satisfied if a trust purchases the property.

3.16 Is the Revenue practice always right?

The Revenue practice does not have the force of law. One *might* get a better result by appealing to Commissioners who will have to try to apply the case law test. But do not expect it except in special cases. And the Revenue themselves say in IR20 paragraph 1.1:

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

Likewise the preface to IR20 provides:

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

It is difficult to complain about that. The author has known cases where the Inland Revenue have accepted that an individual is not resident despite infringing the 91 day rule.

3.17 The *Reed v. Clark* "year out" route to non-residence

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

During the year out he spent virtually the whole time in or around Los Angeles. The taxpayer worked in Los Angeles. Presumably he did not work full time so he did not fall within the scope of the working 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 United Kingdom at all.

It was held that the true and only reasonable conclusion from these facts was that he was not UK resident in the year out.

The Revenue relied on some antique "Mariners cases" in which seamen physically absent from the United Kingdom for a whole year were nevertheless held to be United Kingdom resident.[11] The taxpayer argued that these cases were confined to wanderers with no place of residence except a base in the United Kingdom 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 in practice the taxpayer's argument must in most cases now succeed.

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11 In modern times, seamen are not likely to spend a whole year out of the UK on a voyage. This may explain why there is no reference to this class of case in IR20.

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

Although the point was not an issue in the case, and the Judge did not directly address it, it would seem to follow that Dave Clark also ceased to be ordinarily resident in the United Kingdom in his year out.

It was therefore relevant to the decision that Dave Clark was not merely out of the United Kingdom 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".

It follows that a person who:

(1) wishes to leave the United Kingdom for a period of one tax year;

(2) does not leave to work full time abroad, so does not come within the scope of the working abroad practice

may acquire non-residence by a *Reed v Clark* "year out". He should ideally spend no time whatsoever in the United Kingdom in the relevant tax year.[12] He must acquire a new "base" in his adopted place of residence.

3.17.1 *Revenue practice*

IR20 does not mention the *Reed v Clark* year out route to non-residence. However, the Revenue leaflet NRN1 provides:

> Were you present in the UK at any time during the year ended 5 April 2002?
> If "NO", you are not resident in the UK.

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

Also see Inspector's Manual paragraph 36:

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

3.18 Tax avoidance reason for becoming non-resident

In *Reed v Clark* the taxpayer had carefully organised his "year out" to reduce his UK tax liabilities. The Judge said:

> 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[13] of tax. Likewise with ordinary residence.

The preface to IR20 states:

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

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

3.19 Mobile Workers

For Revenue practice on Mobile Workers (individuals who usually live in the UK but make frequent and regular trips abroad in the course of their employment or business), see Tax Bulletin 52.

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13 As to whether "avoidance" is the right term to use here, see 15.4.2 (Avoidance/mitigation)

3.20 Ordinary residence

Ordinary residence is a different concept from simple "residence". It has no statutory definition. Nor is there much help in the cases. Ordinary residence has been explained as:

> 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.
>
> *R v Barnet LBC ex p. Shah* [1983] 2 AC 309)

3.20.1 *Revenue practice*

IR20 gives just about sufficient guidance in practice. The following practices all govern ordinary residence as they govern simple residence: the working abroad practice, the accompanying spouse concession, the three years abroad practice and the three years in the UK practice. The remaining cases are dealt with in IR20 as follows:

> **Ordinary residence**
> 3.4 You will be treated as **ordinarily resident** if you come to the UK regularly and your visits average 91 days or more a tax year – see paragraph 3.6. Any days spent in the UK for exceptional circumstances beyond your control, for example the illness of yourself or a member of your immediate family, are not normally counted for this purpose.
>
> 3.5 The date from which you are treated as ordinarily resident depends upon your intentions and whether you actually carry them out. You will be ordinarily resident
>
> - from 6 April of the tax year of your first arrival, if it is clear when you first come here that you intend visiting the UK regularly for at least four tax years
> - from 6 April of the fifth tax year after you have visited the UK over four years, if you originally came with no definite plans about the number of years you will visit
> - from 6 April of the tax year in which you decide you will be visiting the UK regularly, if that decision is made before the start of the fifth tax year.

For example

- you first come to the UK during 1999–2000, you intend visiting regularly until at least 5 April 2003 and your visits will average at least 91 days a tax year. You are ordinarily resident from 6 April 1999.
- you come to the UK with no definite intentions, but you visit regularly during the tax years 1999–2000 to 2002–2003 and your visits average at least 91 days a tax year. You are ordinarily resident from 6 April 2003.
- you first come to the UK during 1999–2000 with no definite intentions; you come again in 2000–2001 and 2001–2002 and during 2001–2002 you decide you will come regularly in future years, and your visits will average at least 91 days a tax year. You are ordinarily resident from 6 April 2001.

This is the same as the short term visitors rule for simple residence. IR20 continues:

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

If you come to the UK **as a student** for an extended period of study or education, see paragraph 3.13.

3.9 You will be treated as ordinarily resident from the beginning of the tax year after the third anniversary of your arrival if you come to, and remain in, the UK, but you

- do not originally intend to stay for at least three years, and
- do not buy accommodation or acquire it on a lease of three years or more.

For example, if you arrive in the UK on 21 November 1999 and are still living in the UK on 6 April 2003, you are ordinarily resident from 6 April 2003.

3.10 If, after you have come to the UK, you **decide** to stay for at least **three years** from the date of your original arrival, you will be treated as ordinarily resident from—

- the day you arrive if your decision is made in the year of arrival, or

- the beginning of the tax year in which you make your decision when this is after the year of arrival.

For example—
- you arrive in the UK on 4 January 2000 and decide on 16 May 2000 to stay permanently. You are ordinarily resident from 6 April 2000;
- you come to the UK to work on 14 July 1999 on a 2½ year contract of employment, but in December 2001 your assignment is changed and your contract is extended until after July 2002*. You are ordinarily resident from 6 April 2001.

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

3.11 If you come to, and remain in, the UK, you will be treated as ordinarily resident

(a) from the day you arrive, if—
   (i) you already own accommodation here
   (ii) you buy accommodation during the tax year of arrival, or
   (iii) you have or acquire accommodation on a lease of three years or more during the tax year of arrival; or

(b) from 6 April of the tax year in which such accommodation becomes available, when this occurs after the year of arrival.

3.12 If you are treated as ordinarily resident **solely** because you have accommodation here (paragraph 3.11) and you dispose of the accommodation and leave the UK within three years of your arrival, you may be treated as not ordinarily resident for the duration of your stay if this is to your advantage.

3.13 If you are a **student** who comes to the UK for a period of study or education and you will be here for less than four years, you will be treated as not ordinarily resident, providing—

- you do not own or buy accommodation here, or acquire it on a lease of three years or more, and
- on leaving the UK you do not plan to return regularly for visits which average 91 days or more a tax year.

3.20.2 *Relationship between simple residence and ordinary residence*

A question arises whether an individual can be ordinarily resident in the UK but not resident. The natural meaning of the words, and a review of the income tax cases, *Lysaght* and *Levine,* might suggest not. However, the CGT legislation is clearly drafted on the basis that this is possible, and ss.110, 111 FA 1989 assume that the possibility exists for income tax as well. This is also the Revenue's view: see IR20 and Inspector's Manual para. 36:

> An individual may be ordinarily resident, though not resident in the United Kingdom for a given year, and vice versa (see, for example, IM42 and IM45).[14]

But contrast the Revenue's Notes NRN2, question 6:

> Were you resident in the UK in the year to 5 April 2002?
> If "NO", you are not ordinarily resident in the UK.

In practice I doubt if anyone is ever regarded as ordinarily resident but not resident.

3.20.3 *Why does ordinary residence matter?*

It is possible to be UK resident but not ordinarily resident and this is the only situation where the concept of ordinary residence matters in practice. 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*

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14 See too a published Revenue letter of 10 July 1979:

> "I can confirm that 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."

ordinarily resident) are as follows:

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

(a) The deemed remittance rules: see 7.40 (Deemed remittances).

(b) Sections 739 and 740 ICTA 1988: see 12.7.2 (s.739) and 13.2 (s.740).

(2) Exempt gilts owned by such a person are excluded property for inheritance tax: see 23.3 (Exempt gilts).

(3) Different employment income rules apply: see 8.1 (Employment income).

(4) Commonwealth/Irish citizens may qualify for the Schedule D remittance basis while UK domiciled: see 7.5.1 (Foreign domicile or other requirement).

(5) The individual may be non-resident for CGT in his capacity as trustee: see 4.5.1 (Administration "ordinarily" carried on outside the UK).

3.20.4 *Commentary: Should we abolish ordinary residence?*

The concept of ordinary residence is of almost negligible relevance to tax and there have been calls for its abolition.[15] If dispensed with by Parliament, there would be a significant gain in simplicity and few would be affected by the change. That is not quite enough to justify the abolition of ordinary residence: one would need to go through every occasion where ordinary residence mattered and also whether the change was justified. Of the above list, the only point which really matters is the last. It would be unacceptably harsh to tax a trust to CGT just because a trustee happens to become UK resident for one year, without becoming ordinarily resident.

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15 David Jeffrey *Taxation* 6th December 2001 p.254; STEP submissions on Revenue's 2002 Background Paper on Domicile & Residence. Ordinary residence is also unsatisfactorily vague but (like residence) that could quite easily be put right by a statutory definition.

3.21 Residence of trusts and companies

For residence of trusts, see the next chapter.

Residence of companies is a large and important topic and deserves to be addressed at length and in depth. The reader should study Stephen Brandon QC's *Taxation of Non-UK Companies and their Shareholders* (Key Haven Publications, 2002, para. 2.1) which gives the topic the 50 page analysis it needs, and the IR International Tax Handbook chapters 2 and 3.

3.22 Visiting Forces

Special reliefs apply to a member of a visiting force of a designated country who is not a British citizen, a British Dependent Territory Citizen, a British National (overseas) or a British Overseas Citizen. See s.323 ICTA 1988, s.11 TCGA 1992. This is outside the scope of this book.

3.23 Avoiding acquiring United Kingdom residence: practical advice

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

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

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

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

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

3.24 Losing UK residence and ordinary residence: practical advice

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

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

(2) The three years abroad practice (three years' absence).

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

3.25 Commentary: Residence and the rule of law

The 1936 Codification Committee thought this state of affairs was "intolerable". The 1955 Royal Commission also recommended statutory reform.[16] The ill-fated 1988 Consultation Document (Residence in the UK: the scope of UK Taxation for Individuals) made proposals. The obstacles to law reform seems to be threefold. First, no-one can agree exactly what the residence test should be. Second, any reform of residence which is part of a package reforming the remittance basis is bound to meet a hostile reception. Third, the current mixture of law and practice creaks along just about well enough in practice, even if it falls short of Dicey's conception of "the rule of law". The current review of foreign domicile taxation might have grasped this nettle but that now seems unlikely.

16 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*.

CHAPTER FOUR

RESIDENCE OF TRUSTEES

4.1 Why does trustee residence matter?

Like individual residence, trustee residence is fundamental for many tax purposes, of which the most important are:

(1) The charge to income tax on foreign investment income (which applies to UK resident trustees of discretionary[1] trusts).

(2) Capital gains tax.

There is only one definition of residence for individuals, but there are two main[2] definitions of trustee residence: one for income tax and another for CGT.

The 2004 Budget announced proposals to replace these with a common definition, a proposal formerly made in the 1991 Trusts Consultative document. It did not say what the definition is to be. Draft legislation is promised in the 2004 pre-Budget report, to take effect from 2005/6.

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

2 For good measure there is a third definition of trustee residence for section 218 IHTA 1984: see 36.1 (Reporting requirements). Three definitions was not enough for the drafter of the IHT (Delivery of Accounts) (Excepted Settlements) Regulations 2002 who chose to give another definition for settlements with a trust fund of less than £1,000. One would like to think this was an April Fool spoof which became law by accident, but more likely here was a beginner trying his hand.

4.2 Trustee residence for income tax

If all the trustees (in their private capacities) are resident or non-resident the trust is likewise resident or non-resident for income tax. The Revenue accept this: Trusts Settlements and Estates Manual 1455. The position for mixed residence of trustees is governed by section 110 FA 1989 which provides:

> **Residence of trustees**
>
> (1) Where the trustees of a settlement include at least one who is not resident in the United Kingdom as well as at least one who is, then for all the purposes of the Income Tax Acts—
>
> (a) if the condition in subsection (2) below is satisfied, the trustee or trustees not resident in the United Kingdom shall be treated as resident there, and
>
> (b) otherwise, the trustee or trustees resident in the United Kingdom shall be treated as not resident there (but as resident outside the United Kingdom).
>
> (2) The condition referred to in subsection (1) above is that the settlor[3] or, where there is more than one, any of them is at any relevant time[4]—
>
> (a) resident in the United Kingdom,
>
> (b) ordinarily resident there, or
>
> (c) domiciled there.

A trust with a non-resident foreign domiciled settlor may have UK trustees (as long as they are not the sole trustees). One must beware of a UK connected person 'tainting' the trust by adding even a nominal amount of funds. For the Revenue's view on tainting see SP 5/92.

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3 "Settlor" is defined in s.110(4); it has the usual tax meaning.

4 "Relevant time" is defined in s.110(3):

> "For the purposes of subsection (2) above the following are relevant times in relation to a settlor—
>
> (a) in the case of a settlement arising under a testamentary disposition of the settlor or on his intestacy, the time of his death, and
>
> (b) in the case of any other settlement, the time or, where there is more than one, each of the times when he has provided funds directly or indirectly for the purposes of the settlement."

4.3 Trust residence for CGT[5]

Section 69(1) TCGA 1992 provides:

> ... that body [the trustees] shall be treated as being resident and ordinarily resident in the United Kingdom unless
> [a] the general administration of the trusts is ordinarily carried on outside the United Kingdom and
> [b] the trustees or a majority of them for the time being are not resident or[6] not ordinarily resident in the United Kingdom.
>
> (Paragraphing added)

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

4.4 Actual residence of trustees

One needs first of all to identify the trustees and their actual place of residence in their personal capacities, applying the tests of Chapter 2 (Residence).

4.5 Carrying on trust administration abroad

Where all the trustees are non-resident in their personal capacities, the Revenue have not usually sought to argue that the trust is UK resident (on the ground that the general administration of the trust has been carried on in the UK). But the fact that they have not taken the point in the past would not preclude them from taking it at any time in the future.[7] A retrospective attack cannot be ruled out. (Nor even – experience shows – criminal proceedings. It is a good discipline to be ready to justify any entry in a tax return to a jury unfamiliar with informal Revenue practices.)

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

6 Note it is "or" not "and"; contrast 17.1 (Scope of CGT on individuals).

7 It may sometimes also be in the interest of a beneficiary (especially in a dispute with trustees) to argue that the trust is UK resident. This will defend the beneficiary against a section 87 charge, at the cost of a charge on the trustees!

Crude expectations of uniformity are liable to be misleading. Remember Russell's chicken: "The man who has fed the chicken every day throughout its life at last wrings its neck instead, showing that more refined views as to the uniformity of nature would have been useful to the chicken."

Because the Revenue have never taken the point, there is no authority on the meaning of the expression "the general administration of the trusts of the settlement". The Revenue say:

> The general administration of a trust is treated as being carried on at the place where the trustees carry out their general duties as trustees, though we take account of all the circumstances of the trust when determining the location of its "place of effective management".[8]

This does not take us very far. The passage continues:

> General administration is not the same as the concept of place of effective management used in Double Taxation Agreements.

This is correct.[9]

The general sense of the expression is clear enough. Every act of trust administration is potentially relevant. Ideally, everything will be done outside the UK:

- Trustees' meetings (held as often as the trustees' business requires, at least annually) and any other place where the decisions relating to trust administration may be made.

- The place where all correspondence, faxes and e-mails are dealt with.

- Trust bank accounts.

If there is any UK element it must be subsidiary to the general management of the trusts offshore.

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8 Modernising the tax system for trusts - Definitions & Tests (10/12/03), para 58.

9 For the same reason, no guidance can be found from cases or discussion on "central management and control", the test of corporate residence.

4.5.1 *Administration "ordinarily" carried on outside the UK*

The reference in s.69(1) to the place where the general administration of the trust is *ordinarily* carried on provides the offshore trustees with a measure of protection from an occasional lapse. If some act of trust administration is carried out in the UK, this would not of itself prevent the trust from continuing to satisfy the test of having the general administration of the trust *ordinarily* carried on outside the UK.

However, the use of the words "general administration" would be enough to achieve that result and "ordinarily" must go further. The purpose and meaning of the word "ordinarily", it occurs to the author, can best be understood by comparing the CGT residence rules for individuals and trustees. An individual is within the scope of CGT if he is resident *or* ordinarily resident in the UK. By contrast, a trustee is regarded as non-resident for CGT purposes unless he is resident *and* ordinarily resident in the UK.[10] Thus, if a trustee comes to the UK from abroad for the period of one year only, he has the status of UK resident but not ordinarily resident. In such a case, in his individual capacity, he is within the scope of CGT (albeit perhaps on the remittance basis). However, it was clearly the intention of Parliament that in this case a trust of which the individual was trustee should not become UK resident (the heavy CGT burden which that would bring to the trust is obviously not fair). In a period where an individual is resident but not ordinarily resident, it is likely to be the case that even if the administration of the trust is carried on in the UK, the administration is nevertheless not *ordinarily* carried on here.

4.5.2 *Delegation to UK agent*

The Capital Gains Manual provides (para. 33383):

> The activities of an agent appointed by the trustees to manage the day to day affairs of the trust, for example, to look after the investments, should not normally be taken into account in determining where the general administration of the trust is carried on.

The basis of this may be:

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10 Assuming the general administration of the trusts is carried on outside the UK.

(1) activities of an agent are not regarded as "trust administration"; or

(2) in weighing up the balance (as the "general administration" test requires) one places more weight on the activities of the principal (appointing and supervising the agent) than the activities of the agent; or

(3) one applies the maxim of Roman law *qui facit per alium facit per se* (a person acting through an agent should be regarded as if he were acting personally).[11]

The Manual continues:

> However, where a trust claims to be non-resident, the general administrative duties which would normally fall within the responsibility of trustees (as opposed to any agent appointed by them) must in fact be ordinarily carried on outside the United Kingdom by the trustees.

Presumably this means that the Revenue practice will only apply to matters normally delegated from trustees to agents. What is "normally" delegated must include:

(1) Expert tax and trust law advice.

(2) Preparation of accounts (but accounting and financial records should all be maintained outside the UK).

(3) UK investment managers may be appointed and authorised to manage trust investments on a discretionary basis, but the trustees should put in place adequate appropriate monitoring procedures. The trustees should be in a position at all times to satisfy themselves that the

---

11 The basis is sometimes said to be grounded on a distinction between:
(1) the general administration of the *trusts*, as opposed to
(2) the administration of the *trust assets*.
That distinction should not and indeed cannot be drawn. The trustees have duties to manage the trust assets which are duties imposed by the trust. (The drafter did not have any particular point in mind when he used the plural "trusts" in s.69(1) as he used the singular "trust" with the same meaning in subsection (2).)

investment managers continue to act in accordance with the trustees' investment policy.

The final word concerning trust administration rests at all times with the trustees. This is needed for trust law as well as tax law reasons!

If the settlor (or a beneficiary) is given an investment/consultancy contract by the trustees, to deal with trust property, the matter should be dealt with this way:

(1) The decision to delegate should be made by the trustees (and properly minuted).

(2) There should be a written contract between the trustees and the settlor (or beneficiary).

(3) The authority of the settlor (or beneficiary) under the contract should not be too wide.

(4) The terms of the contract should require the settlor (or beneficiary) to report as often as appropriate to the trustees.

(5) The trustees should supervise the work of the settlor (or beneficiary).

(All the steps would be required for trust law reasons, of course, as well as for tax considerations.) I suggest the contract is modelled on a standard contract used by investment managers because it could not be suggested that contracts of that kind fall outside the scope of the Revenue's statement.

Different considerations apply if the assets are held by a non-resident company. Here the issue is corporate residence[12] and the test is of course where the "central management and control" of the company is situated. In practice, however, the matter should be dealt with along the same lines:

(1) The decision to delegate should be made by the directors of the company (and properly minuted).

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12 Or shadow directorship, see 31.17.1 (When is agent of company a shadow director?).

(2) There should be a written contract between the company and the settlor or beneficiary.

(3) The authority of the settlor or beneficiary under the contract should not be too wide.

(4) The terms of the contract should require the settlor or beneficiary to report as often as appropriate to the directors.

(5) The directors should supervise the work of the settlor or beneficiary.

4.6 Minority of trustees actually UK resident

If one trustee is actually UK resident (in his private capacity) a non-resident trust needs at least two offshore trustees to outnumber him. Ideally these non-resident trustees should consist of or include two corporations and not individuals. Otherwise the death of a trustee could prevent the trust from qualifying as a non-resident trust. (In these circumstances some relief is provided by s.81(5) TCGA 1992 if the foreign residence is restored by the appointment of another trustee within six months.)

If a trustee is actually UK resident, particular care is needed to satisfy the requirement that trust administration is carried on abroad. In practice it is better not to have a minority UK resident trustee unless there is a good reason for it. One such reason may be to arrange that the trust is resident for income tax (avoiding ss.739-40) but not resident for CGT.

4.7 Effect of UK protector on trust residence

It is normal practice to appoint a "protector"[13] who has power:

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

(2) to appoint (and usually to dismiss) trustees.

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13 On trust law and drafting aspects of protectors, see *Drafting Trusts and Will Trusts*, James Kessler QC, Sweet & Maxwell, 6th ed, para. 6.29.

The protector may be a UK resident. A protector could not be regarded as a trustee[14] and so his actual residence is irrelevant in ascertaining the actual residence of the trustees in their personal capacities.

The protector's existence need not prevent the general administration of the trust from being carried on abroad. The downside of a UK resident

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14 Some have doubted this but in the author's view the matter is clear. In *Re Marshall* [1945] Ch 21, it was held that trustees for the purpose of the obsolescent Settled Land Act 1925 are "trustees" for the purpose of the Judicial Trustee Act 1896. Although trust land is not vested in SLA trustees, capital money and investments other than land are vested in them, and *for this reason* they were held to be trustees. In *Manoogian v Sonsino* [2002] EWHC 1304 (Ch) [2002] WTLR 989; 5 ITELR 125 a settlement provided:

> "... the Bank shall make such investments as may from time to time be particularly and specifically directed to be made of it in writing from time to time by the Armenian Patriarchate of Jerusalem."

Jacobs J, held that the Patriarch was not a trustee:

> "His position is analogous to powers of a life tenant under a conventional strict settlement. The life tenant is often given powers to possess land, direct investments and so on, but none of those things make him a trustee of the settlement."

In *Clay v Clay* [2001] HCA 9 (accessible on *www.austlii.org*) the High Court of Australia similarly held that a guardian was not a trustee. Underhill and Hayton, *Law Relating to Trusts and Trustees*, 16th edition, 2003, p29, 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 certainly be a trustee.

All 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 any event be the position, and (ii) that could not be determinative of the meaning of "trustee" in a UK statute.

protector is that slightly greater care is needed to ensure that this condition is satisfied, particularly if the settlor and beneficiaries are also in the UK. For this reason a non-resident protector is preferred by some practitioners, but the practical convenience of a UK protector may easily outweigh this consideration.

4.8 Professional trustees treated as non-resident

Section 69(2) TCGA 1992 provides:

> [a] ... a person:
> [i] carrying on a business which consists of or includes the management of trusts, and
> [ii] acting as trustee of a trust in the course of that business,
>
> [b] shall be treated in relation to that trust as not resident in the United Kingdom if the whole of the settled property consists of ... property provided by a person not at the time ... domiciled, resident or ordinarily resident in the United Kingdom,
>
> [c] and if in such a case the trustees or a majority of them are or are treated in relation to that trust as not resident in the United Kingdom, the general administration of the trust shall be treated as ordinarily carried on outside the United Kingdom.
>
> (Paragraphing added)

This relief applies where the trustee is a person within [a], here called "a professional trustee". The relief does not apply to a person who acts as trustee for no remuneration as that is not acting in the course of a business.

The Revenue say (Trusts, Settlements and Estates Manual, para. 1460) that "the trustee must not be an employee". Presumably the Revenue take the view that an employee is not "carrying on a business which consists of or includes the management of trusts". However, it is considered that an employee is carrying on the "business" of being an employee and such a business may include the management of trusts.[15]

This thoroughly sensible provision allows UK professional trustees to act

15 See Table A, Article 89; *Ronbar Enterprises v Green* [1954] 2 All ER 266; *Drafting Trusts and Will Trusts*, James Kessler QC, Sweet & Maxwell, 6th edn, para. 20.55.

without attempting to tax them. The object is to allow the UK to compete on equal tax terms with foreign trustees. The rule also affects non-resident professional trustees of a trust administered in the UK.

In circumstances where s.69(2) may apply (the settlor being non-domiciled and non-resident when he made the settlement) then one should consider the possibility of:

(1) using UK resident professional trustees;[16] or

(2) using non-resident professional trustees who allow the administration of the trust to be carried on in the UK.

This may keep administrative costs down, and be more convenient. It does not matter if the settlor subsequently becomes resident or domiciled in the UK provided he was not so resident when he made the settlement.[17] Care must be taken that no-one adds property to the settlement while UK resident or domiciled. Take care when a UK professional trustee retires, if a co-trustee is not a professional: the trust may become UK resident!

Unfortunately this provision applies only to CGT and has no counterpart for income tax. Nor does it apply to determine residence of companies held by trustees, so where a trust holds a non-resident company, it may be more convenient to use trustees actually resident where the company is resident. As with the income tax rule, watch out for 'tainting' by a UK connected person: see SP 5/92.

The rule is compulsory: sometimes a UK resident trust may be desired, in which case one must appoint non-professional trustees.

4.9 Commentary: Let's abolish the relevance of trustee residence

Residence is a sensible connecting factor for individuals: everyone will accept that a person who is resident in the UK should to some extent at least be subject to tax in the UK. Residence of trustees is a matter which can be chosen by judicious appointment of trustees, and makes little sense as a connecting factor in the taxation of trusts. A better system would be that trusts with a UK domiciled settlor pay IT and CGT regardless of the

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16 The trust will be resident for income tax but this may not be a problem (e.g. if the settlor has an interest in possession, or no trust income in fact arises).

17 The Revenue accept this: CG Manual 33391.

residence of the trustees. The whole mad structure of sections 86 to 98 TCGA 1992, bolstered (supposedly) by Schedules 4A to 5, can be repealed. The reform, like any, would bring winners and losers but the overall result would be a system which was fairer, simpler and more effective. This is a system operated in Canada, New Zealand and, I suspect, most other common law jurisdictions.

CHAPTER FIVE

YEAR OF ARRIVAL AND DEPARTURE

5.1 Introduction

This chapter is concerned with the tax position in a year during which an individual or a trustee becomes or ceases to be UK resident. It is necessary to consider separately:

(1) The income tax rules for:
  (a) individuals;
  (b) trusts.

(2) The CGT rules for:
  (a) individuals;
  (b) trusts.

5.2 Income tax on individuals: year of arrival and departure

ESC A11 (Residence in the UK: year of commencement or cessation of residence) provides:

> The Income and Corporation Taxes Acts make no provision for splitting a tax year in relation to residence and an individual who is resident in the UK for any year of assessment is chargeable on the basis that he is resident for the whole year.

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

(1) Relief is available by Revenue concession. The concession is ESC A11 and Revenue practice is explained in the booklet IR20 and the

Revenue Manuals. These are the sources for the income tax part of this chapter.

(2) Relief may be available under Double Tax Treaties. These are important but reference will need to be made to each treaty and they are not discussed in this book.

5.3 Concession A11

The concession provides:

> Where an individual—
> (a) comes to the UK to take up permanent residence or to stay for at least two years[1]; 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. It is a condition that the individual should satisfy the Board of Inland Revenue that prior to his arrival he was, or on his departure is, not ordinarily resident in the UK. 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.

The conditions for year of arrival treatment are therefore:

(1) the individual comes to the UK to take up permanent residence or to stay for at least two years; and

(2) prior to arrival, the individual was not ordinarily resident.

The usual conditions for year of departure treatment are:

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1 The context suggests that "to stay for at least two years" must mean "to be resident for two or more tax years". So that 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.

(1) the individual must leave for permanent residence abroad; and

(2) the individual must cease to be ordinarily resident in the UK.

Year of departure treatment is extended to one further case. ESC A11 provides:

> This concession is extended to the years of departure and return where, subject to certain conditions, an individual goes abroad 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 only relevant to an individual who does not leave the UK for permanent residence abroad.

The individual who comes to the UK so as to be resident for one tax year will not qualify for year of arrival treatment but he may qualify for year of departure treatment.

A year in which an individual falls within the concession is described as a split year.

5.4 Computation of liability in split year

ESC A11 simply states that:

> liability to UK tax which is affected by residence is computed by reference to the period of his residence here during the year.

There are several possible ways of computing liability "by reference to the period of residence". How this is applied in practice is explained in the Manuals and IR20. The method used is not the most obvious or the simplest possible, but it works well enough. Different rules apply to year of arrival and year of departure.

5.5 Year of arrival: Schedule D Case IV, V computation

5.5.1 *Schedule D Cases IV and V, UK domiciled individual*

Inspector's Manual 1663 explains:

> **New arrivals on or after 6 April 1997**
> Where an individual arrives in the United Kingdom 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.

I describe this as time apportionment. This applies to a foreign domiciliary if the arising basis applies, for instance, income from Ireland (which is outside the remittance basis).

5.5.2 *Schedule D Cases IV and V, non-UK domiciled individual*

In this case, Inspector's Manual 1663 explains:

> **New arrivals on or after 6 April 1997**
> Where an individual arrives in the United Kingdom 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 ...
> (b) *where the remittance basis applies*, strictly upon the sums received in the United Kingdom in the whole of the year of arrival[2], but may be restricted to the amount which would have

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

been chargeable if the arising basis had been applicable.

For example, an individual arrives in the UK on 6 October 1997 and is regarded as UK-resident from that date. Case V income arose as follows:–

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

On 31 December 1997, £400 of this income is remitted to the UK.
If the arising basis applies, the amount chargeable for 1997–98 will be 6/12 x £700 =£350
If the remittance basis applies, the amount strictly chargeable is £400, but in practice this may be restricted to £350.

5.6 Year of departure: computation of Schedule D Case IV, V liability

Here the Revenue compute tax "by reference to the period of residence here during the year" but there is a different method of computation. The Inspector's Manual again:

1667. Persons ceasing to be resident in UK
Where a person (other than an individual of the type referred to in IM45[3]) takes up permanent residence abroad and ceases to be resident in this country, any liability under Case IV or V for the year in which residence here ceases should be based on—
(a) the proportion, appropriate to the period from 6 April to the date of departure, of the income arising or remitted, as the case may be, in the ... year of departure ...
or
(b) the actual amount of the income arising or remitted, as the case may be, in the period from 6 April to the date of departure,
whichever is the less.

3 The reference is not immediately obvious, but is apparently to an individual who is a habitual visitor: see 5.9 (Habitual visitors).

5.7 Computation of employment income liability in year of arrival and departure

ESC A11 is in general terms, and the Manual states that it applies to employment income, so one computes liability by reference to the period of residence here. EIM 40006 gives further information.

5.8 Income within s.660A ICTA 1988, s.739 and s.740 ICTA 1988

The Manuals do not deal with this expressly, but ESC A11 is in general terms, so one computes liability by reference to the period of residence here and it must be assumed that the D IV and D V rules set out above apply. In a s.739/740 case, the concession may in some cases be withdrawn on the grounds it is being used for tax avoidance.

5.9 Habitual visitors

The Inspector's Manual explains at 1664:

> **Visitors resident from 6 April**
>
> An individual who, by reason of habitual and substantial visits, becomes chargeable as a resident for and from the fifth year of such visits (see (a)(ii) of IM45) should be treated as resident for the whole of the year for the purpose of this guidance.

5.10 Non-resident's exemption for United Kingdom source income in split year

ESC A11 provides:

> Where the concession applies and the tax year is split, FA 1995 s 128 (limit on income chargeable on non-residents—income tax) does not apply for the period for which an individual is treated as not resident. That section only applies to complete years of non-residence.

5.11 Gains from life policies, etc.

The split year concession does not apply to such gains: see 19.2.2

(Individual non-resident in year of chargeable event). There is no good reason for this anomaly, but there it is.

5.12 Income tax on trusts: year of arrival and departure

If a trust changes income tax residence by appointment of new trustees it is considered that the tax year is split into UK and non-UK resident periods. This is the Revenue view, Trusts Settlements & Estates Manual 1455:

> **Trustees who are all resident in the UK change to trustees who are all not resident**
> The trustees are resident in the UK for income tax purposes for the part of the year that resident trustees were in office. They are not resident for income tax purposes for the rest of the year.
> **Trustees who are all not resident in the UK change to trustees who are all resident**
> The trustees are not resident in the UK for income tax purposes for the part of the year that non-resident trustees were in office. They are resident for income tax purposes for the rest of the year.

The position if a trust migrates by the migration of a trustee in his personal capacity (without an appointment of new trustees) is unclear; but in practice this is rare.

5.13 CGT on individuals: year of arrival and departure

Under s.2 TCGA 1992, CGT is charged on gains of a year *during any part of which* the individual is UK resident. If a UK resident individual leaves the UK to take up residence abroad, he is strictly subject to CGT on the disposal of assets until the following 6th April; if, while non-resident, he disposes of an asset, he is strictly subject to CGT if he becomes UK resident before the following 6th April.

As with income tax, this is subject to two exceptions of such breadth that the general principle rarely applies:

(1) Relief is available by Revenue concession: ESC D2.

(2) Double Tax Treaties split UK tax years into resident and non-resident periods. These are discussed at 17.16 (Double tax treaties as a

defence to CGT charge).

5.13.1 *Concession D2*

The Concession provides:

1. An individual who comes to live in the United Kingdom and 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, provided that the individual has not been resident or ordinarily resident in the United Kingdom at any time during the five years of assessment immediately preceding the year of assessment in which he or she arrived in the United Kingdom.

2. An individual who leaves the United Kingdom and 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, provided that the individual was not resident and not ordinarily resident in the United Kingdom 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 United Kingdom.[4]

(Extra-Statutory Concession D2)

5.14 CGT on trusts: year of arrival and departure

The CGT concession applies only to individuals. It does not apply to trustees or to a settlor who is chargeable on the gains of the settlement –

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4 For completeness, note that 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 United Kingdom and which, at any time between the individual's departure from the United Kingdom and the end of the year of assessment, are either:
  (a) used in or for the purposes of a trade, profession or vocation carried on by that individual in the United Kingdom through a branch or agency; or
  (b) used or held for, or acquired for the use by or for the purposes of such a branch or agency."

whether the trustees are resident or non-resident. ESC D2 provides:

> 4. This concession does not apply to the trustees of a settlement who commence or cease residence in the United Kingdom or to a settlor of a settlement in relation to gains in respect of which the settlor is chargeable under TCGA 1992 sections 77-79, or TCGA section 86 and Sch 5.

It is hard to see any reason for this (beyond a generalised disapproval of trusts).

5.15 Tax planning/avoidance and use of the split year concessions

Every concession is qualified by the following words:

> A concession will not be given in any case where an attempt is made to use it for tax avoidance.

This section considers when this "health warning" applies. The difficulty is that tax avoidance is very much a matter of opinion.[5]

There is one case in this area. In *R v IRC ex parte Fulford-Dobson* [1987] STC 344 the taxpayer's wife (a UK resident) gave an asset to her husband who was just about to take up employment abroad. He sold the asset shortly thereafter but before the following 6th April and sought the benefit of the concession. The Revenue refused to apply the concession and an application for judicial review was unsuccessful.

The CG Manual gives some guidance in circumstances where:

(1) a taxpayer leaves the UK during a tax year, and

(2) a disposal takes place after departure (but in the same tax year so that ESC D2 is in point).

The most interesting parts provide:

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5 For a discussion of the "tax avoidance" concept, see 15.4 ("Avoidance" distinguished from "mitigation").

25982. Withholding benefit of ESC D2

In straightforward cases where the contract of sale is delayed until after the date of emigration, see CG25850, the Board have decided that they will not withhold the concession merely on the grounds that the disposal was arranged to take place after the date of departure from the UK. On its own, a genuine postponement of the disposal is not regarded as an attempt to use the concession for tax avoidance, but where coupled with other arrangements it might be so regarded.

...

26010. Other devices

...

26040. Options

Sometimes the owner, before emigrating, grants an option to a potential purchaser to buy the asset, that option to be exercised during a specified period following the owner's emigration. If there is genuine uncertainty in the vendor's mind at the time of emigration as to whether the grantee will exercise the option, there are no grounds for withholding the benefit of the concession. As with pure delay cases, however, there may be evidence to show that the option was a sham and that the vendor is assured of his sale before he leaves the United Kingdom.

...

26050. Cross-options

These are cases where the vendor and purchaser each grant an option to the other party to sell/buy the asset which is the subject of the agreements. Invariably in these cross-options cases, the options are granted before the vendor leaves the United Kingdom, but one of the options is exercised (usually by the purchaser) after the vendor's date of departure. The Board will consider withholding the Concession if there appears to be no commercial reason for the issue of the cross-options.

The introduction of the rules for temporary non-residents[6] has diminished the scope for this type of tax planning, but has not stopped it altogether.

The Manual 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

6 See 17.15 (Temporary non-residents).

ESC D2 is in point).

In order to take advantage of the concession, a taxpayer might arrange disposals just before arriving in the UK . He might do this in various ways:

(1) sell assets;

(2) transfer assets to a trust or company, in which the taxpayer is interested;

(3) enter into a contract with delayed completion.

Arrangement (1) above should not lose the concession (cf CG Manual 25982 cited above). But (2) and (3) take us into what the Revenue would regard as "devices" and should not be adopted unless there is a pressing 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, the Revenue 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.

5.15.1 *Appeal against withdrawal of concession*

There is no appeal to the Commissioners against a decision by the Revenue to withdraw a concession. It is possible to challenge the Revenue by way of judicial review (or by application to the Inland Revenue adjudicator). It is an interesting question whether the taxpayer must show:

(1) the Revenue decision that there is tax avoidance is one which no reasonable person could reach, or merely

(2) the Revenue 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 very difficult to sustain.

5.16 CGT planning before arrival in the UK

There are many possible strategies and the choice will depend on circumstances. A minimum course would be for the individual to dispose of UK situate assets with inherent gains so as to bring their base cost up to market value. This need only apply to UK situate assets which might be disposed of while the individual is resident here. The individual might go further and dispose of non-UK situate assets if he wishes to have the ability to sell the asset and remit the gain.

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

Watch the pre-owned asset rules: see 32.1 (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.

Note that the Revenue (rightly) take the point that the "bed and breakfasting" rules apply to a non-resident so he should not dispose of securities and re-acquire securities of the same class within 30 days: s.106A TCGA 1992; RI 226.

Of course foreign tax on the disposal would need to be considered. It might be possible to arrange a disposal which under UK rules takes place while non-resident but under foreign rules takes place while UK resident.

CHAPTER SIX

INCOME SOURCE AND SITUS

6.1 Introduction

This chapter deals with three related questions:

(1) When is a receipt from a company or trust (or certain other structures) "income" in nature and when is it capital?

(2) Identifying the source of an income receipt.

(3) Identifying the situs of a source for income tax purposes.

6.2 Why does "capital *v.* income" matter?

"Income tax is a tax on income." This slogan is less true now than when it was formulated in 1900; but the first question still remains: is a receipt "income" in the hands of the recipient? If not, it is not subject to income tax under Schedule D Cases III, IV or V and is not normally "income" for the purposes of anti-avoidance provisions such as ss.660A, 739 and 740.[1] This issue arises often in the context of receipts from trusts and non-resident companies, where the income/capital distinction is a difficult one.

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1 However, a receipt which is capital for non-tax (e.g. trust law) purposes may be:
(1) deemed to be income for income tax purposes; or
(2) subject to income tax (without being deemed to be income).
Examples are benefits under s.740; gains from offshore funds and life insurance policies; gains under provisions beyond the scope of this book, including sections 703 and 776 ICTA 1988.

6.3 Why does identity of source matter?

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

(1) in order to identify the situs of the source;

(2) in order to apply the source ceasing principle; see 7.48 (Source ceasing principle);

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

6.3.1 *General comment on identity of source*

There is no statutory definition of "source". The word is too basic to be usefully defined. It has been said that the word is equivalent to "origin": *Hart v Sangster* 37 TC 231 at 235. This, while true, does not take us very far.

The source of income is not merely the sum of funds available for investment. The source of particular income must be located precisely. *Diggines v Forestal Land, Timber & Railways Co* 15 TC 630 might seem to indicate the contrary, that all Case V sources count as one source; however, that case (a curious one) was decided on the basis of statutory wording which has since been repealed.

6.4 Why does situs of source matter?

The question of situs (location) of an income source arises in many areas of tax of which the following are the most important:

(1) income of a non-resident (who is taxable on UK source income, not foreign source income); this is the basic principle of UK tax jurisdiction;[2]

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2 The First Report of the 1955 Royal Commission on the Taxation of Profits and Income sets out the position very clearly:

"The United Kingdom tax system asserts two distinct claims as the basis of tax jurisdiction:

(1) It taxes income arising in the United Kingdom no matter to whom it

(2) income of a UK resident foreign domiciliary (UK source income taxed on arising basis, foreign source income taxed on remittance basis);[3]

(3) withholding tax (applicable to UK source interest and royalties);

(4) double tax treaties. See "Treaty Problems Relating to Source" [1998] BTR 222.

Statute uses a variety of expressions and I use the expression "situs of a

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belongs.

(2) It taxes residents in the United Kingdom no matter where their income arises."

(Cmd 8761 (1955) para 8.) I refer to this as "the fundamental territorial principle". The implementation of this policy in the statute is sometimes harder to follow. Income tax is charged under "schedules" (s.1 ICTA 1988) and s.18(1) ICTA 1988 sets out "Schedule D":

"Tax under this Schedule shall be charged in respect of—

(a) the annual profits or gains arising or accruing—

(i) to any person residing in the United Kingdom from any kind of property whatever, whether situated in the United Kingdom or elsewhere, and

(ii) to any person residing in the United Kingdom from any trade, profession or vocation, whether carried on in the United Kingdom or elsewhere, and

(iii) to any person, whether a Commonwealth citizen or not, although not resident in the United Kingdom from any property whatever in the United Kingdom or from any trade, profession or vocation exercised within the United Kingdom..."

Paragraph (a) imposes (in rather more words than strictly necessary) the fundamental territorial principle. Schedule D continues:

"Tax under this Schedule shall be charged in respect of- ...

(b) all interest of money, annuities and other annual profits or gains not charged under Schedule A or under ITEPA 2003 as employment income, pension income or social security income, and not specially exempted from tax."

In paragraph (b), disconcertingly, the fundamental territorial principle is left to be implied. But the Courts filled that gap in *Westminster Bank v National Bank of Greece* 46 TC 472. The Courts are prepared to supply a territorial limitation on tax legislation or to extend a statutory territorial exemption which they feel to be inadequate; see *Clark v Oceanic* 56 TC 183. The tax law re-write will tidy up the wording.

3 Section 65 ICTA 1988: the test is whether the possession or security is "out of the United Kingdom".

source" as a generic term for them all.

6.4.1 *General comment on situs of source*

In the case of income from land, the situs of the source is obvious. In relation to income from intangible sources (e.g. shares, debts, trades, etc.), the law must somehow choose a connecting factor to link the source to a jurisdiction. In principle, it would not matter much what the rule was, as long as there is some rule and its application is clear. There is a large choice of possible connecting factors, and the selection of the determining factor might be regarded as an arbitrary one.

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

The Income Tax rules for the situs of an income source are different from the *situs* of asset rules for IHT, CGT and private international law; see 35.1 (Situs for CGT and IHT).

6.5 Source of income of UK resident sole trader[4]

The source of income from a trade or profession[5] carried on by a single UK resident person is "out of the United Kingdom" only if it is *exclusively* carried on abroad and no part of the trade is carried on in the UK. There is no *de minimis* rule here; contrast the concept of incidental duties which applies to employment income; see 8.5 (Duties wholly performed outside the UK). If any part of the trade is carried on in the UK then the entire trade falls within Case I and does not qualify for the remittance basis.

If a trade is carried on abroad but is controlled from the UK then the trade is not "out of the UK": *San Paulo Railway v Carter* 3 TC 407. Even tacit oversight and control by a UK resident may suffice for this purpose: *Ogilvie v Kitton* 5 TC 335; *Egyptian Hotels v Mitchell* 6 TC 542.

In consequence, if a sole trader is UK resident it is very difficult (though not necessarily impossible) to show that his trading income has a foreign

4 See "Taxing Foreign Income from Pitt to the Tax Law Rewrite – The Decline of the Remittance Basis", John Avery Jones in *Studies in the History of Tax Law*, Hart Publishing, 2004 p.26ff.

5 In this section and the next, reference to a "trade" includes a profession or vocation as there is no relevant distinction between them.

source.

A different rule applies to a non-resident person carrying on a trade: see Robert Venables QC, OTPR, Vol 7, p.177 and Tax Bulletin 18 for Revenue practice. This is outside the scope of this book.

6.5.1 *Planning for UK resident sole trader*

If a UK resident individual carries on a trade partly in and partly out of the UK, the individual will be taxed under Case I, not Case V. In these circumstances the individual may be able to divide up his activities into two spheres – those in and those out of the UK. He will then be carrying on two separate activities, of which at least one will be wholly situated out of the UK and will receive the more favourable Case V treatment.

How is this division to be achieved? The law is reluctant to analyse a trader's activities into two separate trades:

> The profits of the profession and the profits of the trade come from the general state of activity of the trader or the professional man ... Trades and professions are not to be divided up. If a doctor carries on his profession in England and abroad, you cannot treat that as being two professions. He is carrying on one profession. Similarly, the trader who carries on the trade in England and also abroad is carrying on one trade, assuming that it is not a distinct trade. The fact that part of his trade is carried on abroad does not make it a distinct trade.[6]

A separation of trading activities can be achieved. One technique is to ensure that there are separate activities carried on by separate entities. Overseas activities could be carried on by a specially created partnership controlled from abroad. The offshore partner may be a company. (This was the route successfully adopted by David Frost: see *Newstead v Frost* 53 TC 525.) Alternatively the activities could be carried on by a company of which the individual is an employee. In this way foreign trading income may be converted into foreign employment or dividend income which would enjoy a more beneficial tax treatment.

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6 *Bennett v Marshall* 22 TC 73. There are many other cases where the taxpayer has failed to show that he was carrying on two separate trades: see *IRC v Turnbull Scott* 12 TC 749 (trade); *Davies v Braithwaite* 18 TC 198 (profession).

6.6 Partnership income

6.6.1 *What is the source?*

Each partnership is a separate source. A source will cease to exist if the partnership is wound up, even though the individual may be a member of the other partnership. The Revenue's International Tax Handbook provides at 1618:

> The remittance basis [for United Kingdom domiciled individuals] lasted until 1974. If the [partnership] profits were kept abroad we could not tax them and often did not know there was a partnership. If the partnership was wound up – so that the Case V source ceased – and the accumulated profits were not remitted until the following year even the remittances escaped tax. Until 1965 companies could join in the fun although the very high rates of individual taxation meant that the remittance basis was more attractive to individuals.

6.6.2 *Situs of source*

The position for partnerships is governed by s.112 ICTA 1988. Subsection 1A provides:

> Where:
>
> (a) any persons are carrying on a trade, profession or business in partnership,
>
> (b) the trade, profession or business is carried on wholly or partly outside the United Kingdom,
>
> (c) the control and management of the trade, profession or business is situated outside the United Kingdom, and
>
> (d) any of the partners who is an individual resident in the United Kingdom satisfies the Board that he is not domiciled in the United Kingdom or that, being a Commonwealth citizen or a citizen of the Republic of Ireland, he is not ordinarily resident in the United Kingdom,
>
> [1] section 111 shall have effect in accordance with subsection (1) above as if that partner were not resident in the United Kingdom and, in addition
>
> [2] (as respects that partner as an individual who is in fact resident in

> the United Kingdom), his interest as a partner, so far as it entitles him to a share of any profits or gains arising from the carrying on of the trade, profession or business otherwise than within the United Kingdom, shall be treated for the purposes of Case V of Schedule D as if it were a possession outside the United Kingdom.

[Paragraphing added]

The conditions

This subsection sets out four conditions, all of which must be satisfied:

(a) *The first condition*: There must be a trade, profession or business in partnership.

In the following discussion the word "trade" is used to cover trade, profession and business.[7]

(b) *The second condition*: The trade is carried on wholly or partly outside the UK.

It suffices if the trade is carried on partly outside the UK, so almost any offshore element should suffice.

(c) *The third condition*: The control and management of the trade is situated outside the UK.

The expression "control and management" is drawn from case law on company residence, and it is submitted that it should be given the same meaning here. Thus the company residence case law gives a good deal of guidance.[8]

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7 The words "or business" are probably otiose, as it is difficult to envisage a business in partnership which is not a trade or profession. (The words are probably there for historical reasons, as the predecessor to this section referred to: "trade or business".)

8 There is a discussion in the International Tax Handbook at 1614 as to whether "control and management" are two distinct tests with distinct meanings, or a composite phrase. If the author's approach is right, the words are a single composite phrase.
For a discussion of corporate residence, see the references at 3.21 (Residence of

The Revenue International Tax Handbook says at paragraph 1612:

> Generally speaking we follow the thinking on companies and look at the place of the highest level of management rather than day-to-day management. Outside textbooks follow the same line.
>
> In deciding the location of the control and management of a firm with both United Kingdom 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?

This is unobjectionable, though it does not take matters very far. The Tax Handbook continues with another interesting point at 1613:

> [ICTA 1988, section 112 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 ICTA 1988 s.112 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.

It is thought that 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 Revenue view would probably be upheld.

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trusts and companies).

(d) *The fourth condition*: Any of the partners who is an individual resident in the UK satisfies the Board that he is not domiciled in the UK or that, being a Commonwealth citizen or a citizen of the Republic of Ireland, he is not ordinarily resident in the UK.

This is the same test as for the remittance basis for Schedule D Case V: see 7.5 (Who qualifies for the remittance basis?). The drafter sensibly copied the words verbatim. In what follows we refer in shorthand to a foreign domiciliary.

The consequences

There are two consequences where the four conditions are satisfied. The important one is that (as respects the individual partner who is resident in the UK, but not domiciled):

> his interest as a partner, so far as it entitles him to a share of any profits arising from the carrying on of the trade, profession or business otherwise than within the United Kingdom, shall be treated for the purposes of Case V of Schedule D as if it were a possession outside the United Kingdom.

It is therefore necessary to distinguish between:

(1) profits arising from carrying on the trade within the UK; and

(2) profits arising from carrying on the trade outside the UK.

The latter only is taxable under Schedule D Case V and qualifies for the remittance basis.

The second consequence is couched in the opaque drafting technique of amendments to s.111 ICTA. The law is accurately summarised by the International Tax Handbook at paragraph 1665:

> [ICTA 1988, s.112 includes] express rules applying to all partnerships, not just foreign partnerships, confirming the principle that a non-resident partner is only taxed on his share of the profits earned by the partnership in the United Kingdom. Where the partnership operates wholly or partly abroad and includes a non-resident partner, a computation of the profits is required as if the partnership were an

individual not resident in the United Kingdom. This is then allocated between the partners in accordance with the commercial profit sharing arrangements and of course excludes the profits earned overseas. By the same token, a similar computation is also required for a foreign partnership which includes a partner resident, but not domiciled in the United Kingdom (or resident, but not ordinarily resident and a Commonwealth citizen or citizen of the Republic of Eire) in order to apply the remittance basis to the overseas profits.

6.7 Income from companies

6.7.1 *Distribution from a non-resident company: income or capital?*

"Distributions" (elaborately defined) from a UK resident company are treated as income for tax purposes and the income/capital issue does not arise.[9] For a non-resident company the statutory provisions do not apply; the extensive case law applies to determine whether a receipt is income or capital. This is thoroughly discussed in Stephen Brandon QC's *Taxation of Non-UK Resident Companies and their Shareholders* (Key Haven Publications, 2002) para. 2.2 giving the topic the 60 pages it needs. The Revenue view is set out in Inspector's Manual 1610–1615:

> **1610. Distributions/foreign cos: In cash**
> Published: 9/95
> ... [10] a cash distribution to its shareholders by a foreign company will normally be assessable under Case V, whether it is attributable to the undivided profits or to the capital resources of the company (*CIR v Trustee of Joseph Reid (deceased)*, 30 TC 431). Where, however, cash —
>
> a) is distributed on the liquidation of the company (*CIR v Burrell*, 9 TC 27)
>
> or
>
> b) comprises a return of part of the shareholder's capital interest in the company (*Rae v Lazard Investment Co Ltd*, 41 TC 1; *Courtaulds Investments Ltd v Fleming*, 46 TC 111),
>
> the cash constitutes a capital sum not assessable as income under Case V.

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9 Except in the course of a liquidation; see s.20 ICTA 1988.
10 The omitted words refer to s.123 ICTA 1988 (repealed in 1996).

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

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.

1612. Distributions/foreign cos: Not in cash
Published: 9/95
Where a foreign company capitalises undivided profits and —

a) issues to its shareholders the additional capital so created, in the form of its own shares or debentures, in proportion to the number of shares already held by them

or

b) satisfies a dividend out of such profits by the issue of its own stocks or shares (for example, a 'stock dividend' by a United States company),

such a distribution does not constitute income for Case V purposes in the hands of the shareholder. This principle applies when the distribution is actually made in shares, whether or not an effective option was given to the shareholder to receive cash in place of shares (*CIR v Blott*, 8 TC 101; *Whitmore v CIR*, 10 TC 645; *CIR v Fisher's Executors*, 10 TC 302; *CIR v Wright*, 11 TC 181).
In such cases, where no shareholder takes cash, so that the proportionate holdings in the capital of the company are unchanged, new shares acquired as a result of the distribution should not be regarded as 'an addition to any source' for the purposes of ICTA 1988, s 66(3) (see IM1643). As regards the position for Capital Gains Tax, see CG51700 onwards.
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.

1613. Distributions/foreign cos: Not in cash: Release of assets
Published: 9/95
Where a foreign company releases[11] some of its assets (for example, shares it holds in another company) to its shareholders, the distribution will normally be assessable under Case V by reference to the United Kingdom currency value of such assets at the date of distribution (*Pool v Guardian Investment Trust Co Ltd*, 8 TC 167; *Wilkinson v CIR*, 16 TC 52; *Briggs v CIR*, 17 TC 11). Where, however, the assets are released on liquidation or are otherwise claimed to be a return of capital to the shareholder, the claim should be referred to International Division (Cases IV and V), Strand Bridge House in accordance with IM1610, last sub-para. As regards Capital Gains Tax, the recipient of the assets may be entitled to an adjustment of the cost to him of acquisition of the assets.

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.

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

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11 Author's Note. "Releases" here simply means "transfers". The word "release" was used in *Pool v Guardian*, but is not normally used nowadays in this sense. Although the cases cited are concerned with transfers to shareholders for no consideration, the same would in principle apply:
(1) on a sale at a deliberate undervalue;
(2) on a transfer to the life tenant (bypassing the trustees).
In all these cases ss.94, 99 IHTA 1984 also need to be considered.

> of the shareholder. The first situation falls within the principle of *CIR v Blott* (8 TC 107) – see IM1612. The second gives rise to a Case V charge because the reinvestment in the company is regarded as a voluntary application of income which has already arisen to the shareholder.
> Between these two extremes lies a variety of situations, each of which must be considered by reference to their own facts to determine whether a Case V charge arises. Where there is any doubt as to whether the receipt of shares under the terms of a dividend reinvestment plan gives rise to a Case V charge, refer the taxpayer's file, together with a copy of the plan prospectus, to International Division (Cases IV and V) Strand Bridge House.

6.7.2 *What is the source?*

A holding of securities of a particular nature (such as Exchequer bonds) constitutes a single source of income distinct from other securities. The source will cease to exist if the securities are disposed of, even though securities of a different kind are retained. The same principle will apply to shares in distinct companies: see *Grainger v Maxwell's Executors* 10 TC 139.

6.7.3 *Situs of source*

The House of Lords held in *Bradbury v English Sewing Co Ltd* 8 TC 481 that the source of income from shares is situated in the place where the company was resident – not where it was incorporated or where the shares were registered. This is in stark contrast to the situs rule for CGT, IHT and private international law; see 35.1 (Situs for IHT and CGT). This rule is now statutory: s.20 ICTA 1988 imposes tax under Schedule F on distributions from UK resident companies.

6.8 Foreign unit trust

Inspector's Manual 1617 provides:

> **Foreign investment organisations Unit trust**
> Published: 9/95
> Many unit trusts are established outside the United Kingdom (for

> example, in the Channel Islands, Isle of Man, West Indies and Australia) under arrangements identical with or similar to those operating in the United Kingdom. All such foreign unit trusts are unauthorised unit trusts (see IM4176) and are, therefore, outside the scope of Section 468 ICTA 1988 (see CT3930 onwards), but are unit trust schemes for the purposes of Capital Gains Tax (see TCGA 1992, s 99(1), and CG41300 onwards).
> Normally, a United Kingdom resident shareholder in a foreign unit trust is assessable under Case V by reference to his share of the income of the fund whether [1] this is paid out to him in cash or [2] used to purchase additional units.

This appears to assume that a foreign unit trust is not transparent for income tax purposes. The source of the unit-holder's income is the unit trust, not the underlying assets. That is thought to be correct.

Point [2] is correct if the income is applied voluntarily by the shareholder to purchase the units but in other cases it is doubtful.

6.9 Interest: What is the source?

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

> I think it is argued here that the source of income was the contract. I cannot agree with that. I think the source of income here was the deposit of money upon the terms of the contract. In my opinion, if an addition is made to the amount which is deposited, the words of Section 21[12] are quite wide enough to catch it. I quite agree that certain difficulties might be imposed on the Inland Revenue if they were to pursue every deposit account and find whether or not there had been an addition to the account during the course of the year. That is a matter for the Inspector of Taxes or those responsible for the assessment to decide as to how they will deal with those matters. I do

12 s.21 FA 1950 provided a current year basis for the first two years of income from a new source.

> not suppose that in every case it would be worth the trouble that would be caused to the taxing authorities if they were to inquire into every deposit account and find if the interest had been increased, unless it had been increased by a large amount. Here, of course, the increase of £2,000,000 is very great. In my judgment there is no question but that there has been a source of income in the deposit of money, and at any rate there has been an addition to a source of income here.[13]

Thus it is held, obiter, that every payment into a bank account creates a new source. This was (as the Court realised) quite unworkable in practice. Nowadays, however, the important question is not when a new source arises but when an existing source ceases. Suppose:

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

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

(3) F withdraws £100 from the account.

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

6.10 Situs of source of interest

6.10.1 *Introduction*

UK source interest is taxed under Schedule D Case III and foreign source

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13 37 TC at 237

under Cases IV or V.[14]

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

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

6.10.2 *Principle*

In principle there are many possible connecting factors:

(1) residence[15] of debtor;
(2) the payment of the interest:
   (a) place where payment made;
   (b) situs of funds out of which payment is made;[16]
(3) the contract under which interest is payable:
   (a) proper law;
   (b) place where contract would be enforced;
(4) situs of debt on which interest is payable (i.e. location of deed if debt is a specialty);
(5) purpose for which loan is made (e.g. to purchase UK/non-UK situate asset);
(6) situs of security for debt (if any);
(7) residence of guarantor (if any);
(8) residence of creditor.

Many of these features may change, and it is possible that the source of interest can change its situs. However, it would not be convenient for situs of a source to change very often. There are two ways to deal with this:

(1) to place little or no weight on features which may easily change;

(2) to look at the situation at the time the debt arises, and to ignore later

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14 This is nowhere stated in the legislation but the courts have implied it: see footnote 2.

15 Or similar criteria such as place of business.

16 This is often called the "source" of the payments but it is extremely confusing to use the word "source" in this way.

changes.

Solution (1) seems preferable.

The situs needs to be known by the debtor (who may have to deduct tax at source) and creditor. This suggests no weight should be given to factors not likely to be known by both parties. One such is the location of the deed, as the debtor will not have possession of this and may not know its location.

Debts are frequently assigned, and it is suggested that:

(1) assignment should not alter the situs of the source; and

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

Factors which the parties can easily manipulate without commercial cost or effect are not suitable (at least from the Revenue's viewpoint and one can expect the Courts to sympathise). In this category is the proper law, the situs of the deed (if debt is a specialty), and the place where the contract is made.

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 owned to two creditors resident in different places, but the interest on that debt cannot have two different sources.

No weight should be given to the residence of the guarantor, since what the guarantor pays (if he pays anything) is not interest.

6.10.3 *Case law*

The case law makes dismal reading. The leading case is *Westminster Bank Executor and Trustee Company (Channel Islands) Ltd v National Bank of Greece SA* 46 TC 472 ("*Bank of Greece*").

The features of the debt (using the numbering of the list in the above paragraph were as follows:

(1) The debtor was non-resident.

(2) (a) Payment to residents outside Greece was to be made in sterling

(b) Discharge of the debtor's obligation would have involved in the ordinary course a payment out of funds situate in Greece.

(4) The debt was secured by lands and public revenues in Greece.
(5) Payment was to be made either in London or (at the option of the holder) in Athens, Greece, by cheque on London.
(7) The guarantor was non-resident.

It is obvious (and all sides accepted) that the interest had a Greek source. Almost all the features of the debt pointed the same way. The House of Lords held that the interest had a foreign situs in these words:

> [1] the bond itself is a foreign document, and
> [2] the obligations to pay principal and interest to which the bond gives rise were obligations whose source is to be found in this document.

This was adequate for the decision. However, the dictum is rather inadequate as a basis for understanding or applying the law in other cases, which one might have thought was one of the responsibilities of the House of Lords. The Court did not say how it reached its conclusion: it just listed all the features of the loan and stated its conclusion. This leaves the impression that all the features listed were relevant, and if different features point in different ways, it is a matter of carrying out a balancing exercise (but how? That is not explained.)

The following features in *Bank of Greece* did not show a UK source:

- payment made in sterling
- UK proper law
- interest paid into a UK account if the holder so required.

The actual dispute in *Bank of Greece* concerned the situs of the source of guarantee payments. Such payments are income chargeable under Case III or Case V (depending on situs of source). It is sensible that situs should be determined on principles similar to those which apply to interest. Why was it argued the payment had a UK source?

> [1] The only circumstances relied on by the Appellants as supporting their contention that the obligation was located inside the United Kingdom were as follows. Although the original guarantor had no branch in the United Kingdom, the present Appellants had acquired one on their universal succession in London.
> [2] Moreover, it was argued that, since discharge of the obligations under the bond in Greece had been caught by the moratorium enacted by the Greek Government, it followed that the only place at

which the obligation of the guarantor could have been discharged or enforced was in London.

These changes did not affect the situs:

> Speaking for myself, I do not see how an obligation originally situated in Greece for the purposes of British income tax could change its location either by reason of the fact that
> [1] one guarantor had been substituted for another, or ...
> [2] the second guarantor so substituted subsequently acquired a London place of business, or ...
> [3] the Government of Greece had by retrospective legislation altered by moratorium and substitution of a new guarantor for the purposes of Greek law the obligations imposed upon the principal debtor and the guarantor.
> The Appellants acquired no obligation different from that of the original guarantors, and that was the obligation imposed on the original guarantors by the terms of the bonds.[17]

Once one accepts that sources of interest are not peripatetic, the result was inevitable.

The only subsequent case is the decision at Special Commissioner level in *Hafton Properties v McHugh* 59 TC 420. Here the facts were weighted as strongly as possible in favour of a foreign source, except there was a UK resident payer. Under the original loan agreement, an American 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:

> 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. That is fortified, of course, by the fact that the debt was a mortgage debt. Such

17 46 TC at p 494.

> 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.[18]

There is no discussion of earlier cases in *Bank of Greece*. In *IRC v Broome* 19 TC 667, 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 paid the interest in the UK out of funds in the UK.

(3) The loan was enforceable in Nairobi.

(8) The creditor was resident in Kenya.

Finley J held:

> [1] There was really very little dispute between the Solicitor-General and Mr. Latter as to the law (particularly perhaps as to the Income Tax law) which is applicable. 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. Mr. Latter alluded, without actually quoting, to a very famous passage in a speech of Lord Herschell in which that principle is extremely clearly laid down[19].
>
> [2] ... I think it was payment out of a source here. The first two payments are perhaps a little more clear, because there the payment was actually made to Earl Kitchener personally in this country. He happened to be here; he was resident abroad, but he happened to be here, and he was actually paid by the executors in London; and equally [the other payments] were made in London, were sent to a bank in London, and were remitted by the bank in London to Kenya to be paid there. In these circumstances I am of opinion that this was

18 59 TC at 426.

19 *Colquhoun v Brooks* 2 TC 490 at p. 499.

> a payment made by persons resident in London out of sources in London. If that is right, that fulfils the test laid down in the passage from Lord Herschell's speech to which Mr. Latter referred me.

Paragraph [1] is correct: the question was the situs of the source of interest. Paragraph [2] equates the source of the interest with the situs of the *resources* used to pay the interest. That is, with respect, just a confusion caused by the terminology.

6.10.4 *Revenue guidance*

The Revenue formerly took the view that the residence of the debtor was the principal (and in most cases the deciding) factor. This position was rejected in *Hafton* and formally abandoned in RI 58:

> **Schedule D Case III—meaning of "source"**
> ...The current Revenue view on the location of the source for interest is based on ... the Greek Bank case. The factors considered relevant in that case (leading to the conclusion that the income involved did not have a UK source) were—
> – there was an obligation undertaken by a principal debtor which was a foreign corporation;
> – the obligation was guaranteed by another foreign corporation with no place of business in the UK;
> – the obligation was secured on lands and public revenues outside the UK;
> – funds for payments by the principal debtor of principal or interest to residents outside Greece would have been provided either by a remittance from Greece or funds remitted by debtors from abroad (even though a cheque might be drawn in London).

This is a correct summary of *Bank of Greece*. RI 58 continues:

> 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 [the Revenue] regard the most important as—

> – the residence of the debtor,[20] that is the place in which the debt will be enforced;[21]
> – the source[22] from which interest is paid;
> – where the interest is paid; and
> – the nature and location of the security for the debt.
>
> If all of these are located in the UK then it is *likely* that the interest will have a UK source.
>
> (Emphasis added)

"Likely" is a timid word to use when all these connecting factors point the same way. The problem is when different connecting factors point different ways. Here the RI cops out:

> It is not possible for [the Revenue] 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.

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20 [Author's Note] The International Tax Handbook expands on this at para. 1103: "An important factor in determining the source of interest is the residence of the debtor. 'Residence' does not, however, necessarily mean tax residence, rather it means where the 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 United Kingdom 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 United Kingdom branch of a non-resident company to pay United Kingdom source interest."

21 [Author's Note] It is not always true (perhaps not even generally true) that the residence of the debtor is the place the debt will be enforced: see 35.10 (Situs of simple debt). In *Bank of Greece* the debt was enforceable in the UK.

22 [Author's Note] The expression is ambiguous and may mean:
(1) the situs on IT principles of the source of income out of which the interest is paid; or
(2) the situs on private international law principles of the funds out of which the interest is paid.

For example, if a non-resident company receives UK rents and pays them into a foreign bank account and pays the interest out of that account, situs (1) is UK and situs (2) is non-UK. The meaning here is, presumably, the situs (on private international law principles) of the funds from which the interest is paid and this seems to be the meaning of the expression in *Bank of Greece.*

RI 58 ends with wishful thinking:

> [The Revenue] hope that this summary of [their] views will assist practitioners and their clients in determining for themselves where the source of interest with which they may be concerned is located.

IM 3940 contains another Revenue statement:

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

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

6.10.5 *Discussion*

The approach of *Bank of Greece* is that there is no single decisive factor (or at least none of the factors listed in that case were singly decisive).

(1) Suppose a debt were wholly non-UK connected but secured on UK land; that is, if the UK situate security is the only UK aspect of the debt. For instance, a debt from one non-resident to another non-resident, which arises under a contract governed by a foreign proper law. There is no definite answer to this but it is suggested that interest on such a debt does not fall within Schedule D Case III. It would be wiser to avoid the issue.

By contrast, suppose a debt were made unsecured and later became secured. It is considered that this would not turn a non-UK source into a UK source.

(2) Suppose a debt were wholly non-UK connected but paid out of funds derived from UK source income (e.g. rents of UK land). This cannot be enough to make the interest UK source. The origin of funds used to pay interest is a weak connecting factor. (I would say it should not be a connecting factor at all, but it was referred to in *Bank of Greece*.)

(3) Suppose a debt were wholly non-UK connected but had a UK resident debtor. It is suggested that this alone cannot give the source of interest a UK situs.[23]

For a further discussion, the reader is referred to the excellent discussion in "Taxation Treatment of Interest and Loan Relationships", E.C.D. Norfolk, Butterworths looseleaf, para.3.49; OTPR, Volume 8, p.115 (G Simpson) and p.235 (Robert Venables QC); and *Taxation of Non-UK Resident Companies and their Shareholders*, Stephen Brandon QC, Key Haven Publications, para. 2.3.3.

6.10.6 *Commentary*

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 the Revenue have in practice taken a relaxed view. Of course, there is no

23 Christopher Norfolk points out that s.348(4)(d) ICTA 1988 (now repealed) assumed it was possible for a UK resident to pay interest with a non-UK source.

guarantee that will continue.

A more sensible test would be the test in the OECD Model Treaty.[24]

Legislation (with appropriate transitional provisions) would be needed to make this reform. The gap between the existing law and these solutions is too great to be bridged by case law, except perhaps by the House of Lords. A Revenue consultation document issued 10 December 2003 proposed this reform but the proposal has been deferred for the time being. This is a reform with winners and losers. The losers in these situations tend to cry louder than the winners, and that may be the reason why the reform seems to have been dropped.

6.11 Relevant discounted securities

If the debt is a "relevant discounted security" then the profit on the disposal of that security will be :

(1) charged to income tax under Schedule D Case III; or

(2) if the profit arises from a "security out of the UK", under Schedule D Case IV .

(See paragraph 1 Schedule 13 FA 1996)

How does one decide if a security is "out of the United Kingdom"? It is suggested that the rules are the same rules (whatever they are) which determine whether interest arises out of the UK.

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

> "Interest shall be deemed to arise in a Contracting State when the payer is a resident of that State. Where, however the person paying the interest, whether he is a resident of a Contracting State or not, has in a Contracting State a permanent establishment in connection with which the indebtedness on which the interest is paid was incurred, and such interest is borne by such permanent establishment, then such interest shall be deemed to arise in the State in which the permanent establishment is situated."

An alternative test would be the test for situs of the debt under private international law but this is easily manipulated by the taxpayer.

6.12 Income from trusts: identifying the source

6.12.1 *Interest in possession type trusts*

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".

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

The source of the income is the underlying trust assets (not the trust) if, under the terms of the trust, the beneficiary is entitled to the income of each asset as it arises. This is the case for an interest in possession trust governed by English law: *Baker v Archer-Shee* 11 TC 749. It is assumed that foreign trust jurisdictions apply English law principles in the absence of evidence to the contrary. In practice it is accepted that the English rule applies nearly everywhere.

If under the terms of the trust the beneficiary is not entitled to a proprietary interest in the income as it arises, but merely has the right to call on the trustees to transfer to him "a balance" of net income, then the trust (not the underlying assets) will be the source.[25] This is so even if the beneficiary is described as "life tenant" and is, in economic reality, in the same position as a life tenant under an English law trust. Such a trust is more like an English law estate than an English law trust. This was (rather implausibly) found to be the case in trusts governed by the law of New York State[26] and British India.[27] Since foreign law is a question of fact, a future court would not be bound by those decisions, but in practice they

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25 By concession this rule is not applied for the purposes of double taxation relief: International Manual 166030

26 *Garland v Archer-Shee* 15 TC 693. The finding of fact in *Garland* was accepted as common ground in *Astor v Perry* 19 TC 255. Similar findings have been made in other US jurisdictions; see "Taxing Foreign Income from Pitt to the Tax Law Rewrite – The Decline of the Remittance Basis", John Avery Jones in *Studies in the History of Tax Law*, Hart Publishing, 2004 p.46 for contrary views as to US law.

27 *Duncan's Executors v Adamson* (1935) 14 ATC 22.

are not likely to be challenged.[28]

6.12.2 *Scots trusts*

The more generally held view seems to be that the position under a Scots law trust is like that supposed to apply in New York:

> 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.[29]

This has been reversed for UK resident trusts, section 118(1) FA 1993 provides:

> Where—
> (a) any of the income of a trust having effect under the law of Scotland is income to which a beneficiary of the trust would have an equitable right in possession if that trust had effect under the law of England and Wales, and
> (b) the trustees of that trust are resident in the United Kingdom,
> the rights of that beneficiary shall be deemed for the purposes of the Income Tax Acts to include such a right to that income notwithstanding that no such right is conferred according to the law of Scotland.

It is difficult to see why the statutory rule only applies to UK resident trusts. In practice it will not often matter.

6.12.3 *Discretionary trust: what is the source?*

Where the trust is a common form discretionary trust and a beneficiary receives trust income in the exercise of the trustees' discretion, the same choice arises between:

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28 A similar (doubtful) decision was reached in an English law trust in *R v Special Commissioners ex p The Shaftesbury House v Arethusa Training Ship* 8 TC 367 discussed in *Venables & Kessler on the Taxation of Charities*, Key Haven Publications, 4th edition 2003.

29 *Inland Revenue v Clark's Trustees* [1939] SC 11 at p.24. The passage was approved by Lord Fraser in *Leedale v Lewis* 56 TC at p.538.

(1) regarding the trust (or the trustees' dispositive power over income) as the source of the beneficiary's income; or

(2) regarding the trust assets as the source.

The conventional view is that the trust is the source (not the underlying trust assets). This is supported by *Re Vestey's Settlement* [1951] Ch 209; *IRC v Berrill* 55 TC 429 at 444 and *Memec v IRC* 71 TC at 95.[30]

If a discretionary trust becomes interest in possession in form, the trustees' discretion over income in principle comes to an end and the source has ceased: *IRC v Berrill* at page 444. A more cautious course (if cessation is essential) would be to wind up the trust, as then the source has most certainly ceased.

6.12.4 *Other income payments from trusts*

Where the beneficiary is entitled to an annuity or other "annual payments" under the trust, the trust is necessarily the source: *R v Special Commissioners ex p. Shaftesbury Homes and Arethusa Training Ship* 8 TC 367; *Inchyra v Jennings* 42 TC 388.

6.13 Payment from discretionary trust: income or capital?

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

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30 Robert Venables QC disagrees: PTPR (1999) Vol. 7 p.87 ("*Memec v. IRC* and the Source of Discretionary Income Payments from Trusts"); *Non-Resident Trusts*, 8th edition, 16.3 (Taxation of Beneficiary):

> "Where there are discretionary trusts of income ...and the trustees distribute income in the exercise of their discretion, the taxability of the recipient beneficiary is a matter of some controversy. My own opinion is that in exercising their discretion the trustees simply perfect the settlor's gift so that the position at the end of the day is the same as if the trust instrument had expressly provided that the beneficiary should receive the income. Thus, the income which the beneficiary receives is the same income as that which the trustees received, the beneficiary's source is the same as the trustees' source and any tax paid by the trustees is to be treated as having been paid on account of the beneficiary."

This was assumed to be correct in *Drummond v Collins* 6 TC 525 but the point was not directly considered. Maybe the law could or should have gone down that road but it seems unlikely that it will now do so. Much statute law is drafted on the contrary view. The law can for most purposes be regarded as settled.

6.13.1 *Power over income*

A typical discretionary trust provides this type of power over trust income:

> The Trustees may accumulate the whole or part of the income of the Trust Fund during the Accumulation Period. That income shall be added to the Trust Fund. The Trustees shall pay or apply the remainder of the income to or for the benefit of any Beneficiaries, as the Trustees think fit, during the Trust Period.

A payment of trust income under such a power is income and not capital. This has never been doubted.

6.13.2 *Power over capital*

A typical discretionary trust also provides this type of power over trust capital:

> The Trustees may pay or apply the Trust Fund for the advancement or benefit of any Beneficiary.

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

(1) the payments are made to satisfy an "income purpose", e.g. maintenance of a beneficiary; and

(2) the payments are recurrent (e.g. annual or even monthly).

This follows in the author's view from *Stevenson v Wishart* 59 TC 740. The judgment of Knox J is clearer on this point than the Court of Appeal.

6.13.3 *Accumulated income paid out as income*

A typical 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".[31]

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31 Section 31 Trustee Act 1925.

A payment of trust capital under such a power is income. 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 757.

It might help that the trust accounts recorded an Accumulated Income Fund (instead of recording accumulated income as increasing the capital fund). However, this should not strictly be necessary.

6.13.4 *Accumulated income paid out as capital*

Suppose, lastly:

(1) trustees accumulate income and add it to capital; and

(2) the trustees pay that capital to a beneficiary in exercise of a power like that in paragraph 6.13.2 (Power over capital).

The payment is still capital and not income. In my view this follows from *Stevenson v Wishart.* In that case the distributions which the Revenue sought to tax as income represented original trust capital and not accumulated income. In my view this makes no difference. *Stevenson v Wishart* is authority for the proposition that the income/capital question is governed by the terms of the power concerned.[32]

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

(1) income was accumulated;

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

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

the Revenue would have an attractive argument that the distribution should be regarded as income under general principles or under the rule in *Furniss v Dawson*. In practice it should be practical to avoid this by

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

ensuring that advances of capital are not neatly identifiable with accumulated income.

6.13.5 *The Revenue view*

The Revenue view is in the Trusts Settlements and Estates Manual:

> **3755. Beneficiary receives discretionary payment from a resident trust** [November 2003]
> Trustees of a discretionary trust have the power to decide how to apply the trust income. A discretionary income payment is treated as an amount that is net of tax at the rate applicable to trusts. The beneficiary's income is the net amount grossed at the rate applicable to trusts. It carries tax credit at that rate. It is available for relief or repayment.
> The gross amount is an annual payment. It is a new source of income, usually not identified with the underlying trust income. *Cunard's Trustees v CIR* (27 TC 122) supported the view that when the trustees exercised their discretion, a new source of income came into existence.
> Certain beneficiaries can claim relief under extra-statutory concession B18. This allows them the exemption or reliefs they could have claimed if they had received the underlying trust income directly.
> *When payment made*
> For tax purposes the beneficiary received a payment on
> - the date the trustees made the payment or
> - the date the beneficiary became legally entitled to require the trustees to pay over the income. This could be when the payment indefeasibly vested, following the trustees' resolution....
>
> **3757. Discretionary payment from trust capital**
> A discretionary payment made out of trust capital is usually not regarded as the income of the beneficiary. This view was supported in the case of *Stevenson v Wishart and Others* (59 TC 740).
> Exceptionally, payments out of capital are treated as the income of the beneficiary where the beneficiary has pre existing annual income entitlement
> - of a fixed amount or
> - of a certain defined level as in *Cunard's Trustees v CIR* (27 TC 122)
> - and the trustees can or are required to top up the trust income to that amount or level out of capital.

This is consistent with the above.

6.14 Situs of source when source is a trust

Where the trust is the source, how does one decide its situs: the residence of the trustees; the proper law; the country in whose courts the trust will be enforced? It is suggested that trustee residence is the deciding factor, and this is consistent with ESC B18.

6.15 Income from foreign land

All land outside the UK is treated as a single business, and therefore a single source, no matter how many properties are held: see s.65A(4) ICTA 1988. The disposal of one out of a number of properties and the remittance of the rents in the following tax year will not be effective in avoiding a taxable remittance. However, a remittance in the tax year following the disposal of all the properties would be effective.

6.16 US IRAs, Canadian RRSPs, etc

The Revenue view is set out in Inspector's Manual 1622 to 1625:

> **1622. Canadian RRSPs**
> Published: 9/95
> Canadian Registered Retirement Savings Plans (RRSPs) are tax-deferral vehicles commonly used by taxpayers working in Canada to provide an income or lump sum on retirement. The plan holder is permitted to set aside a certain proportion of his income (on which relief from Canadian tax is received) for investment either directly by the individual or, more usually, through a financial institution such as a bank or insurance company. On retirement or earlier, the taxpayer may withdraw a lump sum from the Plan or roll-over the proceeds into the purchase of an annuity. A lump sum withdrawal is subject to Canadian income tax, but if the proceeds are reinvested in an annuity, only the annuity is taxed.
> The tax consequences for a UK-resident holder of an RRSP are as follows: —
> 1) income invested in the Plan is not eligible for UK tax relief;
> 2) the Plan is treated as 'fiscally transparent', that is income arising

within the Plan is taxable in the UK as if the Plan did not exist, notwithstanding the tax-free accrual of income in Canada.

3) a lump sum withdrawal from the Plan is not taxable as such but the disposal of assets held within the Plan to effect the withdrawal may produce a UK tax charge. For example, a disposal of chargeable assets held within the Plan might produce a capital gains tax charge.
4) if an annuity is purchased the non-capital element will be taxable under Case V of Schedule D (see AP896 onwards). A purchased life annuity should be submitted to Financial Institutions Division 1 for determination of the proportion of the annuity which should be regarded as capital.
5) Canadian withholding tax at a rate of 25 per cent is deducted from withdrawals made by Plan holders who are not-resident in Canada. No tax credit relief is available in the UK for this tax where a tax charge arises in the UK (see (3) above), because the Canadian tax is imposed on a lump sum withdrawal from the Plan, whereas UK tax is imposed on gains resulting from the disposal of assets held within the Plan.
6) under Canadian domestic law, tax at 10 per cent may be withheld from payments of annuities derived from RRSPs, but it is understood that the Canadian tax authorities take the view that where such annuities are paid to UK-residents they will be exempt from Canadian tax under Article 17(1) of the Canada/UK Double Taxation Convention. If a taxpayer claims credit for Canadian tax paid on an annuity he should be advised to seek repayment from Revenue Canada and credit relief will not be allowable in the United Kingdom.

1623. Canadian RRIFs
Published: 9/95
When an RRSP (see IM1622) matures, the Plan holder may, as an alternative to withdrawing the funds or buying an annuity, use the property held within the Plan to establish a Registered Retirement Income Fund (RRIF).
An essential feature of an RRIF is that a minimum amount, arrived at by dividing the fair market value of the property held within the Fund at the beginning of the year by the difference between 90 and the age of the Fund holder at the beginning of the year, must be paid out to the investor each year. In this way, cash benefits are provided each year up to age 90. If, in any particular year, additional funds are required, these may be withdrawn, so long as the total does not exceed the value of the

property held in connection with the Fund immediately before the withdrawal.

Income arising within an RRIF is tax-free in Canada, but there is a Canadian tax charge on withdrawals from the Fund.

For UK tax purposes, the treatment of RRIFs follows that for RRSPs indicated at IM1622(2), (3) and (5). It is understood that Revenue Canada regards the payments made each year as pension income and treats them as exempt from Canadian tax where paid to a UK-resident, under Article 17(1) of the UK/Canada Double Taxation Convention. The Canadian concept of 'periodic pension income' has no relevance, however, in the UK, where it is the income earned by the Fund's investments which is taxable, while withdrawals do not themselves attract a UK tax charge.

Any cases of doubt or difficulty concerning either RRSPs or RRIFs should be referred to International Division (Cases IV & V), Strand Bridge House for advice.

1624. United States Individual Retirement Accounts

Published: 9/95

Individual Retirement Arrangements are United States tax shelters for working US taxpayers wishing to provide for their retirement. They are broadly similar to Canadian RRSPs (see IM1622).

There are two types of Individual Retirement Arrangement, an 'Individual Retirement Account' (IRAC) and an 'Individual Retirement Annuity' (IRAN).

An IRAC is a trust (or similar arrangement known as a custodial account) set up for the exclusive benefit of the taxpayer and, on his death, nominated beneficiaries, which satisfies certain conditions imposed by United States tax law. Contributions to an IRAC are tax deductible in the United States and the funds can be invested in a wide range of investments. IRAC funds can be withdrawn at any time, but if withdrawals are made before the taxpayer reaches the age of 59½ he must pay an additional penalty tax of 10 per cent unless he is disabled.

Provided that the taxpayer does not nominate a beneficiary to receive the balance of the IRAC on his death, the trust is transparent for the purposes of UK Income Tax. Income on IRAC investments is accordingly assessable on the taxpayer under Case IV or V of Schedule D as appropriate, whether or not withdrawals from the IRAC are made. The nomination of a beneficiary creates a settlement within the terms of the provisions of ICTA 1988, s 672. In such a case the taxpayer is liable to UK Income Tax under Case VI of Schedule D on the IRAC income arising in the tax year (ICTA 1988, s 675).

Whether or not a beneficiary has been nominated, an IRAC is a bare trust for the purposes of TCGA 1992, s 60. The taxpayer is therefore chargeable to United Kingdom Capital Gains Tax in respect of any chargeable gains arising on the disposal of IRAC investments. Changes in IRAC investments will generally involve acquisitions and disposals of chargeable assets by the taxpayer.

Withdrawals from an IRAC do not of themselves give rise to a charge to Income Tax or Capital Gains Tax, but they will often be preceded by the disposal of IRAC investments (including the conversion of dollars to sterling) giving rise to a chargeable gain or an allowable loss.

1625. United States Individual Retirement Annuities

Published: 9/95

Under Individual Retirement Annuities (IRANs), contributions are used to purchase an annuity from a life assurance company. No UK tax liability arises until the annuity becomes payable, when the annuity payments become chargeable under Case V of Schedule D.

If an IRAN life annuity was paid for partly or wholly by an employer, the whole of each annuity payment will be taxed as income, but if there was no employer's contribution the provisions of ICTA 1988, s 656 apply so as to exclude the capital element. Any annuity within ICTA 1988, s 656 should be submitted to Financial Institutions Division 1 for determination of the capital element.

Any cases of doubt or difficulty involving IRACs or IRANs should be referred to International Division (Cases IV and V), Strand Bridge House.

CHAPTER SEVEN

THE SCHEDULE D REMITTANCE BASIS

7.1 The six remittance bases

Income tax and CGT employ two fundamental types or bases of assessment:

(1) An *arising basis* under which tax is computed by reference to the amount of income or gains which arise.

(2) A *remittance basis* under which tax is computed by reference to the amount of income or gains which are received in the UK.

A remittance basis applies (in short) when a foreign domiciliary receives any of the following:

(1) Foreign investment income (Schedule D Cases IV and V).

(2) Chargeable overseas earnings.

(3) Foreign income taxable under s.660A ICTA 1988 (the Settlement provisions).

(4) Foreign income taxable under s.739 (transfer of assets abroad – charge on transferor).

(5) Benefits taxable under s.740 (transfer of assets abroad – charge on non-transferors).

(6) Foreign chargeable (capital) gains.

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

This chapter deals with the remittance basis applying to Schedule D Cases IV and V, which is the ancestor of the other remittance bases. It is here called "the Schedule D remittance basis" or (where the context is clear) simply "the remittance basis".

7.2 Why is the remittance basis difficult?

Our subject suffers (in common with much tax law) from unnecessary complexity and obscure statutory drafting. The underlying problem is inherent in the concept of a remittance basis. Although it is an exaggeration to say that "money has no earmark" it is often very difficult to trace or earmark money.[2] But this is what the remittance basis requires to be done. The concomitant of conceptual weakness is a large and not always satisfactory case law and sometimes arbitrary rules with anomalous results. It is not surprising that Viscount Simonds referred to remittances as "this difficult branch of the law".[3]

7.3 History of the remittance basis[4]

The history of the remittance basis is instructive for its own sake and necessary to understand the older cases in their context. Until 1914 all foreign source income was taxed on a remittance basis: s.100 Income Tax Act 1842. Since then the remittance basis has been withdrawn, in stages, for all foreign income except that of foreign domiciliaries. In 1914 income from "securities, stocks, shares, or rents in any place out of the United Kingdom" was brought onto an arising basis: s.5 Finance Act

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1 It is appropriate that s.761(5) ICTA 1988 refers to tax on "*a* remittance basis" rather than *the* remittance basis.

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

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

4 See "Taxing Foreign Income from Pitt to the Tax Law Rewrite-The Decline of the Remittance Basis", John Avery Jones in *Studies in the History of Tax Law*, Hart Publishing, 2004.

1914. This did not apply to foreign domiciliaries and non-ordinarily resident British subjects. Even those who were domiciled and ordinarily resident in the UK retained the remittance basis for any foreign source income which did not consist of securities or rents. Hence the need for decisions such as those discussed in 6.12 (Income from trusts: identifying the source) which decided whether income filtered through trusts was to be regarded as income arising from securities or income arising from the trust.

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: see s.19 FA 1940. The rule was intended, perhaps, to encourage foreign trade. However, it did enable tax planning by splitting a single mixed UK and foreign based trade into separate UK and foreign source trades, the latter qualifying for the remittance basis. An arrangement of this kind was held to be successful in *Newstead v Frost* 53 TC 525. So in 1974 this was abolished and the current position was reached: ss.22, 23 FA 1974.

The same rules applied to companies as to individuals, until the introduction of corporation tax in 1965, which put UK resident companies onto an arising basis.

7.4 Cases IV and V: introduction

Tax under Schedule D is charged under six categories known as "cases": s.18(2). The two cases relevant to this chapter are Schedule D Cases IV and V:

Case IV: income arising from securities out of the United Kingdom;

Case V: income arising from possessions out of the United Kingdom not being income consisting of emoluments of any office or employment.

The essential components of the charge under Schedule D Cases IV and V are:

(1) A UK resident person.

(2) The person receives "income".

(3) The income arises from "securities" (Case IV) or "possessions" (Case V).

(4) The securities or possessions are "out of the United Kingdom".

Points (1), (2) and (4) are discussed in the previous chapter.

The term *possessions* bears a wide meaning:

> *Possessions* is a wide expression; it is not a word with any technical meaning ... it relates to all that is possessed ...
>
> (*Colquhoun v Brooks* 2 TC 490)

This word is all-embracing. A trade, for instance, may be a possession. The boundaries to the concept of possession are only that property falling in other specific Schedules (though a *possession* in this wide sense) is to be dealt with under those Schedules. For instance, employment income is expressly excluded from Schedule D, Case V.

The term *securities* has a variety of meanings. In this context it has a restricted meaning which has been explained, after a fashion, in this way:

> *Securities* denotes a debt or claim the payment of which is in some way secured. The security will generally consist of a right to resort to some fund or property for payment; but I am not prepared to say that other forms of security (such as a personal guarantee) are excluded ... *securities* does not include stocks or shares.
>
> (*Singer v Williams* 7 TC 419)

The possession or security is described as the source of the income.

7.4.1 *No real distinction between Case IV and Case V*

Of course, a security is also a "possession" in the wide sense. Income from securities is nevertheless within Case IV and outside Case V: *Singer* *v Williams* 7 TC 419. However, there is no significant[5] difference between the two cases, so the distinction between "securities" and "possessions" does not matter. This is just as well, considering that the term "securities" is, even after *Singer v Williams*, a somewhat vague expression.

7.5 Who qualifies for the Schedule D remittance basis?

Section 65 ICTA 1988 sets out the basis of assessment for Schedule D Cases IV and V. Subsections (1) to (3) set out an arising basis of assessment. Then s.65(4) provides:

> Subsections (1) to (3) above...shall not apply to any person who makes a claim to the Board stating
> [1] that he is not domiciled in the United Kingdom,
> [2] or that, being a Commonwealth citizen or a citizen of the Republic of Ireland, he is not ordinarily resident in the United Kingdom.
>
> (Paragraphing added)

7.5.1 *Foreign domiciled person*

Two categories of person qualify for the remittance basis. Firstly: "any person who is not domiciled in the United Kingdom" (the foreign domiciliary with whom this book is primarily concerned).

7.5.2 *Non-ordinarily resident Commonwealth/Irish citizen*

The second category is any person who is:

(1) a Commonwealth citizen or a citizen of the Republic of Ireland; and

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5 There is relief for Schedule D Case V expenses and losses; there is no equivalent for Case IV but none is needed, as the nature of interest from securities is such that one cannot expect relief for losses or expenses. For another distinction which is more apparent than real see 7.10.1 (Distinctions between Case IV and Case V remittance bases?). The distinction between the two separate Cases (like so much in the tax system) is due only to historical reasons: the former differences between the basis of assessment of the two Cases were long ago repealed.

(2) not ordinarily resident in the UK; and

(3) resident in the UK (or he would not be within the scope of Schedule D Case IV or V at all); and

(4) domiciled in the UK (or he would fall within the first category anyway).

This must be a rare case. The special tax treatment of Commonwealth (and Irish) citizens is irrational and no doubt the discrimination against EU citizens is in breach of EU law. There are two ways the anomaly may be corrected:

(1) Extend this category so that the remittance basis applies (regardless of citizenship) to any person who is resident in the UK but is either not ordinarily resident or not domiciled here. This would be consistent with the position for earnings income. This was the recommendation of the 1955 Royal Commission on Taxation (Final Report Cmd. 9474 para. 296).

(2) Abolish this category so that all UK residents pay tax on an arising basis unless foreign domiciled (even if not ordinarily resident). This would be consistent with CGT.

It is suggested that the law could be simplified, and the anomaly fairly corrected, by abolishing this category and bringing such persons on to the arising basis. For simplicity I will on most occasions ignore this possibility and simply refer to "foreign domicile".

7.5.3 *"Any person"*

Under s.65(4) any "person" who satisfies the relevant conditions can qualify for the remittance basis. The term "person" generally denotes individuals, trustees and companies. Companies are now taken out of the remittance basis for corporation tax purposes by s.12 ICTA 1988.[6]

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6 "... corporation tax shall be assessed and charged for any accounting period of a company on the full amount of the profits arising in the period (whether or not received in or transmitted to the United Kingdom) ..."

The Schedule D remittance basis therefore applies to individuals and trustees. The usual case is, of course, individuals. A trustee will qualify for the remittance basis if:

(1) the trustee is an individual domiciled outside the UK[7]; or

(2) the trustee is a company incorporated outside the UK.[8]

This could be a convenient way of obtaining income tax advantages of offshore trusts without the inconvenience of offshore trustees. In practice the author has never seen this done. Sections 739 and 740 ICTA 1988 may, of course, apply. If one trustee is UK domiciled, and others are not, the trustees as a body do not qualify for the remittance basis.

7.6 Time of foreign domicile

Section 65(4)[1] applies if the foreign domiciliary "is" not domiciled in the UK. In the context, it is considered that this means that he is not domiciled at the time the income arises. Domicile at the time the claim is made, or accepted, or at any other time in the tax year, is not relevant.

7.7 Rates of tax under arising and remittance basis

See 16.1 (Rates of income tax).

7.8 Claims

Section 65(4) refers to a person "who makes a claim ... stating that he is not domiciled in the UK". The context shows that the person must

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However, companies could formerly qualify for the remittance basis: see 7.3 (History of the remittance basis). This is why some of the old cases on the remittance basis concern companies.

7 Or (a rare case) if the trustee is:
(i) a Commonwealth citizen or a citizen of the Republic of Ireland; and
(ii) not ordinarily resident in the UK.

8 The domicile of a company is its place of incorporation. Section 12 ICTA 1988 does not apply to a company in its capacity as trustee: s.6 ICTA 1988. The possibility of a trustee being taxed on the remittance basis was recognised in *Dawson v IRC* 62 TC 301 at 320.

actually be domiciled outside the UK. That is, the remittance basis only applies to a person making a claim which states *correctly* that he is not UK domiciled. The time limit for a claim is the usual five years after 31 January following the year of assessment to which it relates: see s.43 TMA 1970. The claim must be made to the Board of Inland Revenue. The significance of this is that appeals lie only to the Special Commissioners: see s.46C(1) TMA 1970. In practice a claim is usually made by ticking the appropriate box on the tax return.

7.9 Circumstances where it is desirable not to claim Schedule D remittance basis treatment

These include:

(1) where it is better to have the 10% deduction on a foreign pension: see 9.2 (Taxation of foreign pension);

(2) where it is better to have the Schedule F ordinary or upper rates on remitted dividends: see 16.5 and 16.6 (Rates of tax on remitted income);

(3) where it is better to have relief for foreign trading losses.

If no claim is made in any year for Schedule D remittance basis treatment, the remittance basis still applies for employment income and CGT.

7.10 The remittance basis: the statute

Section 65(5) ICTA 1988 provides:

> Where subsection (4) above applies, the tax shall be computed—
> (a) in the case of income chargeable under Case IV, on the full amount, so far as the same can be computed, of the sums received in the United Kingdom in the year of assessment without any deduction or abatement; and
> (b) in the case of tax chargeable under Case V, on the full amount of the actual sums received in the United Kingdom in the year of assessment
> [i] from remittances payable in the United Kingdom,

[ii] or from property imported,
[iii] or from money or value arising from property not imported,
[iv] or from money or value so received on credit or on account in respect of any such remittances, property, money or value brought or to be brought into the United Kingdom,

without any deduction or abatement other than is allowed under the provisions of the Income Tax Acts in respect of profits charged under Case I of Schedule D.

(Paragraphing added to identify what have been called "the four sub-heads" of Case V)

7.10.1 *Distinctions between Case IV and Case V remittance bases?*

It appears at first that there are two distinct remittance bases here: the terms of s.65(5)(a) (Case IV) are quite different from those of s.65(5)(b) (Case V). But on examination the differences are not significant. Two apparent distinctions can be dismissed out of hand:

(1) The Case IV remittance basis only applies "so far as the [amount] can be computed". It is difficult to say what the drafter could have had in mind when he wrote those words but they have no practical effect.

(2) The Case V remittance basis throws in the word "actual" but this is not thought to carry any significance.

The other distinction appears to be this: Case IV requires only that the sums be received in the UK; under Case V they must be received in the UK from one of the four sub-heads; receipt in isolation is not enough. That would certainly be the natural reading of the words of the subsection. Against this, however, are two powerful considerations. It is difficult to see any good reason why Case IV should have a different remittance basis from Case V; and it is difficult to make sense out of the wording of the four sub-heads. Therefore in *Thomson v Moyse* 39 TC 291, the majority concluded that the four sub-heads are either illustrations (in which case it is not necessary for remitted income to fall within them to be taxable) or else they are all-embracing (in which case all remitted income will necessarily fall within them):

> These four sub-heads, as they have been called, should be treated as illustrations (no doubt intended to be a comprehensive list of illustrations) of the way in which, when foreign income is transmitted to this country, the transmission can be effected and the sterling sums obtained.
>
> These sub-heads, which are not at all very clearly phrased, should accordingly be construed according to their general sense and without too much nicety of language ... I draw attention to this because one or two of our authorities have treated these and other words with more semantic scruple than is appropriate to the context; and from that have come some of our present troubles.
>
> (at page 339)

The minority accepted a theoretical possibility of a remittance not caught under any of the four sub-heads; but suggested that in practice this would not happen.[9] The author is unable to offer an example of a remittance falling outside the four sub-heads. In my view the law is now settled, that there is no difference between the remittance bases of Case IV and Case V. The tax law rewrite project will tidy this up in due course.

7.11 Remittance in tax year after receipt

In *Scottish Provident Institution v Farmer* 6 TC 34, income arose in one year but was not remitted until the following year. The taxpayer argued that (income tax being an annual tax) there could be no liability in the later year for a remittance of income which had accrued in an earlier year. In principle, that argument should have succeeded. It is a fundamental principle that income tax is an annual tax. However, the Court of Session (with one eye fixed firmly on the tax avoidance consequences) summarily

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9 "These four ways seem to comprehend all possible methods, but if a case should ever happen in which a sum is received, but not in one of these four ways, then Case V would not apply: to that extent it is narrower in scope than Case IV." (Lord Reid, p 332); "I do not think these four sources render Case V very different from Case IV. The four heads comprehend almost every conceivable way in which the income can be used to produce sums which are received in the United Kingdom." (Lord Denning, p 342). This was also the view of Lord Cohen in *IRC v Gordon* 33 TC 220.

rejected the taxpayer's argument. The Court of Appeal reached the same conclusion in *Patuck v Lloyd* 26 TC 284. It is interesting to contrast *National Provident Institution v Brown* 8 TC 57, where the House of Lords by a majority applied the principle of the "source doctrine" remorselessly, regardless of the tax planning opportunities thereby revealed.

7.12 Remittance after acquisition of United Kingdom domicile

Suppose:

(1) A foreign domiciliary retains foreign income abroad;

(2) acquires a UK domicile; and

(3) subsequently remits the income.

Is there a charge? Section 65(4) ICTA 1988 provides that the usual arising basis of assessment:

> (4) ... shall not apply to any person who makes a claim to the Board stating that he is not domiciled in the United Kingdom ...
> (5) Where subsection (4) above *applies* the tax shall be computed [on the remittance basis].
>
> (Emphasis added)

On a natural reading, subsection (4) ceases to "apply" once a person is domiciled in the UK. Accordingly, there is no charge under Cases IV and V in these circumstances.

While the contrary view is arguable, it appears that the Revenue accept this view. *Taxation Practitioner,* December 1992 p. 541 records:

> The Revenue ... confirmed that income and gains arising in a non-domiciled period could be remitted during a domiciled period without

incurring a tax charge.[10]

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

7.13 Remittance without claim for Schedule D remittance basis treatment

An interesting question arises if a foreign domiciled individual:

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

(2) in that year remits income.

If the view taken here is correct, then, strictly there is no tax due on the remittance. (Income of the year will be taxed on an arising basis.) This is a high risk strategy. The Revenue may not apply their usual practice in this case, and the result is so absurd that a Court would be tempted to hold that a tax charge applied (even though this overturns generally the Revenue practice set out in the above paragraph). It is worth trying as remedial action if an individual has *actually* remitted a significant sum of foreign investment income to the UK.

7.14 Income arising when resident, remitted when non-resident

Suppose:

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

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10 One's confidence in this statement is slightly dented by the fact that it appears at first sight to extend even to employment income and CGT. For employment income, this is not correct since 1989: see 8.20 (Remittance after acquisition of United Kingdom domicile). For CGT this is probably not correct and certainly not Revenue practice; see 17.8 (Gains remitted after acquisition of UK domicile). But the reference to "income and gains" may and should be taken as a reference to income under Schedule D Cases IV and V. Before the FA 1998 modernised the terminology, the term "profits and gains" was often used to denote "income"; there was an example of this in s.65(5) ICTA 1988 itself.

(2) The individual becomes non-resident and subsequently remits the income to the UK.

The foreign domiciliary is not within the charge to Schedule D on foreign income during his non-resident period, and so no tax charge arises.

This is consistent with the CGT position: see 17.7 (Gains accruing while resident, remitted while non-resident).

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

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

7.15 Remittance after death

Suppose:

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

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

It is submitted that no tax charge arises. On the death, the unremitted income becomes vested in the personal representative of the deceased by operation of law. Remittance by them does not count as a taxable remittance: see 7.25 (Receipt by third party). It makes no difference whether the remittance is in the same tax year as the death or later.

7.16 Income arising when non-resident, remitted when resident

Suppose:

(1) A non-resident foreign domiciled individual receives foreign income. The income is not of course taxed as it arises.

(2) The individual becomes UK resident, and subsequently remits that income.

The sum remitted is not income chargeable under Schedule D Case IV or V[11], so applying the basic principle explained below this is not a taxable remittance. This is consistent with the CGT position: see 17.7 (Gains accruing when non-resident, remitted when resident). The Revenue accept this:

> **Remittance basis income not assessable**
> Published 9/95
> Where the remittance basis applies, it is ordinarily immaterial, subject to the guidance in IM1660–IM1664,[12] in what year the income arose. Where, however ... the taxpayer shows that remittances include income which—
> (i) did not arise during a year of assessment in which he was resident in the UK
> and
> (ii) did not arise in the year which is the basis year of assessment,
> such income should be excluded from the computation of liability.
> *Example*
> X, who is assessable for year 3 on the basis of remittances of income in year 2, was not resident in the United Kingdom for years 1 and 2. His overseas income is £1,500 each year. He remits income totalling £1,000 in year 2 and shows that £300 of this came from income which arose in year 1.
> The assessment for year 3, which would normally be on £1,000, may in the circumstances be limited to £700.[13]

Any other rule would have absurd consequences and breach the basis of UK tax jurisdiction: see 6.4 (UK tax jurisdiction).

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11 Since those cases only apply to income accruing to a person resident in the UK in the year that the income accrues.

12 Set out in 5.5 (Year of arrival).

13 Inspector's Manual 1563. The example has not been revised to take into account the abolition of the preceding year basis in 1994, but this does not affect the point being made.

7.17 Remittance basis only applies to sums received in the UK derived from the foreign income

Under the remittance basis, tax is computed on "the full amount of the *sums* received in the UK". The word "sums" here might at first sight be taken to refer to any sum of money whatever received in the UK from abroad. But that would lead to absurd results:

(1) If a foreign domiciliary received foreign income of £10, but inherited and remitted from abroad £100,000, he would be taxed on the £100,000! (This would also conflict with the principle that "income tax is a tax on income".)

(2) Likewise, if the foreign domiciliary received foreign income of £10, and a UK source income of £100,000 which was received out of the UK and remitted to the UK. The UK source income would be taxed once on an arising basis and again on the remittance basis.

More reasonably, one might perhaps have thought that a remittance should (at least generally) be regarded as made out of foreign income if the individual had foreign income to remit: that is, one would not need to trace any particular remittance to any particular receipt.[14]

However, it was assumed in *SPI v Allan*, decided in *Kneen v Martin*, and confirmed in *Thomson v Moyse* 39 TC 291, that the remittance basis is computed by reference only to sums received in the UK which are or represent the sums of foreign income subject to the charge under Schedule D Case IV or V. The remittance of any other sums does not count.

> The sums must be sums "of" the [foreign] income, by which I would understand "sums of money derived from the application of the [foreign] income to achieving the necessary transfer".[15]

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14 This is (sensibly) the approach taken in deciding whether a sum is "paid out of the profits brought into charge to tax"; see *Chancery Lane Deposit & Offices Co Ltd v IRC* 43 TC 83; *Fitzleet Estates Ltd v Cherry* 51 TC 708. It is also the approach taken in the taxation of estates of deceased persons: see s.696 ICTA 1988.

15 *Thomson v Moyse* 39 TC at 335. Likewise Lord Denning, expansively: "These sums must be directly referable to Mr Moyse's New York income in this sense, that they must come out of his New York income, or be deductible from it or be traceable to it, so that in the end his New York income is seen to be the provider of sums

I shall refer to sums of foreign income, or sums derived from the foreign income, but remember that "derived from" is not the statutory expression, but a judicial expression of the implied statutory requirement, which could be expressed in various ways.

For the CGT remittance basis the statutory question is whether the amount received in the UK is "in respect of" the chargeable gains. For the employment income remittance basis the statute applies if the earnings are remitted. It is considered that the test is exactly the same in each case.

7.18 Conditions for the remittance basis charge

Thus three conditions must be satisfied for there to be a charge under the remittance basis:

1. There must be a receipt which is an income receipt within Schedule D Case IV or V.

2. There must be a sum received in the UK.

3. The sum received in the UK must be the foreign income, or a sum derived from it.

None of these conditions has proved easy. First a note on terminology.

7.19 Capital/income terminology in remittance basis context

One might start off by thinking that a remittance of income is taxable and a remittance of capital is not. It is not that simple. The terminology of "capital" and "income" in the context of the remittance basis is potentially confusing.

A sum received in the UK may not be taxable under the remittance basis because it is not derived from income but from some fund easily identified as capital in the hands of the taxpayer, such as a gift or inheritance; or borrowing. In cases in this category it makes sense to say that the remittance is tax free because it is one of capital.

A sum received in the UK may not be taxable under the remittance basis

received in England"; at p.340.

because:

(1) the donor was non-resident when this particular sum accrued; or

(2) the sum remitted has already been subject to income tax; or

(3) the source of the income ceased in a previous year.

Such sums are "income" in the normal sense of the expression. These examples show that a remittance of a sum which is income in nature may nevertheless be tax free on the remittance basis.

Suppose a UK resident foreign domiciliary accumulates income offshore for many years; the accumulated fund is his "capital" in the normal sense of the expression, and not his income. Yet for the purposes of the remittance basis, it is in principle taxable if remitted.[16] Perhaps it is better described as "income". Best of all is not to use the terminology of capital/income where it is unnecessary to do so.

7.20 The tracing principle

In order to decide whether a remittance is derived from foreign income, one can (unsurprisingly) trace income through various transformations. If the income is invested abroad in foreign investments and the investments are sold and the proceeds of sale are remitted, there will be a taxable remittance. The proceeds of sale are derived from the foreign income: an example is *Patuck v Lloyd* 26 TC 284.

Likewise, if foreign income is invested in assets which are brought to the

16 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."

UK and sold and the proceeds received here; the receipt of the proceeds of sale is derived from the foreign income: see *Walsh v Randall* 23 TC 55.

7.21 When is there a remittance?

7.21.1 *No requirement of "bringing in" the foreign income*

In *Thomson v Moyse* 39 TC 291, the taxpayer held foreign income in a US dollar account. He drew a cheque on that account payable to the order of a UK bank. Had he cashed the cheque and received the proceeds in the UK, there would clearly have been a remittance. Instead he sold the cheque to the bank (which cashed the cheque on its own behalf). He argued that he did not *bring in* his dollars to the UK, and so there was no remittance. The House of Lords rejected the argument. There was no requirement of "bringing in to the United Kingdom" the foreign income (or if there were, the income was "brought in" in the relevant sense).

> He parted with his dollars: he got his sterling. He emptied one pocket of dollars in order to fill another pocket with sterling.
>
> (39 TC at 333)

7.21.2 *Method of remittance does not matter*

There is a remittance if there is a "transmission" of income

> from one country to the other by whatever means the agencies of commerce or finance may make available for that purpose.
>
> (39 TC at 335)

7.22 Receipt in UK must be of money or commercial equivalent

> A sum of money may be received in more ways than one, e.g. by the transfer of a coin or a negotiable instrument or other document which represents and produces coin, and is treated as such by business men. Even a settlement in account may be equivalent to a receipt of a sum of money, although no money may pass; and I am not myself prepared to say that what amongst businessmen is equivalent to a receipt of a sum of money is not a receipt within the meaning of the Statute which your

> Lordships have to interpret.
>
> (Lord Lindley, *Gresham Life v Bishop* 4 TC 464)

In *Scottish Widows' Fund Life Assurance Society v Farmer* 5 TC 502, Lord Dunedin, the Lord President, said that the word in the Statute

> is "receipt" and nothing less than actual receipt will do. Now, actual receipt of money, it seems to me, can only be effected in one of two ways. Either the money itself must be brought over in specie, or the money must be sent in the form which, according to the ordinary usages of commerce, is one of the known forms of remittance.

Lord Denning, in *Thomson v Moyse* 39 TC 291 put the point this way:

> Nor is it necessary that Mr Moyse ... should receive the sums in coins or dollar notes or treasury notes. It is sufficient if he ... receives the sums in England in any of the other forms of money recognized by commercial means, such as bills of exchange, cheques, promissory notes or cash at bank.

The Revenue Manual puts the point this way:

> Income is received in the United Kingdom if funds provided in the United Kingdom are derived from income arising overseas. The precise mechanisms of banking and commerce used to achieve this result are immaterial. The receipt may be in any commercially recognised form of money, for example, cash, notes, cheques, promissory notes, bills of exchange, or financial credit. Such money does not have to be physically imported. It may be received from another United Kingdom resident in respect of the transfer to him abroad of money or assets representing the income.
>
> (Inspector's Manual, para 1564, published 9/95)

These passages are putting the same point in different ways. They are saying that foreign income represented by financial instruments – such as cheques, promissory notes, bills of exchange, etc. – (which are received in the UK) is regarded as remitted here *if* the instrument is a commercially recognised form of money.

The next question is when an instrument is a "commercially recognised form of money". This question was not decided or discussed in *Thomson v Moyse*. The question is to some extent a question of fact, not law. Commercial practice can change over time. Some guidance can be found in contract law cases on "payment" obligations. See *Chitty on Contracts* (28th ed., 1999), Chapter 22, Part 4, especially at 22–045. There is also guidance closer to home.

7.22.1 *Receipt of uncashed cheque in United Kingdom*

The Inspector's Manual contains a helpful statement here:

> **1564.** ... Where ... the receipt is in the form of a cheque, the sum is received in the United Kingdom when it is realised in the United Kingdom, for example, it is credited to a United Kingdom bank account (*Parkside Leasing Ltd v Smith*, 58 TC 282), exchanged for cash in the United Kingdom (through a bank or otherwise), accepted by a third party in settlement of a debt owed by the taxpayer .... A cheque representing income assessable under Schedule D, Case IV or V, which is received in the United Kingdom 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 United Kingdom'.

This is right since a cheque is not a "commercially recognised form of money". This is obviously so if the cheque is not transferable; but the same applies to a cheque which is transferable, unless perhaps it is a bankers draft payable to bearer.[17]

7.22.2 *Receipt of marketable bearer bonds in United Kingdom*

In *Scottish Widows' v Farmer* 5 TC 502, foreign income was invested in the form of bearer bonds. The bonds were brought to the UK. It was held that no sum of money had been received in the UK, as the bonds were not the commercial equivalent of money. The bonds were negotiable instruments, and easily marketable, but they were of fluctuating value.

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17 Another example is *Walsh v Randall* 23 TC 55 which concerned a demand draft in favour of a hospital brought to the UK. It was assumed that there was no remittance until the draft was given to and cashed by the hospital. Unfortunately, the report is uninformative about the nature of this "demand draft".

The Lord President said:

> Nobody ever heard of remitting money by means of a bearer bond, for this very good reason: you could not possibly remit money by it and know exactly what you are doing, because the price of bearer bonds fluctuates in the market every day, and a bond might start from New York at one price and arrive in London at a perfectly different one. It therefore is not at all in the same category with that way which modern arrangements have perfected, by which you may send money from one country to another in the form of hard cash consigned in a package or box, or by means of a bank draft, which is, of course, simply a transaction of debtor and creditor between different persons on different sides of the Atlantic. But those are well-known methods of remitting money.

It follows *a fortiori* that the mere investment of unremitted income in assets which are UK situate under the international law situs rules does not amount to a taxable remittance. In *Scottish Widows*, the bearer bonds were UK situate under the IHT/private international law *situs* rules, but that had "no bearing on the point in question".[18]

7.22.3 *Conclusion*

In summary, cheques, promissory notes, bills of exchange, etc., which represent foreign income and are received in the UK, are taxable remittances only if:

(i) they are "commercially equivalent to money" – which in practice is not usually the case; or

(ii) the cheque is cashed, or the promissory note is sold, or redeemed, and the cash proceeds are received in the UK.

7.23 Foreign income from bond or coupon held in the UK

Scottish Widows' Fund Life Assurance Society v Farmer 5 TC 502 is a

18 The same point arose on the facts of *SPI v Farmer* 6 TC 34; but the point was not discussed in argument.

difficult case to follow. A close reading is necessary in order to appreciate that two distinct points were involved. Firstly, foreign income arising abroad was invested in bearer bonds and the bonds were brought to the UK. It was argued that this income had been remitted. The argument was rejected for the reasons set out above.

Quite independently, the taxpayer held foreign bearer bonds in the UK. Coupons were attached to these bonds in the usual way. Before the time came when interest was due on the coupons, the taxpayer company sent the coupon to America, where it was presented. The Revenue argued that all the interest from these bonds was to be regarded as received in the UK since the bonds were here, or since the coupons had been here prior to their redemption. This argument is obviously wrong. The question is whether the interest on the bonds had been remitted to the UK, thus

(1) the situs of the bonds from which the income arose (under private international law situs rules) is obviously irrelevant, and

(2) the situs of the coupons *prior* to the date of payment is equally irrelevant.

The interest could not be remitted to the UK before it was due and payable. This, it is submitted, is what the Court of Session said, or meant to say, in this dictum:

> Now, how can this money be said to have been received in this country? As far as the bond itself is concerned, it is, of course, a piece of paper, but it represents a debt. But the debt is a debt which is not presently payable, but which, taking the bond we have taken as an illustration, is a debt which is not payable till the year 1935, and then is not payable in this country, but in New York. In the same way the interest is not payable here; it only is payable, taking the specimen coupons, on the first day of October, 1907, at the agency in the City of New York. Now, it is quite certain that that debt is still extant until it is paid. That is to say, there is still the debt of the principal till 1936, and if one were speaking of a period before the first of October, 1907, the interest is payable until 1907 comes and it is paid. What I have been absolutely unable to understand is the answer to the question I put, and put in vain so far as any answer was given – how money could be in two places at once. According to the argument of the Crown the money was received in this country the moment the bond came into the Company's safe in

> London or in Edinburgh. *Equally it was in America, because the day of payment had not yet come, and therefore it was, so to speak, in the pocket of the debtor.* How it can be at one time both in America and in this country is, I think, a difficulty which surpasses even the powers of legal fiction.
>
> (Emphasis added)

It would be more accurate to say that the income did not exist before it became due, rather than to say that it was "in the pocket of the debtor".[19] But nothing turns on this.

7.24 Chattels purchased out of foreign income and brought to the UK

Is there a charge to tax if a taxpayer expends his foreign income in the purchase of a chattel (such as a picture or a motor car) and that asset is received by him in the UK?[20]

The conventional view is that there is no taxable remittance. For a chattel is not "money" (or the commercial equivalent of money) and the line of cases cited above – *Gresham Life v Bishop*; *Scottish Widows v Farmer* 5 TC 502[21] – all assume that sums of *money* (or the commercial equivalent) must be brought to the UK.

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19 "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).

20 If the remittance of the asset to the UK was not a taxable remittance, there would of course be a remittance if the asset is sold and the proceeds received in the UK (unless the source ceasing principle applied).

21 And some dicta in *Thomson v Moyse* where Lord Radcliffe adopted the conventional view:

> "If, having foreign income, I invest it in property, import the property, and then sell it here, the sterling proceeds arise in the United Kingdom from a sale made here: yet the proceeds are certainly computable (see, for instance, *Scottish Provident Institution v Farmer*, 6 TC 34)."

The Court was not of course considering our particular question and another dictum in the same speech has been cited to support the opposite conclusion:

> "... what importance can there be in the actual place of making the instrument, or in its physical movements, if the direct result of the mechanism employed was to turn the taxpayer's income in one country into money *or value* in the other country, to which he had decided to transfer it?"

The cases may be distinguished. In *Gresham Life*, foreign income was retained abroad, and the only act the Revenue identified as "receipt in the United Kingdom" was the credit in the UK accounts. So while no "money" had been brought to the UK, it was also a feature of the case that *the foreign income remained identifiably abroad.* In *Scottish Widows v Farmer*, foreign income was applied in buying bearer bonds which were brought to the UK. Bearer bonds are in some respects equivalent to chattels, and therefore the case supports the proposition that there is no tax charge on the remittance of chattels *in specie*. However, negotiable instruments differ from ordinary chattels and to some extent resemble contracts. See *Chitty on Contracts* (28th ed,. 1999), para. 34–001. So there is no case directly covering our point.

The point is debated in the OTPR where Robert Venables QC argues for the view that the importation of a chattel does give rise to a tax charge on the remittance basis. Richard Bramwell QC takes up arms for the conventional view.[22]

In practice, however, the view taken by the Revenue is the conventional view that there is no taxable remittance:

> The investment of income abroad does not change its character as income and whether the investments or assets are realised abroad and the proceeds remitted here (*Walsh v Randall*, 23 TC 55, and *Patuck v Lloyd*, 26 TC 284) or whether they are transferred here and then realised

22 See OTPR, Vol 2, July 1992, p.99 (Robert Venables QC); Vol 2, 1992, p.183 (Richard Bramwell QC); Vol 6, February 1996, p.23 (Robert Venables QC). The author need not repeat all the arguments set out in these articles, but will add supplementary points for those who have read the articles and want to take the point further. (i) Dicta in *McCrone v IRC* 44 TC 142 (a case on the Settlement Provisions) may be taken to support the Venables view: "A 'sum' is just an amount, and payment may be made in various forms, including the transfer of marketable securities of a value equivalent to that sum." (ii) There is this practical difficulty with the Venables view. Suppose £100,000 foreign income is spent on a picture. The picture is brought to the UK two years later, worth £50,000. Is there a remittance of £100,000 or £50,000? If the latter, what if it is sold later for £80,000? (iii). The statutory definition of 'sum' in s.24(4) ICTA 1988 might be taken as supporting the conventional view. This provides "References in this section to a sum shall be construed as including the value of any consideration, and references to a sum paid or payable or to be the payment of a sum shall be construed accordingly." This would not be necessary on the Venables view (except for the avoidance of doubt).

> (*Scottish Provident Institution v Farmer*, 6 TC 34), such transactions give rise to 'sums received'. *On the other hand, the mere transfer to the United Kingdom of such investments or assets* other than commercially recognisable forms of money does not constitute 'sums received' (*Scottish Widows' Fund Life Assurance Society v Farmer*, 5 TC 502).
>
> ...
>
> If an overseas credit card is used abroad and the account is settled direct to the card company out of overseas income within Cases IV and V, no liability to United Kingdom tax will arise. *But if an asset purchased using the card is brought to the United Kingdom and subsequently sold here, there will be a taxable remittance, at the date of disposal,* up to the amount of any Case IV or V income used to settle the original account.
>
> (Inspector's Manual paragraphs 1564 and 1569, emphasis added)

7.24.1 *Dividend of chattel in specie*

Suppose a company declared a dividend *in specie*[23] of a chattel which is received in the UK by a foreign domiciled shareholder. It is suggested that the same principle applies. There is no taxable remittance until the chattel is sold.

7.24.2 *Application of trust income for benefit of beneficiary*

Where trust income is applied for the benefit of a beneficiary, for example by maintaining him, then the income so applied becomes that of the beneficiary for tax purposes: *Drummond v Collins* 6 TC 526. However, there is a charge under the remittance basis only if the income is actually received here before being so applied (as was the case in *Drummond v Collins* where the income was paid to the mother of the beneficiary to apply for his benefit).

7.25 Receipt by third party

Section 65 imposes a charge on sums "received in the UK". One might have thought that the remittance basis would apply only if the sums are

23 See Table A article 105.

received in the UK by the taxpayer.

This formulation would have left the flexibility inherent in the concept of receipt "by the taxpayer". For instance, receipt by an agent or credit to a bank account of the taxpayer would be receipt by the taxpayer. An application of income in the UK for the direct financial benefit of the taxpayer, by payment of his debts, or provision of goods or services for him, could likewise naturally be characterised as receipt by the taxpayer.

The law took a strange turn in *Timpson's Executors v Yerbury* 20 TC 155, a decision of the Court of Appeal.[24] Reference was made to what is now s.59(1) ICTA 1988:

> ... income tax under Schedule D shall be charged on and paid by the persons receiving or entitled to the income in respect of which the tax is directed by the Income Tax Acts to be charged.

The conclusion drawn from this provision was that:

> the actual sums of the taxpayer's income should at least come to this country under such circumstances that the taxpayer, if he does not actually receive them, is entitled to them.[25]

What is astonishing is the application of this anodyne principle to the facts of the case. In that case bankers drafts were given to Mrs Timpson's children, and cashed by them in the UK. In the High Court the learned judge held that the sum was "received" by Mrs Timpson. This was obviously wrong, and the Court of Appeal so held. However, it was said that Mrs Timpson was "entitled" to the sum when it came into the UK. This is right if what came into the UK was not an ordinary cheque but a bankers draft, the commercial equivalent of money; see 7.22 (Receipt must be of money or commercially equivalent). If what arrived was an ordinary cheque then the taxpayer was at no time entitled to the money in the UK. Before the money was received by the children, it was outside the UK; after, Mrs Timpson was not entitled to it. The Court of Appeal relied

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24 The case was followed at first instance in *Walsh v Randall* 23 TC 55.

25 20 TC at p.181. In *Carter v Sharon* 20 TC 229 Lawrence J echoed this observation: the income tax rules "only apply to income from foreign possessions which is either received by the taxpayer in this country or to which he is entitled at the time it comes to this country."

on the fact that the payment was "out of her income"; but that is *nihil ad rem*.

Lord Denning justified the conclusion of the case in a different way, in an obiter dictum in *Thomson v Moyse*:

> But he [the taxpayer] need not receive them [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* (see [what is now section 59(1) ICTA 1988] and *Timpson's Executors v Yerbury*).

Whatever the reasoning, this much is plain: if a foreign domiciliary writes a cheque on a foreign bank account, gives it to a donee, who cashes the cheque in the UK, there is a remittance of the foreign income.

Suppose unremitted income is transferred from an offshore account direct to a third party's UK account by electronic transfer (not by cheque or bankers draft). It is suggested that *Yerbury* or *Timpson* should be distinguished and in this case there is no remittance.

7.26 Gift to third party completed abroad

If:

(1) foreign income is transferred to another person and received by him abroad, and
(2) the recipient remits the sum to the UK,

there will have been no taxable remittance of that income. See *Carter v Sharon* 20 TC 229.

If a foreign domiciliary wishes to make gifts to UK residents he can therefore safely do so out of his foreign income without incurring any tax. It is only necessary to arrange for the sums of income to be received by the donee abroad and subsequently brought by him into the UK. In this way a foreign domiciliary can effectively remit income to his children or to his spouse, though not to himself.

The practical advice is plain enough: The gift must be completed outside the UK. The easiest procedure in practice is to arrange that the income is credited to a foreign bank account in the name of the donee. An alternative is to deliver cash or a bankers draft to the donee abroad.

The Revenue practice is as follows:

> It may be claimed that income arising abroad has been alienated from the taxpayer's possession by gift abroad (for example, to a relative) so that it is no longer his income when received in the United Kingdom. This may be challenged on the grounds that the gift was not completed until the income was received in the United Kingdom (*Timpson's Executors v Yerbury*, 20 TC 155) or that financial consideration for the 'gift' has been received in the United Kingdom. Before any such claim is accepted, a full report should be made to International Division (Cases IV and V), Strand Bridge House.
>
> (Inspector's Manual 1565, published 9/95)

7.27 Purchase of foreign situate asset out of foreign income

Suppose an individual purchases a foreign asset with foreign income for full value. If the purchase price is paid out of the UK, there is no question of a remittance.

Suppose the purchase price is paid by a remittance to a UK account of the vendor. It might be thought that there is a remittance under the principle of *Timpson's Executors v Yerbury*: the receipt in the UK account is "by the authority" of the individual. It is considered that there is no remittance: under the tracing principle, the foreign income becomes identified with the foreign asset – which remains safely out of the UK. (If large sums are involved, it would be wise to make the payment for the asset out of the UK, for the avoidance of doubt.)

7.28 Purchase of UK situate asset out of foreign income

Suppose now the individual purchases a UK situate chattel. Suppose that the purchase price is paid abroad (e.g. to a foreign bank account of the vendor). Is this a remittance?

There is a strong technical argument that there is no remittance. For no sum of money is received in the UK. The issue is similar to that discussed above in relation to the import of chattels, and the same doubts arise. However, it would be anomalous if:

(1) importation of a chattel was not a taxable remittance;

(2) purchase completed abroad of a UK situate chattel was a remittance.

If that is right, there is no taxable remittance on the purchase of UK situate land, if the purchase price is paid abroad. There may in some cases be a charge under s.740. There is no published Revenue practice on the point.

The taxpayer would be in a stronger position if a company or trust, funded out of foreign income, uses its funds to purchase the land.

7.29 Payment for services

Similar considerations apply to payment for services in the UK. If the payment is completed outside the UK, then there is a strong technical argument that there is no taxable remittance: no "sums" are received here. It is understood that some firms of solicitors and accountants maintain offshore bank accounts in order to facilitate payment by foreign domiciled clients. The argument is similar to that on the purchase of an asset in the UK, but stronger, as it is harder to identify "value" in the UK.

7.30 Repayment of debt of another out of foreign income

Suppose one individual borrows money in the UK and another individual repays the debt out of foreign income. There is clearly no remittance if the repayment is completed abroad. If the repayment is made here the matter is more doubtful.

7.31 Loans made from foreign income

Suppose:

(1) an individual lends foreign income to a borrower. The loan is completed by a payment out of the UK.

(2) the borrower remits the sum he borrowed to the UK.

There is no remittance of the foreign income, for two reasons:

(1) The foreign income has ceased to be the income of the individual, and the principle in *Carter v Sharon* applies;

(2) The foreign income is represented by the loan, under the tracing principle. If the loan were called in (or sold) and the proceeds remitted, there would be a remittance.

This is so even if the loan is on favourable terms, or interest free. See *R v Preddy* [1996] AC 815.

7.32 Credit cards

The simplest case would be the use of a UK credit card for purchasing goods or services in the UK. This would create a debt in the UK; discharge of the credit card balance with foreign income would represent a remittance if only under the debt rules considered below at 7.40 (Deemed remittances).

What if an overseas credit card is used? The Revenue take the view that in such circumstances the individual would be using the credit card to settle his UK debts just as he would use a bank and that the discharge of the liability with foreign income represents a remittance.

The Inspector's Manual provides:

> **1569. Remittance Basis**
> **Use of credit cards**
> Published: 9/95
> If a taxpayer who is chargeable on the remittance basis uses a United Kingdom credit or charge card to pay for goods or services, either in the United Kingdom or elsewhere, and subsequently settles his credit card account out of overseas income chargeable under Case IV or V of Schedule D, then the payment sent to the United Kingdom to settle the account constitutes a taxable remittance, even if it is made direct to the credit card company, since the remittance does not have to be received by the taxpayer personally, it merely being sufficient that it is received in the United Kingdom by some other person on his authority (see IM 1564(1)).

Where an overseas credit card is used in the United Kingdom instead of cash, the taxpayer is effectively authorising the credit card company to settle his account in just the same way as if the taxpayer had instructed his foreign banker to send a remittance to the supplier. If, on that basis, the taxpayer's overseas income is ultimately the provider of sums received in the United Kingdom (by the supplier) then there is a taxable remittance.

It is sometimes argued that any indebtedness created by the use of an overseas credit card lies between the cardholder and the card company, rather than between the cardholder and the supplier. The debtor/creditor relationship thus established, however, amounts to a loan of money expended on purchase by the debtor by the use of his card, which would be caught by ICTA 1988 s.65(6).

The terms of the particular credit card agreement must be examined. If, under the terms of the agreement, the money is regarded as lent to the cardholder at the moment when his card is accepted as payment in lieu of cash, then the lending can be said to take place in the United Kingdom and any repayment of either the loan or any interest out of Case IV or V income is regarded as a taxable remittance.

If, on the other hand, the money is only regarded as being lent at the date the overseas card company settles the supplier's account on the cardholder's behalf, then the lending takes place outside the United Kingdom and ICTA 1988, section 65(6)(b) operates to treat the repayment of the loan, but not any interest, as a taxable remittance.

If an overseas credit card is used abroad and the account is settled direct to the card company out of overseas income within Cases IV and V, no liability to United Kingdom tax will arise. But if an asset purchased using the card is brought to the United Kingdom and subsequently sold here, there will be a taxable remittance, at the date of disposal, up to the amount of any Case IV or V income used to settle the original account.

It is arguable that this is incorrect. The argument is based on the premise that the individual has incurred a UK debt which is being met by the overseas credit card company on his behalf. However, the individual has a contract with the overseas credit card company and so does the UK supplier. The relationship between the UK supplier and the debtor is not one which gives rise to a debt between them: *Re Charge Card Services Ltd* [1989] Ch 497. Accordingly, the credit card company discharges its own debt to the supplier and the individual discharges his own debt to the overseas credit card company. Discharging this debt from foreign income does not give rise to a remittance as this is not a debt for money lent in the UK; the debt is for money lent to him outside the UK and is not "received in or brought to the United Kingdom". The only exception would be if the individual were to use the overseas credit card to obtain cash in the UK.

However, those wishing to avoid an argument with the Revenue on this point will be well advised to ensure that credit cards used in the UK are discharged from foreign capital funds.

7.33 The problem of mixed funds

It can happen that there are brought together into a single fund two (or more) funds which are of a different nature and qualifying for different tax treatment under the remittance bases. The classic example is a mixture of:

(1) foreign unremitted investment income (taxed on the Schedule D remittance basis) and

(2) capital (e.g. an inheritance) not taxed at all on remittance.

However, the variety of possible ingredients of a mixed fund is much greater than this. One might have:

(1) Foreign investment income (taxable in full on remittance under Schedule D rules).

(2) Chargeable overseas earnings (taxable in full on remittance under employment income rules).

(3) Income on which some foreign tax has been paid (taxable on remittance but with credit under DTT rules). Income from different sources may have different amounts of credit available.

(4) "Income" which is not taxable on remittance because:

(a) the sum has already been subject to income tax; or

(b) the donor was non-resident when this particular sum arose; or

(c) the source of the particular investment income has ceased.

(5) Proceeds of disposal on which a chargeable gain has accrued (taxable on remittance to the extent of the gain). Almost every disposal will be a different mix of base cost and capital gain

(6) "Capital" (not being sums representing income) tax free on remittance.

Any combination of these funds may become mixed. This section discusses the problems which then arise when some (but not all) of the money is remitted to the UK. Does the money remitted represent one fund or another or a mixture of both?

7.34 Income and capital accounts at one bank

In *Kneen v Martin* 19 TC 33 the taxpayer paid Case V income in one account (described as an "income account"). He paid the proceeds of sale of the shares from which the income was derived into another account at the same bank (described as a "capital account"). He later remitted a sum from the capital account and that was held to be a remittance of capital. It must follow that:

(1) different types of funds are not "mixed" if they are held in separate accounts at one bank, or

(2) they are "mixed" at the bank but "unmixed" by a remittance from a specified account so what is remitted may be regarded as purely one type of income or the other.

Since a bank (as a matter of general banking law)[26] owes only a single debt to its customer, analysis (2) is to be preferred.

7.35 Remittance from mixture of taxed and untaxed income

In *Duke of Roxburghe's Executors v CIR* 20 TC 711 a taxpayer received and held offshore:

(1) income subject to UK tax on an arising basis ("taxed income");[27] and

(2) foreign income which qualified for the remittance basis, and which was therefore untaxed unless and until remitted ("untaxed income").

These were wisely held in separate accounts and so a remittance out of the taxed income account would not have been taxable. The taxpayer correctly directed the bank to make a remittance to the UK out of her taxed income account. Unfortunately the bank made a remittance out of the wrong account, so the sum remitted could (largely) be traced to untaxed income!

The Commissioners applied a tracing principle. The sum remitted was traced to taxed income, as to part; but the balance was traced to untaxed income, and so there was a tax charge on this remitted amount. The Court of Session surprisingly reversed this decision, on two alternative grounds.

The first ground identified the sum remitted as taxed income because the Duchess had *intended* the remittance to come out of taxed income:

> the Duchess was entitled to have the remittance debited against any fund belonging to her and under her control and that she did so effectually by the *instructions* to debit it against money not derived from the [untaxed] income.[28]

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26 This assumes that English banking law principles apply; that is to be assumed in the absence of evidence of foreign law.

27 Being foreign source income of a class of income not then qualifying for the remittance basis and so subject to UK income tax on an arising basis.

28 Lord Normand at page 726. This was also the view of Lord Fleming who expressed himself in similar words: "I base my decision in favour of the Appellants 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

(Emphasis added)

The second ground was that a remittance out of a bank account with taxed and untaxed income is necessarily to be treated as out of the taxed income. The intention of the taxpayer is irrelevant. This applies in every case unless very unusually[29] there is something in the substance (as opposed to book-keeping) to show the contrary. Lord Normand and Lord Fleming inclined to this view, without deciding it; Lord Moncrieff based his decision on this view.

The Revenue accept the second view of the decision: the Inspector's Manual reads:

> **1568. Mixed fund/income assessable: Arising/remittance**
> Published: 2/87
> Where a person maintains abroad a mixed fund consisting partly of income assessable on the arising basis and partly of income assessable on the remittance basis, any remittances made to this country out of that fund may be regarded as made primarily out of the income assessable on the arising basis and only the balance out of income assessable on the remittance basis.

The result would certainly have been the same if the funds of taxed and untaxed income had been held in a single bank account. This was accepted without argument in *Walsh v Randall* 23 TC 55.

It is arguable that the result would have been the same if:

(1) the taxed funds had been held at one bank; and

(2) the untaxed fund had been held at a separate bank (so there were two debts as a matter of banking law).

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their hands which had already borne British Income Tax." (p.732).

29 Lord Normand gives one example of the exceptional case: "For example, if the Duchess, in the present case, had enjoyed [taxed income] under the condition of applying a part of it to some expenditure or purpose in the United States, she might have been disabled from asserting that the whole of that income was used for remittance to the United Kingdom. Accounts made up on the footing that the whole of that income was available for remittance would then fall to be ignored or corrected."

7.36 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.

(2) The remittances (from the Australian agents) had been accompanied by letters stating that the sums remitted represent repayments of the loans. The loans had in some cases been repaid only very shortly before the remittance.

(3) The sum remitted (£200,000) was only a small proportion of the loans and interest received (each about £1.5m).

It was held that the remitted sum was the foreign income, not capital. The Lord Chancellor said:

> It is obvious that the mere nicknaming the sum received and ascribing to it, because it is so named, the character of capital and not of income, cannot defeat the right of the Crown to have the tax levied upon that which in substance and truth is [income] ...

Lord Davey:

> I must say that that is a draft upon my credulity, a strain upon my powers of belief, which they will not bear. I agree that the mere calling it capital for the purpose of the Inland Revenue Department will not make into capital that which is essentially and in truth ... the interest received on the securities.

Two points shine out:

1. The description of the remittance as capital does not make the remittance capital if "in truth" it is income. This is obviously right, an application of the Shakespearean principle that "a rose by any other name ..." However, this principle does not address the more fundamental question of *how* the courts determine what is income and what is capital.

2. The answer to this second question is that the courts look to the substance.

However, it is one thing to look for the substance, and another to find and identify it. Why, in substance, was the remittance from the income, not from the capital? The answer may be found in the speech of Lord Robertson: "The facts of the case must furnish the inference."

The following facts were relevant:

> [1] First of all there is the fact of remittance in two consecutive years ...
>
> [2] There is no suggestion that any exceptional reason required remittances of capital, in either year or in both.
>
> [3] On the other hand it is certain that the amount of invested capital left behind in the Colony, after these remittances, is larger than before; so that the capital is fully accounted for.
>
> [4] Well then, what is done with this so-called capital remitted? The answer is, exactly what would be done with profits.

[Paragraphing added]

This is explained by Lord Shand in argument:

> If it is capital you have brought back and distributed as bonus, you have been paying back capital, which I should think you have no authority to do.

This is why Lord Robertson concluded:

> The inference from these facts is that the moneys remitted were in fact profits, [i.e. income] ...

The Revenue view is in the Inspector's Manual at paragraph 1566:

> 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 International Division (Cases IV and V), Strand Bridge House.

The Revenue view over-simplifies the law as expounded in *SPI v Allan*. There is no rule that the remittance of a mixed fund of income and capital is bound to be treated as income. Suppose a taxpayer remits a substantial amount, exceeding the income, and applies it to an investment in the UK, or on capital expenditure here, such as the purchase of a house. It is considered that the "substance" of the matter, applying Lord Robertson's approach, is that the remittance is one of capital. The position is even stronger if the taxpayer first uses an amount equal to the income of a mixed account on expenditure abroad of an income nature. It is understood that the Revenue have accepted this view in practice.

It is also important to note that *SPI v Allan* was a case where the mixed fund was capital and income. The case can have no application where the mixed fund consists of:

(1) income and income; see 7.35 (Taxed and untaxed income);

(2) capital and capital; see 7.37.1 (CGT remittance out of mixed capital funds).

In some cases it may be difficult to identify sums as "income" or "capital": see 7.19 (Capital/income terminology in remittance basis context).

7.36.1 *Reconciling* SPI v Allan *and* Duke of Roxburghe

At first sight there is some tension between these two cases. In the first, "mere nicknaming" was contemptuously dismissed; in the second, it was the "legal right" of the Duchess to direct whether the remittance was from one 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.

7.36.2 *Further authorities?*

The above are the only authorities in point. A similar question, once extensively litigated, is whether charges on income were paid from "profits brought into charge to income or corporation tax". It is suggested in *Roxburghe*[30] that this line of cases sheds some light on the remittance issues; I am inclined to think that such guidance is very limited, because this question is answered in an entirely different manner: see 7.17 (Remittance bass only applies to sums received in the UK derived from foreign income). Likewise the extensive trust law cases on tracing are of no assistance here – the tracing approach was expressly rejected in *Roxburghe.*

7.37 Remittance from mixture of untaxed income and income qualifying for DTT relief

Suppose an individual holds in one mixed fund:

(1) income which is subject to foreign tax and qualifies for UK double tax relief; and

(2) untaxed foreign income taxable in full on the remittance basis.

---

30 I add for completeness that Lord Moncrieff (who was one of the judges in *Roxburghe*) repeated this view in *Commissioners of Inland Revenue v Ayr Town Council* 22 TC 381.

It is considered that the *Roxburghe* approach applies. A remittance from this mixed fund should be regarded as made first of all out of the income which qualifies for UK double tax relief. However, it would be better practice:

(1) to pay the income qualifying for DTT relief into a separate account, and

(2) to remit funds from that account.

Then this issue does not arise and a remittance from the DTT account can easily be identified as qualifying for DTT relief.

7.37.1 *CGT remittances out of mixed capital funds*

Suppose an individual holds in one mixed fund:

(1) capital which does not include any capital gain within the scope of CGT; and

(2) the proceeds of a disposal on which a capital gain accrued.

A remittance from this fund should for CGT purposes be treated as coming out of the tax free source first. It would be wise to adopt the narrower view of *Roxburghe,* and have the taxpayer direct the bank to make the remittance from the tax free capital, rather than the taxed capital.

For the quite different question where a single disposal has given rise to a gain, and it is desired to separate the original capital "tranche" and the gain, see 17.5 (Remittance of part of gain).

7.38 Circular transactions returning funds to the taxpayer

There is an important exception to the *Carter v Sharon* principle where funds find their way back to the taxpayer.

In *Harmel v Wright* 49 TC 149, a taxpayer used his foreign employment income to subscribe for shares in A Ltd; the money was lent by A to B Ltd, and lent by B back to the taxpayer. Applying the principle in *Carter v Sharon*, there should have been no remittance, since the income had been transferred to a third party out of the UK: see 7.26 (Gift to third party completed abroad).[31] But the taxpayer had the misfortune to appear before the vehement opponent of tax avoidance schemes. The result was inevitable. Templeman J said:

> Although at various stages different cheques are written on different accounts, one can, with fascination, with certainty and no difficulty at all, follow, for example, a salary of £25,000 paid by cheque from the South African company [the employer] to the taxpayer; then by cheque by the taxpayer to Artemis; then by cheque by Artemis to Lodestar, and finally by cheque by Lodestar to the taxpayer in England. Ignoring for the moment exchange control and the possibility that some cheques will be in rands and others in sterling, and ignoring the costs that will drip away, that sum begins in South Africa from the employers of the taxpayer and ends up in this country with the taxpayer. In my judgment, in the peculiar circumstances of this case – and I say nothing about other cases where it may be possible that the money *does en route disappear and it is not possible to follow with the same certainty as in the present case* – the sums which the taxpayer eventually receives represent and are the emoluments which start off from his South African employers in the first place.
>
> Mr Nolan, appearing for the taxpayer, says that that is a wrong analysis. He says that the emoluments start off in South Africa from the South African company [the employer], they are paid to the taxpayer and they are then used by him to purchase shares in Artemis and there they stay. The emoluments are not received in this country because they have become, and are, the shares in Artemis, and what the taxpayer receives in this country is something entirely different, namely, a loan extended to him by Lodestar. He submits that it is impossible to come to any other conclusion unless one strips aside the corporate veil and looks behind Artemis to study the shareholders and looks at the reality of the situation behind the corporate veil.
>
> [1] To my mind this case does not depend on stripping aside the corporate veil at all.
>
> [2] This case depends on keeping one's eye on the emoluments, on the original sum of £25,000, and seeing what happens to it. It is true that it is paid over at one stage as the purchase price for shares, and it is true that one cannot normally identify money, but in the present case

31 An independent argument arises under the tracing principle, since the foreign income was represented by the shares in company A. It may be said that the assets held by Company A did not represent the same income.

> you can; you do not need to get behind the corporate veil to perceive and know that the £25,000 which goes in as the purchase price for shares comes out on the instant in the form of the loan to Lodestar. In my judgment, on the wording of section 156 one does not need to strip aside the corporate veil if you find that emoluments, which mean money, *come in at one end of a conduit pipe and pass through certain traceable pipes until they come out at the other end to the taxpayer.*

(Emphasis and paragraphing added)

This judgment does little to help in other cases as:

(1) sometimes money "comes in at one end of a conduit pipe and passes through certain traceable pipes until it comes out at the other end to the taxpayer". I call this "the *Harmel v Wright* principle";

(2) sometimes money "does en route disappear and it is not possible to follow with the same certainty" as in *Harmel v. Wright.*

The judge says "nothing" about where the dividing line comes. This is one of those omissions which so commonly make Templeman judgments easy to read but difficult to apply.

In *Grimm v Newman* [2002] STC 1388 the taxpayer had foreign employment income (chargeable overseas earnings) which he gave to his wife. The transfer was completed abroad. He and his wife purchased a house jointly, his wife using the sum she had been given to pay for her share. They lived in the property together. The *Harmel v Wright* principle did not apply. Paras 57–60 of the judgment read:

> [1] ... Mr Grimm [did not retain] any beneficial interest therein or contractual right of control over the property he gave to Mrs Grimm. Thus in February 1992 the investments were the absolute property of Mrs Grimm for her to do with them what she willed. On the basis of *Carter v Sharon*, at that stage the investments lost the characteristics which made them potentially liable to UK tax in the hands of Mr Grimm.
>
> [2] Second, the passages in the speech of Lord Radcliffe in *Thomson v Moyse* to which I have drawn attention do point to the need for monetary or financial equivalence between the foreign income or

emolument and that which is received, used or enjoyed in the United Kingdom. Mr Grimm did not receive, use or enjoy the monetary or financial equivalent of what he gave. Nor did he transmit the proceeds of sale of the investments to the United Kingdom.

[3] Third, the analogy with *Harmel v Wright* is false. In that case the taxpayer received from Lodestar the monetary equivalent of what he had disposed of to Artemis. The original disposer and ultimate recipient was the same and the "conduit pipe" through which the money was poured readily identifiable.

[4] Fourth, the real issue, as it seems to me, is whether the legislation dealing with constructive remittances entitles the court to treat husband and wife as the same person. In my view it does not. In many contexts specific provision is made to that effect. But in the context of constructive remittances there is no such provision in the legislation and, in my view, none can be implied. Likewise, there is nothing in the *Ramsay* principles[32] ...to justify any such treatment.

As I see it, paragraph [1] represents the *prima facie* position, the rule in *Carter v Sharon*. Paragraphs [2] and [3] represent the reasons for rejecting the challenge to it:

[2] Mr Grimm did not receive use or enjoy the monetary equivalent of the unremitted income which he gave Mrs Grimm.

[3] The *Harmel v Wright* principle only applies when the money received by the taxpayer is "readily identifiable" with the foreign income. That was, apparently, not the case in *Grimm v Newman*.

One explanation of *Harmel v Wright* is that it represents a pre *Ramsay* application of the *Ramsay* principle. (It would help if the Courts would make up their mind what the *Ramsay* principle was.) However, this is not the way that the *Harmel v Wright* principle has been expressed, either in *Harmel v Wright* itself or in *Grimm v Newman*. I suggest that the dividing line between *Carter v Sharon* and *Harmel v Wright*, while not entirely clear, is likely to be formed upon the following lines.

Suppose:

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32 Interesting that the judge refers to the *Ramsay* principles (in the plural). But that is another book.

(1) T transfers unremitted foreign income to a trust under which he is the principal beneficiary; and

(2) the trustees transfer or loan the funds to him.

Even if the two steps are not part of a preordained series of transactions, and the trustees have genuinely exercised their discretion, this falls within *Harmel v Wright*: T has received the monetary or financial equivalent of what he gave. The funds are readily identifiable. The transfer to the trust does not amount to a "clean break". After all, the reality is that the trustees are expected to pay close attention to the wishes of the settlor, and in doing so they are merely "filling in the blanks" left by the settlor: see *Muir v Muir* [1943] AC 468.

Suppose:

(1) T transfers unremitted foreign income to an individual, W; and

(2) W transfers or lends the funds to him.

In this case it is suggested that the line should be drawn depending on whether or not the decision by the individual to transfer assets to T is generally independent. The question is very similar as to whether a person has provided funds indirectly and so is a settlor; see 34.18 (Tax planning to create settlement with foreign domiciled settlor).

This was accepted in another context in *Cohen v. Petch* [1999] STC (SCD) 207. Here:

(1) T borrowed funds from a building society and used them to purchase an asset from his mother.

(2) The mother immediately gave or lent the proceeds of sale back to the son.

(3) The son lent the money to a company.

The Special Commissioner said:

> I cannot overlook the fact that once the money had been borrowed [by][33] the taxpayer from the society it was paid to his mother and became her funds. Subsequently, three days later, the sum of £46,600 was returned to the taxpayer by his mother either in the form of a loan or as a gift. The funds, whether or not they are traceable in specie, were no longer the money borrowed from the society. They were funds lent or given by Mrs Daphne Cohen to her son. *There was no longer any link between the money which the taxpayer eventually lent to the company and the money which he borrowed from the society.*

Suppose:

1. an individual transfers foreign income to a trust under which he is the principal beneficiary, and

2. He sells UK property to the trust and occupies that property.

It is submitted that there is no remittance, because what the individual receives, which is merely the licence to occupy the property, does not amount to the financial equivalent of the unremitted foreign income.

7.39 Foreign exchange profits and losses

Inspector's Manual provides:

> **1670. Exchange**
> Income chargeable on the arising basis should be translated into sterling at the rate of exchange prevailing at the time when the income arose (see IM1640); where, however, credits are frequent and the taxpayer desires to translate at the mean rate of exchange for the basis year, that course may be followed, provided that it is adopted consistently year by year, and that the amounts to be assessed are not materially affected. ...

This is not contentious. The Manual continues:

> ... Where income is chargeable on the remittance basis, the income should be taken to be the amount received in the United Kingdom, translated to sterling, if necessary, at the rate of exchange prevailing on

33 The text erroneously reads "from".

> the date of receipt.
> Any case of difficulty should be referred to FID (Exchange).

This is more doubtful, as the last sentence tacitly accepts. There is no authority on the point.

7.40 Foreign income used to repay loans: deemed remittances

The provisions of section 65(6) to (8) apply to the individual who is ordinarily resident in the UK. I refer to these as "deemed remittances". These are sometimes called "constructive remittances".

Section 65(6) ICTA 1988 provides:

> ... any income arising from securities or possession out of the UK which is applied outside the United Kingdom by a person ordinarily resident in the United Kingdom in or towards satisfaction of—
> (a) any debt for money lent to him in the United Kingdom or for interest on money so lent, or
> (b) any debt for money lent to him outside the United Kingdom and received in or brought to the United Kingdom, or
> (c) any debt incurred for satisfying in whole or in part a debt falling within paragraph (a) or (b) above,
>
> shall be treated as received by him in the UK.[34]

Adopting the terminology of s.33 ITEPA 2003, I refer to a debt within s.65(6) as a "UK-linked" debt.

Foreign income used to repay a UK-linked debt is treated as remitted. There is of course no remittance on repaying a UK-linked debt so long as it is not repaid out of unremitted foreign income or chargeable gains.

More importantly, there is no remittance on satisfaction of a debt which is not a UK linked debt even if it is satisfied by payment of unremitted Schedule D Case V income, so long as the payment is completely abroad.

The effect of the legislation is that there will be a remittance if the taxpayer carried out arrangements of the kind used in *IRC v Gordon* 33 TC 220.

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34 The text continues ("and ... as so received from remittances payable in the UK") so as to bring the deemed remittance within one of the four sub-heads of Case V; see 7.10 (The statute).

7.40.1 *UK-linked debt*

In the present context of foreign loans it is considered that "money" includes foreign currency.[35]

All debts for money lent in the UK are UK-linked. Money lent outside the UK is only a UK-linked debt if "received in or brought to" the UK. The question of whether money is received in the UK is decided by applying the remittance basis rules. The additional words "or brought to" appear to be otiose.

A liability which is not a "debt for money lent" is not a UK linked debt; this is a significant restriction, but it is consistent with the Schedule D Case V principle that remittances of non-money assets are not taxable. An example of a debt not for money lent is an obligation imposed in divorce proceedings. Payment of such a debt outside the UK is not a remittance for Schedule D Case V purposes.

7.41 Advantages of foreign loans

The legislation draws a distinction between:

1. Money lent to a person in the UK ("a UK loan"); and

2. Money lent to a person outside the UK ("a foreign loan") and received in the UK.

In each case there is a UK-linked debt. But income is treated as remitted if used in satisfaction of the loan or interest on a UK loan. Income is treated as remitted if used in satisfaction of a foreign loan – but not the interest. Why the legislation has made this distinction the author cannot guess.

When is money lent "in the United Kingdom" and when is it lent "outside the United Kingdom"? The context shows that the answer

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35 Though in other contexts "money" often means only sterling. In *Goodbrand v Loffland Brothers North Sea Inc* 71 TC 57 Millett LJ said that foreign currency was not "money" (for the purposes of s.38 TCGA 1992) but money's worth. Where Parliament intends the term "money" to apply to a foreign currency, it often states this expressly: e.g. s.81(6) FA 1996.

depends solely on where the money is received. If it is received outside the UK (e.g. credited to an account outside the UK) then it is lent outside the UK. Other UK connections are not relevant. The loan may be made by a UK lender, under English law, with UK situated security.

If a loan is received outside the UK, it does not matter that:

(1) the proceeds are remitted to the UK the next day; or

(2) the loan is secured on UK property;[36] or

(3) the loan is used to purchase a UK asset; or

(4) the decision to lend the funds is made in the UK.

If the money is paid direct from a foreign lender to discharge a debt of the borrower in the UK it is arguable that the loan is "lent" outside the UK, but it would be better not to have to rely on that.

In case the Revenue take a different view it would be safer to arrange:

(1) a non-UK lender;

(2) a foreign law loan agreement;

(3) the agreement is made outside the UK.

If the money borrowed is used for a qualifying purpose the interest may be deductible against the individual's UK income.

7.41.1 *Basic planning with loans*

A basic planning idea, therefore, is as follows:

(a) an individual borrows money outside the UK;

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36 If the loan is secured on UK real property, the security must be governed by a UK law, but that would not matter. The security would be relevant in deciding whether the interest had a UK source: see 6.10 (Situs of source of interest); but that would only concern the borrower, not the lender, unless the interest is subject to UK withholding tax.

(b) he remits the money borrowed;

(c) he uses foreign income to pay the interest on the loan as it accrues.

This has obvious finance costs but it does avoid any tax charge on the remittances. The loan may be repaid after the foreign domiciliary has died: see 7.15 (Remittance after death). Likewise, the loan may be repaid in a year when the foreign domiciliary is not resident in the UK: see 7.14 (Remittance while non-resident). Further, the loan may be repaid in a year when the foreign domiciliary is not ordinarily resident in the UK (even though resident here).

7.41.2 *Converting a UK loan into a foreign loan*

Suppose a foreign domiciliary has borrowed money in the UK and wants to finance the interest out of foreign income. To do so would give rise to an income tax charge because of s.65(6)(a). He should, of course, have borrowed the money abroad. Is there anything he can now do to correct his error? Yes: he can borrow outside the UK and repay the UK debt. He may thereafter pay interest on the foreign loan without a remittance.

7.41.3 *Loans to repay UK-linked debt*

The reader may have thought of the following ingenious arrangement:

(a) The foreign domiciliary borrows money outside the UK ("the first loan") and remits it here.

(b) If the foreign domiciliary were then to use foreign income to repay the first loan, there would be a deemed remittance. So instead he borrows abroad again ("the second loan") and uses the proceeds to repay the first loan.

The second loan is not UK-linked under s.65(6)(a) because it is not lent in the UK. It is not UK-linked under s.65(6)(b) because it is not received here. However, it is UK-linked under s.65(6)(c); it is a debt incurred for satisfying a loan under (b), so foreign income used to repay the second loan is treated as remitted.

The individual could borrow a third time abroad and use the proceeds of the third loan to repay the second. This would not be UK-linked under (a), (b) or (c). However, it would still be UK-linked by s.65(9):

> ... a debt incurred for satisfying in whole or in part a debt falling within paragraph (c) of subsection (6) above shall itself be treated as falling within that paragraph.

So no number of new loans will wash away a UK-linked loan.

The first part of s.65(9)(a) provides:

> A debt for money lent shall, to the extent to which that money is applied in or towards satisfying another debt, be deemed to be a debt incurred for satisfying that other debt.

Money may be borrowed for an entirely different purpose, but if it is in fact used to repay a UK-linked debt, the loan of that money is UK-linked.

7.41.4 *Foreign loan remitted in part*

What if a person borrows money abroad and remits part of it to the UK? On a strict reading the section does not apply. Where the drafter wishes to deal with parts and not the whole, he does so expressly; see s.65(7) "*wholly or partly*" and s.65(9) "*to the extent to which ...*" and s.65(6) itself "*wholly or partly*" and "*in or towards satisfaction*".

Can the Court fill in the gap by construction? It is not easy to do so, especially where "mixed fund" issues arise. Suppose a foreign domiciliary borrows £4m abroad, remits £2m and repays £1m out of foreign income. Does one say that:

1. This is a remittance of £1m, being the repayment of money brought to the UK; or

2. No remittance, the £1m being the repayment of money kept out of the UK; or

3. A remittance of 50% of the amount repaid?

The answer which makes best sense is probably 3, but that requires reading a good deal into the section which is not there. It is therefore arguable that a foreign loan remitted in part is not UK-linked. However, a Court is likely to take a robust view and apply solution 2, by analogy with *Duke of Roxburghe,* see 7.35 (Remittance from mixture of taxed and untaxed income), or solution 3, by analogy with CGT, see 17.5 (Remittance of part of gain).

7.41.5 *Loan used to repay UK-linked debt and for other purposes*

At first sight there are anomalies where a foreign loan is used partly to repay a UK-linked debt.

Suppose:

1. A foreign domiciliary borrows a small sum (say, £1,000) in the UK; a UK-linked debt.

2. He later borrows a larger sum abroad (say, £1m).

If he uses the £1m to repay the smaller debt, the entire £1m is a UK-linked debt under s.65(6)! So if it is repaid out of foreign income, is there a remittance of £1m even though in reality only £1,000 has been received in the UK? The answer is no, because the second loan, the larger sum, is only incurred "for satisfying" the other debt to the extent that the money is used to repay that debt: s.65(9)(a).

7.42 Foreign loan repaid out of foreign income and proceeds later remitted

Section 65(6) deals with the situation where a person:

1. Borrows abroad;
2. Receives the money in the UK;
3. Repays the loan out of foreign income.

The section does not apply if the order of steps 2 and 3 is reversed – i.e. he borrows, repays out of foreign income and then remits the money borrowed. It is likely that the Courts would trace through and identify the money borrowed with the foreign income. There would then be a charge on the remittance. However, one cannot blame the Revenue for blocking this argument in advance by subsection (7):

> [a] Where a person ordinarily resident in the United Kingdom receives in or brings to the United Kingdom money lent to him outside the United Kingdom, but
> [b] the debt for that money is wholly or partly satisfied before he does so,
> [c] subsection (6) above shall apply as if
> [i] the money had been received in or brought to the United Kingdom before the debt was so satisfied,
> [ii] except that any sums treated by virtue of that subsection as received in the United Kingdom shall be treated as so received at the time when the money so lent is actually received in or brought to the United Kingdom.
>
> (Paragraphing added)

7.43 Use of foreign income as security for loans

7.43.1 *The statute*

This topic takes us to the unnecessarily tangled s.65(8) ICTA 1988:

> Where—
> (a) a person ("the borrower") is indebted for money lent to him, and
> (b) [*The security condition*]
> [foreign] income is applied by him [the borrower] in such a way that the money[37] or property representing it is held by the lender on behalf of or to the account of the borrower in such circumstances as to be available to the lender for the purpose of satisfying or reducing the debt by set-off or otherwise,
> that income shall be treated as applied by the borrower in or towards satisfaction of the debt [and so treated as remitted]
> [*the linked loan condition in the proviso*]
> if, under any arrangement between the borrower and the lender,
> [i] the amount for the time being of the borrower's indebtedness to the lender, or
> [ii] the time at which the debt is to be repaid in whole or in part,
> depends in any respect directly or indirectly on the amount or value

37 The context shows that "the money" here means the foreign income.

so held by the lender.

(Paragraphing and sub-headings added)

For this purpose "lender" has an extended meaning:

> "lender" includes, in relation to any money lent, any person for the time being entitled to repayment.
>
> (s.65(9)(b))

In what follows it is assumed that the individual has borrowed from a foreign bank so that the condition in s.65(8)(a) is satisfied.

The principal conditions of subsection (8) can be identified under two headings:

(1) The security condition in s.65(8)(b).

(2) The linked loan condition (in the proviso).[38]

7.44 The security condition

This condition requires that two matters are satisfied:

(1) [Foreign] income is held by the lender:

 (a) on behalf of the borrower, or

 (b) to the account of the borrower.

(2) The income is available to the lender for the purpose of satisfying or reducing the debt by set-off or otherwise.

An asset is held by a lender *on behalf of* an individual if the lender holds as nominee for the individual. In this case the income is "available" to

38 It would have been simpler if the drafter had placed the second condition in a new s.65(8)(c) but this does not ultimately matter. Section 34 ITEPA 2003 renames them condition A and condition B.

satisfy the debt if there is a charge or contract to that effect.

Money is held[39] by a lender *to the account of* an individual if it acts as a banker, i.e. the money is paid to the lender and credited to the account of the individual (the foreign income account). In this case the foreign income (represented by the account in credit) is normally available to satisfy a debt to the lender[40] by way of set-off because:

(1) the bank's standard terms of loan will normally so provide, or

(2) (in the unlikely event that the loan agreement is silent on the point), the general banking law will confer a right of set-off (at least if English law principles apply).

It is of course possible as a matter of contract law to arrange that the foreign income is deposited with a bank without a right of set-off for any debt due to the bank.

What if the individual *charges* the foreign income (or property representing it) but it is not "held by the lender"? A chargee is not normally said to "hold" the asset charged. A purposive construction would probably be applied, so this too is caught.

The security condition also requires that the foreign income is *applied* by the borrower in such a way that these two matters are satisfied. If the two matters come to be satisfied without an "application" by the borrower then the security condition is not satisfied.

Example 1
F has over a period of time accumulated £100,000 unremitted foreign income at an offshore bank.
F subsequently borrows £100,000 by overdrawing another account at the same bank and remits this to the UK.

The two conditions discussed above are satisfied:

39 "Credited" is a more accurate word than "held" since when the foreign income is paid to the lender (as banker) it becomes the property of the lender. But the meaning is reasonably clear.

40 The debt will normally take the form of another account which is overdrawn, but that does not matter.

(1) The foreign income is held by the bank to the account of the borrower.

(2) The foreign income is available to the bank for the purpose of satisfying or reducing the debt by set-off (unless the parties have expressly agreed the contrary).

It is considered that the security condition is not satisfied because the individual has not "applied" the foreign income.

Example 2
As Example 1 but F expressly agrees that the bank should have a right of set-off.

It is considered that the result is the same: F has still not "applied" the foreign income.

Example 3
As Example 1 but F transfers the income to a new bank, and borrows from that bank.

Although this is closer to the line, it is arguable that there is still no "application" of the income, so the security condition is not satisfied. It has been held in a trust law context that an "application" requires some change of title: *Re Vestey* [1951] Ch 209. But it would be anomalous to draw a distinction between this Example and Examples 1 and 2, and the better view is that this is an application. It would certainly be wiser in practice not to do this.

Example 4
As Example 1, but
– F agrees not to withdraw the accumulated foreign income while the debt is outstanding; or
– F charges the foreign income.

The security condition is now satisfied.

Example 5
F borrows £100,000 and deposits foreign income of £100,000 as security. (The security condition is satisfied in relation to this £100,000 income –

see Example 4.)
As time passes, (say) £50,000 new income accrues on the deposit and (say) £60,000 interest accrues on the loan.

The security condition is not satisfied in relation to this £50,000 new income as it has not been "applied."

7.44.1 *Possible avoidance of section 65(8)*

Under the terms of section 65(8):

(1) the deposit must be held by the lender; if it is held by another person (even a person connected with the lender) the section does not apply.

(2) the security must be given by the individual; the section does not apply in terms if the individual has settled the income and the trustees make the arrangements.

7.45 The linked loan condition

This condition requires firstly that one of two matters are satisfied:

> (1) the amount for the time being of the borrower's indebtedness to the lender, or
> (2) the time at which the debt is to be repaid in whole or in part,
> depends in any respect directly or indirectly on the sums held by the lender.

Suppose the arrangement was that:

(a) an individual deposits a sum in a bank; and

(b) the bank was only prepared to lend up to the value of the sum deposited.

Matter (1) is plainly satisfied. Suppose however that:

(a) a bank makes a loan to an individual; and

(b) subsequently the individual deposits funds at the bank (on usual banking terms) so the security condition is not satisfied.

In principle matters (1) and (2) are not satisfied.

The second aspect of the linked loan condition is that these matters are satisfied "under arrangements between the banker and the lender". But "arrangements" is so wide that it is difficult to see what difference this makes.

7.46 Property held jointly by husband and wife

Section 282A ICTA 1988 provides:

> (1) Subject to the following provisions of this section, income arising from property held in the names of a husband and his wife shall for the purposes of income tax be regarded as income to which they are beneficially entitled in equal shares.

The section goes on to set out a number of exceptions, with which I need not be concerned here. 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 282A applies so that half the income is deemed to be the income of W.

(3) W is not domiciled in the UK.

It could be argued that W's income being merely deemed income cannot be remitted and cannot be subject to tax; contrast 17.9 (Deemed gains). The consequence is somewhat too good to be true. Following through the deeming, it is suggested that half the income of H is to be regarded as the income of W for the remittance basis, so that if H remits the income, there is a charge to tax on W.

7.47 Avoiding remittances: basic tax planning

The best way to avoid any question of a remittance basis liability is simple and (if the word has any meaning in a tax context) "natural": the income should be retained abroad.

The income should be carefully segregated from capital: see 7.36 (Remittance from mixture of capital and foreign income). The income may be applied to meet the foreign domiciliary's foreign expenditure. It may also be reinvested. Capital can be remitted free of income tax. The Revenue accept in CG Manual 25410 that this "common practice" is effective.

The income can be used to make gifts to individuals out of the UK or to individuals in the UK so long as the money is received by them abroad: see 7.26 (Gifts to third parties completed abroad). If the individual prefers not to make gifts to his wife, he might make loans to her instead. Suppose the wife uses the income given to her to meet living expenses which would otherwise be joint expenses. It is considered that there is still no taxable remittance – all that matters is that the funds do not return to the taxpayer himself.

7.48 Source ceasing principle

The principle is that there is a charge to IT on remitted income only if the income arises in any year from a source in existence during that year. This principle, the source doctrine, was established by the House of Lords in *National Provident Institution v Brown* 8 TC 57.[41] It is derived by a remorseless application of three rules:

(1) Income tax is not a tax on income of every kind; it is a tax on income *from various specified sources* (the Schedules): s.1 ICTA 1988. Different rules apply to different sources. It is necessary to identify the source of income in order to apply the rules. In the absence of a source there is no charge.

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41 Post-cessation receipts of a trade taxable under Schedule D Case I were once exempt from tax by virtue of this rule: *Stainer's Executors v Purchase* 32 TC 367 and *Carson v Cheyney's Executors* 38 TC 240. In such circumstances, ss.103 and 104 ICTA 1988 now impose a tax charge.

(2) Income tax is an annual tax. The charge to income tax is imposed each year for the period of one year by a specific provision in the Finance Act of that year. One should, in principle, treat each income tax year as a separate and independent matter; one must ask in each year whether in that year the conditions of the charge to tax are satisfied.

(3) Income tax is *charged* on income arising in any year from specified sources in that year; it is merely *computed* (for the foreign income of a foreign domiciliary) on sums received in the UK: s.65 ICTA 1988. It is not *charged* on remitted income. The section draws a distinction between a *charge* and a *computation*. A *charge* is the general liability to pay. There will be a charge to tax whenever income arises to a UK resident from a specified source in any year. Once a charge to tax has arisen, the amount of that charge must be *computed*. For the foreign domiciliary, the statute does not adopt the natural and accurate means of computation, namely to ascertain arithmetically the amount of income arising from that source. Instead the computation is an artificial one: it is based on the amount remitted to the UK.

The *computation* is subsidiary to the *charge*. If there is no charge to tax then there is nothing to compute. It is quite irrelevant to compute what the amount of that charge might have been if the conditions of the charging section had been satisfied.

The conclusion is so extraordinary that, had the House of Lords not decided it long ago, one would not have thought the argument would have any realistic prospect of success. In other contexts the principle that income tax is an annual tax is not applied if the result is unreasonable.[42] But there it is. This principle is accepted by the Revenue. This was published as long ago as the 1988 Consultative Document (Residence in the UK: The Scope of UK Tax for Individuals) paragraph 4.18; and is now published in Inspector's Manual paragraph 1563:

> **Remittance basis: Income not assessable**
> Published: 9/95
> Where the remittance basis applies, it is ordinarily immaterial, subject to the guidance in IM 1660–IM 1664, in what year the income arose.

42 See 7.11 (Remittance in tax year after receipt).

> Where, however ... the source of the income has ceased before the commencement of the year in which a remittance is made ... such income should be excluded from the computation of liability.

It is understood that if a foreign domiciliary disposes of a source of income in the same tax year that he becomes UK resident, but before the date of his arrival, the Inland Revenue will not seek to charge subsequent remittances from that source. This is a generous practice; there would seem to be no technical justification for it, although it is broadly consistent with Concessions A11 and D2. A taxpayer relying on this is at risk.

The source doctrine does not apply to employment income: see 8.17 (Remittance after employment ceases). It does not apply for CGT.

It was suggested a few years ago that s.660A ICTA 1988 might counteract the source doctrine. This is not correct for two independent reasons. Source ceasing arrangements do not constitute a "settlement", lacking any element of "bounty"; see 10.3 ("A settlement"). Further, the source ceasing rule applies to s.660A: see 10.13 (Trustees remit trust income to UK). In practice the Revenue seem to accept this.

7.49 Source ceasing tax planning

Income from any Schedule D Case IV or V source which is remitted in any year after the source has ceased will not be chargeable to income tax. The principle offers a practical means of bringing income into the UK while avoiding the remittance basis charge. If a taxpayer "closes down" his sources of income in one year he may remit the income from those sources in the following year.

For this purpose, a source ceases if an asset is transferred to:

(1) another individual;

(2) a company, or

(3) a discretionary trust, or

(4) an interest in possession trust governed by some laws such as that of New York; see 6.12.1 (Interest in possession type trusts).

Thus it is not necessary to dispose of an asset to a third party and lose all interest in it.

7.50 Foreign income taxable on arising basis: income from Ireland

There are some exceptions to the general rule that foreign income qualifies for the remittance basis. The remittance basis does not apply to "property situate in and profits or gains arising in the Republic of Ireland": see s.68 ICTA 1988. The reason is historical. The Union with Ireland Act 1800 provided that:

> The said Kingdoms of *Great Britain* and *Ireland* shall, upon the first Day of *January* which shall be in the Year of our Lord one thousand eight hundred and one, and for ever after, be united into one Kingdom, by the Name of *The United Kingdom of Great Britain and Ireland*.

"For ever" lasted until the creation of the Irish Free State in 1922. Irish source income would until then have been subject to UK tax on an arising basis. The current provision dates back to the 1926 UK/Ireland Double Tax Treaty and so continued the former position. It might have pleased the framers of the Union with Ireland Act to know that, at least in this backwater of taxation, Great Britain and Ireland are even now regarded as "one Kingdom". The discrimination against Ireland is probably inconsistent with EU law. But given the UK/Ireland double tax treaty, this point may not often arise.

In full detail, s.68 provides:

> **Special rules where property etc situated in Republic of Ireland**
> (1) Notwithstanding anything in section 65, but subject to the provisions of this section, income tax chargeable under Case IV or V of Schedule D shall, in the case of property situated and profits arising in the Republic of Ireland, be computed on the full amount of the income arising in the year of assessment, whether the income has been or will be received in the United Kingdom or not, subject in the case of income not received in the United Kingdom—
> (a) to the same deductions and allowances as if it had been so received; and
> (b) to a deduction on account of any annuity or other annual payment (not being interest) payable out of the income to a person not resident in the United Kingdom.

This is consistent with the treatment of such income received by UK domiciled individuals. Relief may be available under the current UK/Ireland double taxation convention. On Irish pensions, see 9.3 (Irish pensions).

7.50.1 *Trading income from Ireland*

Section 68 lays down special rules here:

> (2) Subsection (1) above shall not apply—
>
> (a) to any income which is immediately derived by a person from the carrying on by him of any trade, profession or vocation, either solely or in partnership; or
>
> (b) to any income which arises from any pension.
>
> (3) The tax in respect of any such income as is mentioned in subsection (2) above arising in the Republic of Ireland shall be computed either—
>
> (a) on the full amount thereof arising in the year of assessment; or
>
> (b) on the full amount thereof on an average of such period as the case may require and as may be directed by the inspector;
>
> so that, according to the nature of the income, the tax may be computed on the same basis as that on which it would have been computed if the income had arisen in the United Kingdom, and subject in either case to a deduction on account of any annuity or other annual payment (not being interest) payable out of the income to a person not resident in the United Kingdom; and the person chargeable and assessable shall be entitled to the same allowances, deductions and reliefs as if the income had arisen in the United Kingdom.
>
> The jurisdiction of the General or Special Commissioners on any appeal shall include jurisdiction to review the inspector's decision under this subsection.

Subsection (4) sets out further rules for losses on Irish trades (a matter too specialist to set out here).

7.51 Foreign income taxable on arising basis: Schedule D Case VI income

Schedule D Case VI applies to:

> Any annual profits or gains not falling under any other Case of Schedule D and not charged by virtue of Schedule A or by virtue of ITEPA 2003 as employment income, pension income or social security income.

In practice (apart from anti-avoidance provisions which are considered elsewhere), Case VI applies mainly to casual consultancy profits.

Income tax under Case VI of Schedule D is computed "on the full amount of the profits or gains arising in the year of assessment": s.69 ICTA 1988. The remittance basis does not apply, even if the recipient of the income is not UK domiciled, and qualifies for the remittance basis for Schedule D Case IV and V income.

Some commentators have suggested that there is a gap in the remittance basis, which poses a trap here for the foreign domiciliary. He must try to arrange that foreign income arises under Schedule D Case V, not Case VI, or he will lose the advantage of the remittance basis. It is suggested that there is no gap. For if the source of the casual profits is "out of the United Kingdom" the income will fall within Case V, and therefore not within Case VI (which does not apply to income within the other cases).[43] Thus Schedule D Case VI only applies to profits with a UK source. The Tax Law Re-write team agree: paper CC (03) 11 [2003] STC 1717.

7.52 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", and further details are revealed in *Al Fayed v Advocate General* [2002] STC 910. The taxpayers involved were wealthy UK resident non-domiciled individuals.

The Revenue 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 United Kingdom living expenses; deducted from that the amount of United Kingdom income; the balance then represented funds which will be required annually from overseas upon which tax liability was expected. United Kingdom sources of income remain taxable in the normal way. The subscription rate method of taxation relates to income and gains within the remittance basis only.

Malcolm Gunn explained:

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43 The income must be income from "a kind of property" or it is not within the scope of Schedule D at all: see s.18(1)(a)(i) ICTA 1988. The "kind of property" will be a "possession" within Schedule D Case V.

> 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.
>
> ... The maximum term for a contract will be six years, although a shorter period such as three years might sometimes be suggested.
>
> The agreement terminates at the end of a fixed period or at an earlier time if the taxpayer either acquires a United Kingdom domicile of choice or becomes non-United Kingdom resident for tax purposes.[44]

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.

Now these agreements have been held to be *ultra vires* in a judgment in which Lord Justice Clerk was rightly indignant.[45] Where such agreements have been made in the past, a taxpayer may have a defence to an assessment if he can show he has suffered prejudice.

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44 Transition from taxation under the agreement back to taxation by law raises additional problems discussed in Malcolm Gunn's article.

45 *Al Fayed v Advocate General* [2002] STC 910 paras. 115–120. *Al Fayed* style bargaining is however the basis on which taxation of wealthy foreigners is agreed in Switzerland, France and Austria (and I daresay many other countries).

CHAPTER EIGHT

EMPLOYMENT INCOME

8.1 Introduction

ITEPA 2003 imposes charges to income tax on:

(1) employment income;

(2) pension income;

(3) social security income.

"Employment income" is subdivided (in short) into:

(1) general earnings (the term includes benefits in kind);

(2) specific employment income (not discussed here).

The law before 2003 is set out in a predecessor to this chapter which is accessible on *www.kessler.co.uk*. Double tax relief and NICs may also need consideration but these are beyond the scope of this book.

8.2 Resident, ordinarily resident and foreign domiciled employee

Section 21 ITEPA 2003 imposes a charge on an arising basis on all the "general earnings" of an employee who is UK resident and ordinarily resident but foreign domiciled:

> except to the extent that they are chargeable overseas earnings for that year.

Chargeable overseas earnings (formerly Schedule E Case III) are taxed on s.22 ITEPA 2003:

> **Chargeable overseas earnings for year when employee resident and ordinarily resident, but not domiciled, in UK**
> (1) This section applies to general earnings for a tax year in which the employee is resident and ordinarily resident, but not domiciled, in the United Kingdom to the extent that the earnings are chargeable overseas earnings for that year.
> (2) The full amount of any general earnings within subsection (1) which are remitted to the United Kingdom in a tax year is an amount of "taxable earnings" from the employment in that year...

8.3 Chargeable overseas earnings

The expression "chargeable overseas earnings" imposes two sets of requirements: there must be "overseas earnings" and they must be "chargeable". The key part of the definition is "overseas earnings". Section 23(2) ITEPA 2003 provides the definition:

> General earnings for a tax year are "overseas earnings" for that year if—
> (a) in that year the employee is resident and ordinarily resident, but not domiciled, in the United Kingdom,
> (b) the employment is with a foreign employer, and
> (c) the duties of the employment are performed wholly outside the United Kingdom.

The concept of "chargeable" overseas earnings brings in the rules for deductible expenses (not discussed here) and for associated employments.

8.4 Foreign employer

One requirement of "overseas earnings" is that the employment is with a "foreign employer". The definition is in s.721(1) ITEPA 2003:

> "foreign employer" means—
> (a) in the case of an employee resident in the United Kingdom, an individual, partnership or body of persons resident outside the United Kingdom and not resident in the United Kingdom or the Republic of Ireland, ...

8.4.1 *Foreign employer: Revenue practice*

The Employment Income Manual paragraph 40102 provides:

> An employee may maintain that general earnings are chargeable overseas earnings taxable on remittance under section 22 rather than on receipt under section 21. This is likely to lead to a significant reduction in the amount of taxable earnings. You should examine the facts closely before accepting that emoluments fall within this exception. In particular you should find out whether the employer has any place of business in the United Kingdom. If you can trace an accounts file for the employer, ask the accounts Inspector for instructions on the employer's residence status.

8.4.2 *Employer resident in Ireland*

The remittance basis does not apply if the employer is resident in Ireland. This is achieved by the drafting technique of saying that an Irish resident employer of a UK resident employee is not a "foreign employer". That might surprise the residents of Eire. The rule is consistent with that applied to foreign investment income: see 7.50 (Income from Ireland).

8.5 Meaning of "duties performed wholly outside the UK"

The next requirement of "overseas earnings" is that "the duties of the employment are performed wholly outside the UK". This concept is explained in s.39 ITEPA 2003:

> **Duties in UK merely incidental to duties outside UK**
> (1) This section applies if in a tax year an employment is in substance one whose duties fall to be performed outside the United Kingdom.
> (2) Duties of the employment performed in the United Kingdom whose performance is merely incidental to the performance of duties outside the United Kingdom are to be treated for the purposes of this Chapter as performed outside the United Kingdom. ...[1]

1 Sections 39(3) and 40 ITEPA 2003, relating to seafarers and duties performed on vessels or aircraft, are too specialist to be considered here.

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? The Revenue interpret this strictly:

> 5.7 Whether duties you perform in the United Kingdom are "incidental" to your overseas duties depends on all the circumstances. If the work you do in the United Kingdom is of the same kind as, or of similar importance to, the work that you do abroad, it will not be merely incidental unless it can be shown to be ancillary or subordinate to that work. It is normally the nature of the duties performed in the United Kingdom rather than the amount of time spent on them that is important, but if the total time you spend working in the United Kingdom is more than 91 days in a year, the work you do will not be treated as incidental. Examples of duties which are normally not regarded as incidental are:
>
> – attendance at directors' meetings in the United Kingdom by a director of the company who normally works abroad,
> – visits to the United Kingdom as a member of the crew of a ship or aircraft, or
> – visits to the United Kingdom in the course of work by a courier.
>
> 5.8 If the work you do in the United Kingdom has no importance in itself but simply enables you to do your normal work abroad, it may be treated as incidental. We will decide after looking at all the circumstances in your case. Examples of duties which are regarded as incidental are:
>
> – visits to the United Kingdom by an overseas representative of a United Kingdom employer to report to the employer or to receive fresh instructions, or
> – training in the United Kingdom by an overseas employee as long as
>   (i) the total time spent in the United Kingdom for training is not more than 91 days in a year, and
>   (ii) no productive work is done in the United Kingdom in that time.
>
> (IR20 paragraphs 5.7 and 5.8)

The statement is consistent with the only authority on this point, *Robson v Dixon* 48 TC 527. This concerned a pilot based in Holland whose average of seven landings in the UK per annum were not regarded as merely incidental to his overseas duties. The test therefore does seem to be one of quality and not quantity; the duties performed in the UK must be minor compared with the overseas duties and they must further the purposes of the overseas duties without having a character or importance of their own.[2]

The statement is also consistent with the 1955 Royal Commission which gave two examples of incidental duties: "returning for report" and "to collect samples, etc".[3]

8.6 Dual contract arrangements[4]

Where a UK resident foreign domiciled employee has duties partly within and partly outside the UK, the common strategy is for him to have two contracts of employment:

(1) Under one contract he would undertake the UK activities. The earnings for the UK duties will be chargeable on the arising basis.

(2) The other contract would be in respect of his activities in the rest of the world. The earnings for foreign duties will be chargeable on the remittance basis if the other conditions (foreign employer) are satisfied.

It would be tidier to have separate employment contracts with separate companies–even if they are members of the same group. This stops the Revenue arguing there is actually only one contract. But this is not essential.

Section 24 ITEPA 2003 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

2 However, one take-off and landing in the UK in a single year is disregarded: SP A10. This is no doubt a considerable comfort for fiscally aware pilots and their passengers, in the event of a mid-air emergency in the vicinity of the UK.

3 Cmd. 9474 para 300.

4 Alistair Ladkin has written a valuable article on this topic in *Taxation*, Vol. 150, No. 3900, p.632 (27 March 2003).

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 United Kingdom.

(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 United Kingdom, and

(ii) those performed in the United Kingdom, and

(b) all other relevant circumstances.

(3) For the purposes of subsection (2) "the aggregate earnings for a year from all the employments concerned" means the amount produced by aggregating the full amount of earnings from each of those employments for the year mentioned in subsection (1) so far as remaining after subtracting any amounts of the kind mentioned in step 2 in section 23(3).

(4) In this section-

(a) "the employments concerned" means the relevant employment and the associated employments;

(b) "associated employments" means employments with the same employer or with associated employers.

(5) The following rules apply to determine whether employers are associated—

Rule A An individual is associated with a partnership or company if that individual has control of the partnership or company.

Rule B A partnership is associated with another partnership or with a company if one has control of the other or both are under the control of the same person or persons.

Rule C A company is associated with another company if one has control of the other or both are under the control of the same person or persons.

(6) In subsection (5)—

(a) in rules A and B "control" has the meaning given by section 840 of ICTA (in accordance with section 719 of this Act); and

(b) in rule C "control" means control within the meaning of section 416 of ICTA (meaning of expressions relating to close companies).

(7) If an amount of chargeable overseas earnings is reduced under step 3 in section 23(3) as a result of applying any limit imposed

> by this section, the amount of general earnings corresponding to the reduction remains an amount of general earnings within section 21(1).

The Revenue examine these arrangements closely. Employment Income Manual 40103–4 sets out the Revenue view:

> **40103. Taxable earnings: "chargeable overseas earnings**
> Sections 22 to 24 ITEPA 2003
> Non-domiciled individuals sometimes come to work for United Kingdom resident employers. Depending on the length of their visit they may be resident and ordinarily resident from the date of arrival. They may locate in London but the job may have European or global dimensions, which requires foreign travel and the performance of duties outside of the United Kingdom.
> The full amount of general earnings from a single employment with duties performed inside and outside of the United Kingdom will be taxable under Section 21.
> In the circumstances described above the employee may be offered two employments instead of one:
> - employment 1 covering the performance of duties in the United Kingdom and
> - employment 2, usually with an associated company resident offshore, covering duties performed in the rest of the world, excluding the United Kingdom.
>
> The two, or more, employments may require very similar duties to be performed. The only significant difference is the geographical areas in which those duties are carried out.
> The advantage to the taxpayer is that the earnings from employment 2 will be chargeable overseas earnings and will only be taxable under Section 22 if remitted to the United Kingdom. For this reason, dual contract arrangements are popular among non-domiciled employees assigned to work in the United Kingdom.
> *Identification*
> Taxpayers should complete a separate copy of the employment pages in the SA Return for each employment held during the relevant year. This includes the two or more employments held under a dual contract arrangement. Employment pages returning the second 'offshore' employment may only carry a statement of total earnings paid or provided. If there have been no remittances in the year there will be a matching deduction in Box 1.31.
> *Action in Inland Revenue offices*

You may seek to establish that:

- there are two (or more) employments in reality and not one employment that has been artificially divided to exploit Section 22
- no duties under the 'offshore contract' have been performed in the United Kingdom.

If earnings paid under the two (or more) contracts appear to be disproportionate you may consider invoking Step 3 of the three steps set out in Section 23 in order to calculate the amount of chargeable overseas earnings. Step 3 applies any limit imposed by Section 24 thus restricting the amount of chargeable overseas earnings within Section 22. Section 24 permits a reapportionment of the remuneration on a commercial basis, to ensure that the amount paid in respect of UK duties is a fair proportion of the total remuneration from both or all associated employments. The effect of such a reapportionment is to limit the chargeable overseas earnings whilst increasing the taxable earnings within Section 21.

Where the facts of a case lead you to suspect that the provisions of Section 24 should be invoked, submit the papers to Revenue Policy, Personal Tax, Solihull, before taking any other action. Further guidance and information on dual contract arrangements may be obtained from the Personal Tax, Solihull.

See example EIM40104.

40104. Dual contract arrangements: Example

Section 22 ITEPA 2003

A US citizen is employed by ABC Inc, a company resident in the US. The employee is assigned to work in London for a subsidiary company DEF Ltd for a period of 5 years. It is estimated that 40% of duties will be performed outside of the United Kingdom, in Europe and the US.

The employee relocates to London. In consequence of his intention to remain in the United Kingdom for 5 years he is resident and ordinarily resident from the date of arrival but not domiciled.

The employee is invited to structure the employments as described below:

ABC Inc.

This employment continues from before and throughout the period of the assignment. The letter of assignment specifies a list of clients and duties to be serviced and dealt with outside of the United Kingdom.

DEF Ltd.

The new employment commences with the employee's arrival from the US. Duties specified in the contract include a portfolio of clients and line management responsibilities in the United Kingdom.

The contract with ABC Inc is remunerated at a rate approximately 50% higher than that with DEF Ltd.
Comments
The employee is not domiciled in the United Kingdom. ABC Inc is not resident here but resident in the US. If the duties of this employment are performed wholly abroad then the earnings will be chargeable overseas earnings within Section 22 and will only be taxable if they are remitted to the United Kingdom.
Emoluments from DEF Ltd fall into Section 21 and the taxable amount will be the full amount of Section 21 earnings received in the tax year.
If the employee was assigned to carry out one employment, but at a later date that was sub-divided to exploit Section 22, you may challenge and seek evidence that there are two employments in reality.
ABC Inc and DEF Ltd are "associated" with each other. See Rule C in Section 24(5) and Section 24(6) that imports the definition of control from Section 416 ICTA 1988. The disparity in levels of remuneration may require use of Section 24.
Seek advice from Revenue Policy, Personal Tax (Technical), Solihull before taking action on the single employment issue or invoking Section 24.

8.6.1 *Implications for employer*

Inspector's Manual para. 5348 provides:

Apart from the Schedule E implications there are other questions to consider:-
- 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.
- 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?
- 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?

8.7 Resident but not ordinarily resident employee

Sections 25 and 26 ITEPA 2003 provide:

> **25 UK-based earnings for year when employee resident, but not ordinarily resident, in UK**
>
> (1) This section applies to general earnings for a tax year in which the employee is resident but not ordinarily resident in the United Kingdom if they are—
>
> (a) general earnings in respect of duties performed in the United Kingdom, or
>
> (b) general earnings from overseas Crown employment subject to United Kingdom tax.
>
> (2) The full amount of any general earnings within subsection (1) which are received in a tax year is an amount of "taxable earnings" from the employment in that year...
>
> **26 Foreign earnings for year when employee resident, but not ordinarily resident, in UK**
>
> (1) This section applies to general earnings for a tax year in which the employee is resident, but not ordinarily resident, in the United Kingdom if they are neither—
>
> (a) general earnings in respect of duties performed in the United Kingdom, nor
>
> (b) general earnings from overseas Crown employment subject to United Kingdom tax.
>
> (2) The full amount of any general earnings within subsection (1) which are remitted to the United Kingdom in a tax year is an amount of "taxable earnings" from the employment in that year....

This imposes:

(1) a charge on an arising basis on general earnings in respect of duties performed in the United Kingdom; and

(2) a charge on a remittance basis on other earnings.

This is better than the remittance basis for UK resident and ordinarily resident foreign domiciliaries:

(1) It is not necessary to have a foreign employer.

(2) It is not necessary that duties are performed *wholly* outside the UK. So it is not necessary to have dual contract arrangements.

8.8 Non-resident employee

Section 27 ITEPA 2003 provides:

> **UK-based earnings for year when employee not resident in UK**
>
> (1) This section applies to general earnings for a tax year in which the employee is not resident in the United Kingdom if they are—
>
> (a) general earnings in respect of duties performed in the United Kingdom, or
>
> (b) general earnings from overseas Crown employment subject to United Kingdom tax.
>
> (2) The full amount of any general earnings within subsection (1) which are received in a tax year is an amount of "taxable earnings" from the employment in that year.

This applies regardless of domicile.

8.9 "Duties performed in the UK"

The concept of "duties performed in the UK" is relevant for:

(1) A resident but non-ordinarily resident employee, where it makes the difference between an arising and a remittance basis.

(2) A non-resident employee, where it makes the difference between taxable income and tax free income.

Section 38 ITEPA 2003 provides:

> **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 United Kingdom.
>
> (2) General earnings for a period of absence from the employment are to be treated for the purposes of this Chapter as general earnings for duties performed in the United Kingdom except in

so far as they would, but for that absence, have been general earnings for duties performed outside the United Kingdom.

Special rules apply for:

(1) duties on board vessels or aircraft, see s.40 ITEPA 2003;

(2) duties performed in the UK sector of the Continental Shelf, see s.41 ITEPA 2003.

8.10 Earnings "in respect of" duties performed in the UK

SP 5/84 para 2 states:

> 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 emoluments are attributable to the UK duties. Apportionment of emoluments is essentially a question of fact, but for many years now the Revenue have accepted time apportionment, based on the number of days worked abroad and in the UK, except where this would clearly be inappropriate, and it is not intended to disturb this practice. For example, in the case of an employee with 200 working days in the UK and 50 working days outside the UK, the proportion of emoluments attributable to UK duties would be 200/250.

Time apportionment would be inappropriate if there are different rates of pay in the two places of work, but the employee will need to provide evidence of this. In *Perro v Mansworth* [2001] STD (STC) 179, payment under a tax equalisation scheme relating to UK tax was held to be a payment of earnings in respect of duties performed in the UK. See too *Varnam v Deeble* 58 TC 501, *Brown v Platten* 59 TC 408; *Coxon v Williams* 60 TC 659, Tax Bulletin 62.

8.11 Summary

The taxation of employment income can be summarised in this table:

UK Resident	Ordinarily Resident	UK Domiciled	Scope of charge	Charging Section
Yes	Yes	Yes	All earnings: AB	15
Yes	Yes	No	(1) chargeable overseas earnings: RB (2) other earnings: AB	21 22
Yes	No	irrelevant	(1) UK duties: AB (2) other duties: RB	25 26
No	irrelevant	irrelevant	(1) UK duties: AB (2) other duties: tax free	27 –

Key AB: Arising basis RB: Remittance basis

8.12 Meaning of "remitted to the UK"

Section 33 ITEPA 2003 provides:

> **Earnings remitted to UK**
> (1) This section explains what is meant for the purposes of this Chapter by general earnings being remitted to the United Kingdom.
> (2) If general earnings are—
> (a) paid, used, or enjoyed in the United Kingdom, or
> (b) transmitted or brought to the United Kingdom in any manner or form,
> they are to be treated as remitted to the United Kingdom at the time when they are so paid, used or enjoyed or dealt with as mentioned in paragraph (b).

Subsection (2) (which dates back to 1956) is perhaps intended to extend the concept of "remittance" beyond that which applies to the Schedule D remittance basis. Though it is just as likely that the drafter only had in mind a modern paraphrase of the antique language of the four sub-heads of Schedule D Case V; see 7.10.1 (Case IV and Case V remittance bases). There is no authority discussing these words. (The question was raised but left open in *Harmel v Wright* 49 TC 149.)

Most of the principles of the Schedule D remittance basis apply to the employment income remittance basis. In particular the principle of *Carter v Sharon* 20 TC 229 applies, with the result that income transferred abroad to others may be remitted by them to the UK without any charge to tax.

The Employment Income Manual provides at 40302:

> *Paid in the United Kingdom*
> Earnings are remitted to the United Kingdom if they are paid to the employee in cash in this country or if the employee's bank account here is credited with them. Employees may arrange to have earnings paid into offshore bank accounts to avoid this rule.

This is correct. The Manual continues:

> Money that is transmitted from the employer's bank in the United Kingdom to the employee's offshore bank is not treated as remitted here. It has been in the banking system all of the time; the employee did not have access to it.

This conclusion is correct, though the statement that the money has "been in the banking system" is layman's language.[5]

8.13 Claims

No claim is required: if the employment income remittance basis applies, it is compulsory. This is probably deliberate as there are few circumstances where a taxpayer would wish *not* to make a claim. Contrast the Schedule D remittance basis; see 7.8 (Claims).

8.14 Assets purchased out of employment income and brought to UK

If employment income is applied in the purchase of chattels which are brought to the UK, it seems clear that the income has been enjoyed in the UK. This is the Revenue view: Employment Income Manual 40302:

> *Assets*
> If an employee receives earnings abroad but then uses them to purchase assets such as a car or a painting and then brings the assets into the United Kingdom the earnings used to purchase the assets are regarded

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5 "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).

as remitted to the United Kingdom.

This is also supported by an *obiter* comment in *Grimm v Newman* [2002] STC 1888, para. 100–101. Contrast the Schedule D remittance basis: see 7.24 (Assets brought to the UK). The same would apply if the earnings are applied in the purchase of a house occupied by the employee.

What is the position if employment income is re-invested in UK situate property without being enjoyed *in specie*? For example, if it is held in UK situate shares or land let as an investment? It would be arguable that these sums have been "brought to the UK" in some "money or form", so there has been a remittance. However, it is tentatively suggested that the scheme of the remittance basis is only to tax the individual if he has actual enjoyment of the assets, and merely making them UK situate is not enough. One can infer from the specific reference to chattels in the Revenue Manual passage that the Revenue accept this view.

8.15 Deemed remittances

Sections 33 and 34 ITEPA 2003 provide:

> (3) If, in the case of an employee who is ordinarily resident in the United Kingdom, general earnings are used outside the United Kingdom to satisfy a UK-linked debt, they are to be treated as remitted to the United Kingdom at the time when they are so used.
> This is subject to subsection (5)(b).
> (4) In subsection (3) "UK-linked" debt, in relation to an employee, means—
> (a) a debt for money lent to the employee in the United Kingdom, or for interest on money so lent, or
> (b) a debt for money lent to the employee outside the United Kingdom and received in the United Kingdom, or
> (c) a debt incurred for satisfying—
> (i) a debt falling within paragraph (a) or (b), or
> (ii) another debt falling within this paragraph.
> (5) In the case of a debt (within subsection (4)(b) or (c)) for money lent to the employee outside the United Kingdom—
> (a) it does not matter whether the money lent is received in the United Kingdom before or after the general earnings are used to satisfy the debt, but
> (b) if the money lent is not received in the United Kingdom until

after the general earnings are used to satisfy the debt, the general earnings are to be treated as remitted to the United Kingdom at the time when the money lent is received there (instead of at the time provided in subsection (3)).

(6) In subsections (4) and (5) any reference to money lent being received in the United Kingdom includes a reference to its being brought there.

(7) Section 34 (further provisions about UK-linked debts) applies for the purposes of subsections (3) to (5).

34 Earnings remitted to UK: further provisions about UK-linked debts

(1) This section applies for the purposes of the provisions of section 33 which relate to general earnings that are used to satisfy a UK-linked debt.

(2) General earnings are to be treated as used to satisfy a debt for money lent to a person ("the borrower") if conditions A and B are met.

(3) Condition A is that the earnings are dealt with in such a way that the lender holds money or property representing the earnings on behalf of or on account of the borrower in such circumstances that it is available to the lender to satisfy or reduce the debt (by set-off or otherwise).

(4) Condition B is that under an arrangement between the borrower and the lender—

(a) the amount for the time being owed by the borrower to the lender, or

(b) the time at which the debt is to be wholly or partly repaid,

depends in any respect, directly or indirectly, on the amount or value the lender holds on behalf of or on account of the borrower as mentioned in subsection (3).

(5) If and to the extent that money lent is used to satisfy a debt, the debt for the money lent is to be treated as incurred for satisfying that other debt.

(6) In this section "lender" includes, in relation to any money lent, any person for the time being entitled to repayment.

(7) In this section and section 33 "satisfy", in relation to a debt, means satisfy wholly or in part.

This rewrites in plain English the deemed remittance rules discussed at 7.40 (Deemed remittances).

8.16 Remittance after year for which earnings are paid

The charge on the remittance basis applies "whether the earnings are for that year or for some other tax year": ss.22(3)(a), 25(3)(a) and 26(3)(a) ITEPA 2003.

8.17 Remittance after employment ceases

The charge on the remittance basis applies "whether or not the employment is held at the time when the earnings are remitted": ss.22(3)(b), 25(3)(b) and 26(3)(b) ITEPA 2003. This may be contrasted with the Schedule D remittance basis: see 7.48 (Source ceasing principle).

8.18 Earnings for non-UK resident year

To be "overseas earnings" the earnings must be for a year of assessment in which the employee was resident and ordinarily resident in the UK. Accordingly, any earnings for a year during which the employee was not UK resident can be remitted at any time without any charge to tax. The concept of earnings "for" a year is explained in s.29 ITEPA 2003.

8.19 Remittance when not UK resident

Suppose:

(1) In year 1, an individual has unremitted chargeable overseas earnings for a year.

(2) In year 2, the individual is not UK resident and remits the earnings.

Section 22(2) ITEPA 2003 taken at face value states that the remitted earnings are taxable earnings in year 2. It is doubtful whether that odd result can be correct.

8.20 Remittance after acquisition of UK domicile

Where:

(1) A foreign domiciliary retains chargeable overseas earnings abroad,

(2) acquires a UK domicile, and

(3) subsequently remits the income,

the income is still taxable. Contrast the position for Schedule D Case V income; see 128 (Remittance after acquisition of UK domicile).

8.21 Remittance after death of employee

The drafter has also provided for this case. If personal representatives receive chargeable overseas earnings in the UK, there is a tax charge on them: s.13(4) ITEPA 2003. If they receive emoluments out of the UK and assent to beneficiaries, there is no charge.

8.22 Remittance out of earnings for mixed UK/foreign duties

Statement of Practice 5/84 explains:

> **Employees resident but not ordinarily resident in the UK: liability under Schedule E Cases II and III**
> 1 An employee resident but not ordinarily resident in the UK is liable to UK tax under Schedule E Case II, on emoluments wherever received for duties performed in the UK. He is also liable under Schedule E Case III, on emoluments for duties performed outside the UK but only to the extent that they are received in or remitted to the UK.
> ...
> 3 Where an employee resident but not ordinarily resident in the UK performs the duties of a single office or employment both in and outside the UK and is remunerated wholly abroad, he is permitted, by a broad interpretation of the decision in the case of *Sterling Trust Ltd v IRC* 12 TC 868, to say that any remittances made to the UK are made primarily out of emoluments for that year in respect of duties performed in the UK assessable under Case II, and only any balance out of emoluments assessable on the remittance basis.[6]
> 4 However, where part of the emoluments have been paid in the UK, or benefits have been used or enjoyed in the UK, it has been the practice

6 This is arguably correct in law and not a concession: see 7.35 (Remittance from mixture of taxed and untaxed income).

of the Revenue to regard the proportion of emoluments paid, used or enjoyed in the UK, as in respect of duties performed both in and outside the UK, and to treat that proportion of such emoluments as is attributable to duties performed outside the UK as "received in" the UK for the purposes of Case III.

5 The Board of Inland Revenue has now decided that the procedure should be simplified 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 liable under both Schedule E Cases II and III, in respect of emoluments from that employment; and

(c) receive part of their emoluments in the UK and part abroad.

In such cases, provided the emoluments assessable under Case II are arrived at in a reasonable manner (ie in the presence of special facts, the proportion of the emoluments, 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 Case III liability will arise only where the aggregate of emoluments paid in, benefits enjoyed in, and emoluments remitted to, the UK exceeds the amount assessable under Case II for that year; and to restrict the Case III assessment to the excess of the aggregate over the Case II assessment.

No doubt this will eventually be rewritten in the light of ITEPA.

8.23 Foreign service exemption for termination payments

When a foreign domiciliary comes to the UK having worked for an overseas employer for a number of years, he may receive a termination payment after his arrival in this country. This would ordinarily be chargeable as employment income by s.403 ITEPA 2003 to the extent that it exceeds £30,000. However, s.413 ITEPA 2003 provides a territorial exemption.

A payment satisfying the above conditions can be remitted free of income tax to the UK. It is a moot point whether the payment may give rise to CGT, but it may be that in practice the Revenue do not take that point.

8.24 Overseas Crown employment

General earnings from overseas Crown employment subject to UK tax[7] are taxed on an arising basis regardless of residence and domicile and place of work. The reason is given in the 1955 Royal Commission Report:

> International comity does not permit the salary of the servant of one State to be taxed by another State: consequently a Crown servant, even if spending his whole time on work abroad, is not amenable to the local taxing jurisdiction and, if he is to be taxed at all, must be taxed by the United Kingdom taxing authority. No doubt the scale of remuneration for Crown servants abroad is fixed with these considerations in mind.[8]

8.25 Benefits in kind

This is discussed in 31.7ff (Family home: benefit in kind charge) as the most important issues relate to the family home and its chattels.

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7 The expression "general earnings from overseas Crown employment subject to UK tax" is defined in s.28 ITEPA 2003.

8 Cmd. 9474 para 307.

CHAPTER NINE

FOREIGN PENSIONS

9.1 "Foreign pension"

Section 573 ITEPA 2003 provides:

> **Foreign pensions**
> (1) This section applies to any pension[1] paid by or on behalf of a person who is outside the United Kingdom to a person who is resident 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 in the United Kingdom, see Chapter 3 of this Part.

I refer to this as a foreign pension.

9.2 Taxation of foreign pension

Section 575 ITEPA 2003 provides:

> **Taxable pension income**
> (1) If section 573 applies, the taxable pension income for a tax year is the amount on which tax would be chargeable if the pension were charged to tax under Case V of Schedule D for that year (see in particular the provisions of ICTA listed in subsection (2)).
> (2) Those provisions of ICTA are—
> (a) sections 65 and 68 (calculation of the amount of the income on

---

1 Section 574 extends the meaning of pension to include voluntary pensions, to reverse the decision in *Stedeford v Beloe* 16 TC 505.

which tax is to be charged in the tax year);
(b) section 584 (relief for unremittable overseas income);
(c) section 585 (relief on delayed remittances).

This incorporates the Schedule D rules by reference.

A UK domiciled person is allowed a 10% deduction from foreign pensions: s.65(2) ICTA 1988 provides:

> ... income tax chargeable under Case IV or V of Schedule D on income arising from any pension shall be computed on the amount of that income subject to a deduction of one-tenth of the amount of the income.

This rule was introduced when the remittance basis on foreign pensions was abolished in the FA 1974. It is difficult to see a good reason for it but presumably this was a political douceur to ease the abolition of the remittance basis, and which has survived ever since. This deduction does not apply to a foreign domiciliary whose pension is taxed on the remittance basis: s.65(3) disapplies subsection (2). One relief was thought to suffice; fair enough. The foreign domiciliary may always choose to be taxed under an arising basis: see 7.8 (Claims).

9.3 Irish pensions

Irish source income of a foreign domiciliary is taxed on an arising basis, not the remittance basis: see 7.50 (Foreign income taxable on arising basis: income from Ireland). Section 68(5) ICTA 1988 provides:

> In charging income arising from a pension under subsection (3) above, a deduction of one-tenth shall be allowed unless it is the income of a person falling within section 65(4).

In consequence, a foreign domiciled individual who qualifies for and claims the Schedule D remittance basis does not qualify for the 10% deduction on an Irish pension, even though he pays tax on that pension on an arising basis. That seems anomalous. In such cases the UK/Ireland double tax convention also needs consideration.

CHAPTER TEN

THE SETTLEMENT PROVISIONS: SECTION 660A

10.1 Section 660A

Part XV[2] ICTA 1988 contains a code of anti-avoidance provisions known as the Settlement Provisions. The most important (and the only provision discussed in this book) is s.660A ICTA 1988 which provides:

> (1) Income arising under a settlement during the life of the settlor shall be treated for all purposes of the Income Tax Acts as the income of the settlor and not as the income of any other person unless the income arises from property in which the settlor has no interest.

In the following discussion "a settlement within s.660A" is one where the settlor is living and has an interest. Foreign domiciliaries often create such settlements.

10.2 "The settlor"

On the definition of "settlor" see 34.1 ff (Who is the settlor?).

10.3 "A settlement"

Section 660G provides that:

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2 A note on style. The "parts" of ICTA and other legislation have always been numbered in roman numerals until ITEPA 2003 used arabic numerals presumably as part of its plain English principles.

> In this Chapter "settlement" includes[3] any disposition, trust, covenant, agreement, arrangement or transfer of assets....

The Revenue rightly say in Trusts Settlements and Estates Manual:

> **4110. Restrictions to the definition of settlement**
> A purely commercial transaction at arms length is outside the meaning of 'settlement'.
> Settlement must include an element of bounty, as decided in the tax case of *CIR v Plummer* (54 TC 1). Bounty is the provision of value without any corresponding quid pro quo, usually a gift or a transfer at less than full value.

In this book, I only consider settlements which are trusts in the common sense of the word.

10.4 "Income arising under a settlement"

Section 660G(3) provides:

> References in this Chapter to *income arising under a settlement* include,[4] subject to subsection (4) below,[5]
> [1] any income chargeable to income tax by deduction or otherwise, and
> [2] any income which would have been so chargeable if it had been received in the United Kingdom by a person domiciled, resident and ordinarily resident in the United Kingdom.
>
> (Paragraphing and emphasis added)

The points made in 11.13 (Measure of income of person abroad) and 12.11 (Capital receipts deemed to be income) apply also for the purposes of ascertaining what is the "income arising under a settlement" in the context of s.660A.

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3 The context shows this is an exhaustive definition, i.e. the word "includes" really means "means".

4 The context suggests this is an exhaustive definition, i.e. the word "include" really means "mean". Compare fn.2 above.

5 For this exemption see 10.8 (Foreign domicile defence to s.660A).

10.4.1 *Is income of company held by trustees "income arising under a settlement"?*

Income arising to a company held by trustees (not to trustees) is not in principle "income arising under a settlement". This follows from the repeal by Sch 17, Part V, FA 1989 of s. 681(2)(b) ICTA 1988 (which formerly brought such income into the scope of s.660A).[6] This conclusion is also supported by reference in the definition to "income chargeable to income tax". Income arising to a company would normally be chargeable to corporation tax. Company income may fall within the transfer of asset provisions discussed in the following chapters.

10.4.2 *Is income of life tenant (not the settlor) "income arising under a settlement"?*

Income payable under the trust to a life tenant is "income arising under a settlement". Admittedly, such income is usually regarded for tax purposes as the income of the life tenant, not of the trustees.[7] But that is not relevant for s.660A, because:

(1) the expression is "income arising under the settlement", not "income accruing to trustees"; and

(2) "settlement" is very widely defined: see 10.3 ("A 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.660A.[8]

10.4.3 *Income of life tenant settlor*

Where the settlor has an interest in possession, trust income actually received by the settlor is not within s.660A, and is subject to income tax under general principles. The Revenue accept this: see 10.20 (Revenue

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6 This was part of the repeal of the close company apportionment provisions, at a time when the Government paid more than lip service to tax simplification.

7 See 6.12.1 (Interest in possession type trusts).

8 This is also supported by the wording of s.689A(1) ICTA 1988.

view on completion of settlor's tax return). The reason is this. If the income of the life tenant settlor was within section 660A, then applying section 660A(1) that income "shall be treated" as the income of the settlor. However, income of this kind *is* the income of the settlor. Accordingly the deeming provision is not necessary or appropriate; one does not usually "deem" something to be the case which actually *is* the case.[9]

In practice it rarely matters much whether income is actually the income of the life tenant settlor, or is merely deemed to be the income of the life tenant settlor under section 660A. It can however affect the rates of tax on interest and dividends: see 16.7 (Rates of tax on settlor).

10.4.4 *Rental income*

IR 150 (Taxation of Rents) contains helpful statements here on how one calculates rental income and the treatment of losses:

> **50.** 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 Case VI of Schedule D but, where the income is within Schedule A, the normal Schedule A rules apply in calculating the income. (Section 660C ICTA 1988)[10]
>
> **51.** The more common case is where your trustees carry on the Schedule A business but you are a settlor caught by Section 660A ICTA 1988. Here you can't set any rental business losses of your trustees against your personal Schedule A income. Similarly you can't merge your personal rental business losses and the trust rental business profits which are deemed to be yours and charged under Case VI of Schedule D. Thus:
>
> - where your trustees have a rental business loss and you have a personal rental business profit, the trust loss is carried forward and you are taxed on your personal rental business profit; the amount of

9 This view is supported by an obiter comment in *Perry v Astor* 19 TC 255 at 291 on a predecessor of s.660A:

> "It would be odd that the income of the funds covered by the disposition should be 'deemed' to be the income of the person whose income it is in fact."

See too the references in *The Law's Two Bodies*, J.H. Baker, OUP, 2001, p.44, fn.37.

10 In particular it follows that interest is in principle deductible.

the trustees' rental business profit charged on you in the following year under Case VI will be reduced by the trust loss carried forward;

- where your trustees have a rental business profit and you have a personal rental business loss, you are taxed on the trust rental business profit under Case VI; your personal rental business loss can't be merged with the trust profit; but, as a separate matter, you may in some cases be able to set a personal Schedule A loss sideways against your other income, including any Case VI income deemed to arise from your trustees' rental business; see paragraph IR150 423 onwards for more details.

52. The position is different where you are:

- the settlor; and
- the life tenant; and
- you carry on the Schedule A business (as outlined in paragraph IR150 44 onwards).

53. Here you (the settlor) can merge your personal property losses with your deemed income from the trust and vice versa.

This is thought to be correct.

10.4.5 *Gains from life policies and offshore funds*

See:

(1) 19.8 (Section 660A and life policies);

(2) 20.7 (Interaction with s.660A: UK resident trusts) and 20.8 (Non-resident trusts).

10.5 "Property in which the settlor has no interest"

Subject to narrow exceptions not discussed here, s.660A(2) provides:

> a settlor shall be regarded as having an interest in property if that property or any derived property[11] is, or will or may become, payable to or applicable for the benefit of the settlor or his spouse[12] in any

11 "Derived property" is defined in s.660A(10).

12 On the meaning of "spouse" see s.660A(3) and 29.2 (IHT spouse exemption) and *Drafting Trusts & Will Trusts*, 6th ed., James Kessler QC, para. 4.30.

circumstances whatsoever.

In practice the settlor and spouse are usually expressly included as a beneficiary or expressly excluded, and no doubts or questions arise. For further discussion see *Drafting Trusts & Will Trusts*, 6th ed., Chapter 12.

10.5.1 *Subsequent exclusion of settlor from his settlement*

If the settlor originally has an interest in trust property but is later totally excluded (together with his spouse) then s.660A ceases to apply to income arising after the date of their exclusion. If the settlor is excluded from part of the trust fund, then he is strictly still within the scope of section 660A on all the income arising under the settlement.

10.6 Transfer to new settlement

If the trust fund is transferred to a new settlement from which the settlor is not excluded, then s.660A continues to apply. The old settlor is the settlor of the new trust: see 34.7 (Transfer from trust A to trust B by exercise of trustees' power).

If the entire trust fund is transferred to a new trust from which the settlor (and spouse) are entirely excluded then s.660A ceases to apply.

If part of the trust fund is transferred to a new trust from which the settlor and spouse are excluded, and part remains in the existing trust of which the settlor continues to be a beneficiary, then it is suggested that s.660A ceases to apply to the income arising under the new settlement. For the new settlement is a separate "settlement" within the income tax definition.

10.7 Rates of tax on settlor

See 16.7 (Rates of tax on settlor).

10.8 Foreign domicile defence to s.660A

Subsection 660G(4) ICTA 1988 is as tortuous as any in the Income Tax Acts, and that is really saying something. It is a quadruple negative. Divided into parts, for comprehension, it begins:

> [1] Where the settlor is not domiciled, or not resident, or not ordinarily

resident, in the United Kingdom in a year of assessment,

[2] references in this Chapter to *income arising under a settlement* do not include income arising under the settlement in that year

[3] in respect of which the settlor, *if he were actually entitled thereto,* would not be chargeable to income tax by deduction or otherwise by reason of his not being so domiciled, resident or ordinarily resident.

(Emphasis added)

I consider here a settlor who is UK resident but not UK domiciled and s.660G confers on such a person what I shall refer to as the "foreign domicile defence to s.660A". We must imagine that the settlor is actually entitled to the income arising under the settlement. We then ask:

(1) would the settlor be chargeable to income tax in respect of that income, and if not,

(2) would he not be so chargeable by reason of his foreign domicile?

I call this "the first counterfactual question".

10.9 Meaning of "chargeable" in s.660G(4)

Is a UK resident foreign domiciled settlor "chargeable" to income tax on unremitted foreign income? In a strict sense he is "chargeable" on that income. Section 18(1) ICTA 1988 provides:

SCHEDULE D
Tax under this Schedule shall be *charged* in respect of—
(a) the annual profits or gains arising or accruing—
(i) to any person residing in the United Kingdom from any kind of property whatever, whether situated in the United Kingdom or elsewhere...
...

Admittedly, in *computing* the measure of the charge, the remittance basis would apply, so (if no income were remitted) the *computation* of the charge would be zero. Section 65(5) provides:

> Where [the conditions for the remittance basis] applies the tax shall be *computed*—
> (a) in the case of tax *chargeable* under Case IV, on the full amount ... of the sums received in the United Kingdom in the year of assessment ...
> (b) in the case of tax *chargeable* under Case V, on the full amount of the actual sums received in the United Kingdom ...

The distinction between "charge" (the general liability to pay) and "computation" (the artificial method of ascertaining arithmetically the amount of income chargeable to tax) is drawn by Schedule D and s.65 ICTA 1988.[13]

However, in s.660G(4) it is plainly assumed that a foreign domiciled individual is not regarded as "chargeable" to tax on unremitted foreign income. (This must be so since the proviso to s.660G(4) plainly implies that a UK resident but non-domiciled person may not be "chargeable" to income tax.) So in this context a person is only "chargeable" to income tax on an amount of income if the tax is (in the words of s.65(4)) computed on that amount; that is, if the amount is remitted.[14] It is unfortunate that the statute does not use clearer or more consistent language, but there it is.

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13 The distinction is fundamental to the source ceasing principle: see 7.48 (Source ceasing principle).
It was likewise assumed by the drafter of s.37 TCGA 1992 (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 Schedule D remittance basis applies but the CGT remittance basis does not apply. (One example of that would be certain Commonwealth citizens: see 7.5.1 (Foreign domicile or other requirement). Another example would be income accruing from an asset which was UK situate for CGT purposes, but a foreign income source for income tax purposes.)

14 The proposition that "chargeable" takes its meaning from context needs no authority; for an example, see *Bibby v Prudential Assurance* [2000] STC 459. For another example, see *R v Kensington Income Tax Commissioners ex p. Aramayo* 6 TC 613 at 620:

> "My Lords, this case affords a striking illustration of the involved and almost unintelligible expression of the law contained in the Statutes relating to income tax. ... The same word is used here in one sense and there in another."
> (Lord Wrenbury)

10.10 An implication of the first counterfactual hypothesis

In imagining that the settlor is entitled to the income, one must imagine that he is entitled to the income as it arises, that is, that he has rights in the source of the income at the time it arises. This must follow from the fact that the settlor is deemed entitled to the income: he could not be entitled to the income unless he were entitled to the source of the income.

10.11 A simple example

Let us turn to the first counterfactual question and see how this works with an example. Suppose:

(1) A discretionary trust within s.660A receives foreign investment income outside the UK.

(2) A settlor is UK resident but not UK domiciled.

The answer to the first counterfactual question seems plain:

(1) The settlor would not chargeable to income tax on unremitted foreign investment income (had it been his), and

(2) the reason he is not so chargeable is his foreign domicile.

In short, income is *prima facie* outside the scope of s.660A if:

(1) the settlor is not UK domiciled (though UK resident), and

(2) the income is foreign source income received (by the trustees) outside the UK.

10.12 The 660G proviso

Section 660G(4) continues with a clause brought into the legislation in 1995. This is here called "the 660G Proviso". Again, splitting up the clause for convenience:

[1] But where such income is remitted to the United Kingdom

[2] in circumstances such that, *if the settlor were actually entitled to that income when remitted*, he would be chargeable to income tax by reason of his residence in the United Kingdom,

[3] it shall be treated for the purposes of this Chapter as *arising under the settlement* in the year in which it is remitted.[15]

(Emphasis added)

Two pre-conditions must be satisfied for the 660G Proviso to take effect:

(1) there must be "such income": i.e. income within the scope of the first sentence of s.660G(4) (foreign income of settlement with foreign domiciled settlor); and

(2) such income must be remitted to the UK.

Then comes what I shall call "the second counterfactual question". We must imagine that the settlor is actually entitled to the income arising under the settlement when remitted. We then ask:

(1) would the settlor be chargeable to income tax on the remitted income, and if so,

(2) would he be chargeable by reason of his residence in the UK?

In practice this concerns discretionary trusts within s.660A. Income of a trust where the settlor has an interest in possession is outside the scope of s.660A: see 10.4.3 (Income of life tenant settlor).

Let us try to see how this works by examples.

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15 The 660G Proviso has effect "for the year 1995–96 and subsequent years of assessment and applies to every settlement, wherever and whenever it was made or entered into": s.74 FA 1995. It is considered that the Proviso applies to income accruing before 1995–96, but remitted subsequently; though the point is arguable.

10.13 Trustees remit trust income to UK

Suppose first the simplest case. A settlor ("S") has made a discretionary trust of which he is a beneficiary. S is UK resident, but not UK domiciled. The trustees receive foreign income, so the circumstances of the first sentence of s.660G(4) are satisfied. Later the trustees remit the income to the UK (without transferring it to S).

We ask the second counterfactual question: if S were actually entitled to that income when remitted, would he be chargeable to income tax by reason of his residence?

In principle an individual is subject to tax on remitted income if the following conditions are satisfied:

(1) The individual is entitled to the source of income when the income arises. It is suggested that a counterfactual assumption to this effect is implied by the 660G Proviso. Otherwise the 660G Proviso could never operate.

(2) The individual is UK resident when the income arises and at the time of remittance.

(3) The individual is not UK domiciled when the income arises. (If the person was UK domiciled the income would be taxed on an arising basis and the 660G Proviso would not operate.) The individual is also not UK domiciled in the year of remittance.

(4) The source also exists in the year of remittance.

(5) The individual is also entitled to the source in the year of remittance. It is suggested again that a counterfactual assumption is implied by the 660G Proviso to the effect that the settlor is entitled to any source to which the trustees are entitled. Otherwise the 660G Proviso could never operate.

In short, income which is *prima facie* outside the scope of s.660A because of the foreign domicile defence falls back within s.660A if it is remitted.

So income remitted by the trustees is *prima facie* taxable.

Suppose trustees accumulate income and turn it into trust capital. The capital is then remitted. It is suggested that the remitted sum is taxable.

Its status as income or capital for trust law purposes is irrelevant; compare 7.19 (Capital/income terminology).

Suppose trustees purchase UK assets out of foreign income (land, say, or shares, or a residence, or chattels). They take care that the income is not remitted to the UK in order to pay the purchase price: the purchase price is paid abroad. There is no taxable remittance. If the settlor had dealt with his foreign income in this way, he would not be subject to tax. See 7.22 (Receipt must be of money) and 7.28 (Purchase of UK situate asset out of foreign income).

The deemed remittance rules[16] do not apply in the context of s.660A. For instance if:

(1) Trustees of a discretionary trust within s.660A borrow.

(2) The debt is UK-linked (lent in the UK or lent outside and remitted).

(3) They use income to repay the borrowing (out of the UK).

There is no charge under the Proviso. Although one applies the counterfactual assumption that the settlor is entitled to the income, one does not apply the further counterfactual assumption that the trustees' loan is made to the settlor.

10.14 Critique of s.660G Proviso

The Proviso has an appearance of symmetry with the ordinary remittance basis, but the two situations are not closely comparable. If an individual remits his own income to the UK, he is able to spend it here and there is some sense in taxing him. If trustees of a discretionary trust remit their income to the UK, the settlor is not in any way advantaged unless and until the trustees decide to transfer the income to him.

10.15 Avoiding income tax under the Proviso

Practical ways of avoiding a tax charge under the Proviso are as follows:

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16 See 7.40 (Deemed remittances).

(1) Give the settlor an interest in possession, so trust income is taxed on the normal remittance basis, not s.660A.

(2) The trustees do not remit any trust funds to the UK at all.

(3) The trustees segregate trust income and trust capital carefully and remit trust capital, not trust income. See 7.17 (Remittance basis only applies to sums derived from foreign income). There is no charge under the 660G Proviso if trustees remit to the UK a sum which is not income arising under the settlement. The question may arise as to whether a simple remittance by trustees is of income. This is decided in accordance with the principles set out in 7.20 (The tracing principle) and 7.33 (The problem of mixed funds).

(4) The trustees only remit income from sources which have ceased in the tax year before the year of remittance, or earlier. There is no tax charge if the source ceased to exist before the year of remittance. An example would be if the income is bank interest and the bank account was closed. It is suggested that the same applies if the trustees dispose of the source of income. (That could possibly be brought about by a transfer to a company or a new trust.) See 7.49 (Source ceasing tax planning).

10.16 Trustees pay income to beneficiary (not settlor)

Suppose now:

(1) Trustees of a discretionary trust within s.660A pay the income to a beneficiary (B) (not the settlor); and

(2) B receives the sum out of the UK but remits the sum to the UK.

Is there a tax charge under the 660G Proviso? One might say no, since the settlor is not entitled to the sum remitted. See 7.26 (Gift completed abroad). However, one is bound to put the question on the counterfactual basis that the settlor is entitled to the sum! So that argument fails. It is submitted that there is, nevertheless, no tax charge on the remittance; and the reason is that what is remitted to the UK is not "such income"; that is, it is not "income arising under the settlement". It loses its nature as "income arising under the settlement" upon payment to B. It would be surprising if there were a tax charge because:

(1) The settlor may have no way of knowing whether the income is remitted by B.

(2) The payment to a UK resident beneficiary will often involve a tax charge on that beneficiary (under general principles or s.740 ICTA 1988) so there would be double taxation.

10.17 Trustees accumulate income and transfer or lend to settlor

Suppose now:

(1) the trustees accumulate the income;

(2) the trustees pay it to the settlor as capital or lend it to the settlor; and

(3) the settlor receives the sum outside the UK but remits the sum to the UK.

By parity of reasoning it is arguable that there remains no charge under the 660G Proviso; but it is unlikely that the Courts will accept the argument. The better view is that the principle in *Harmel v Wright* applies. There is no "clean break". The sum received is to be regarded as "such income": see 7.38 (Funds returning to taxpayer).

10.18 Income arising to trustees when settlor is non-resident, remitted when settlor is resident

The 660G Proviso states:

> But where such income is remitted to the United Kingdom in circumstances such that, if the settlor were actually entitled to that income when remitted, he would be chargeable to income tax by reason of his residence in the United Kingdom, it shall be treated for the purposes of this Chapter as arising under the settlement *in the year in which it is remitted*.
>
> (Emphasis added)

It seems at first sight that income arising while the settlor is non-resident, remitted while the settlor is resident, is caught by s.660A as it is treated under the 660G Proviso as arising in the year of remittance. That would, however, be inconsistent with the scheme of s.660A, which is to put the settlor in the position he would be in if he had not made the settlement. Income of a non-resident person is not taxable if remitted during a resident period: see 7.16 (Income arising when non-resident, remitted when resident). It is submitted that the subsection must be construed so as to avoid that result. This applies whenever the settlor is domiciled.

10.19 Non-resident's defence to s.660A

I return to s.660G(4) ICTA 1988:

> [1] Where the settlor is not domiciled, or not resident, or not ordinarily resident, in the United Kingdom in a year of assessment,
>
> [2] references in this Chapter to *income arising under a settlement* do not include income arising under the settlement in that year
>
> [3] in respect of which the settlor, *if he were actually entitled thereto,* would not be chargeable to income tax by deduction or otherwise by reason of his not being so domiciled, resident or ordinarily resident.
>
> (Emphasis and paragraphing added)

Where the settlor is non-resident, UK source trust income is within the scope of s.660A, but foreign source income is not.

10.20 Revenue view on completion of settlor's tax return

The Revenue Trusts Settlements and Estates Manual provides:

> **4575. Settlements legislation: how settlor returns income** (February 2002)
> *Settlor is a life tenant*
> The settlor returns the trust income, after trust management expenses, according to its source. UK source income goes on the Trust page (there are a few exceptions detailed in the Notes on Trusts etc.). Foreign source income goes on the Foreign pages.

The amount of trust management expenses is chargeable on the settlor under the Part XV legislation. The settlor shows it on the SA return at 'Other income'. The grossing factor depends on the rate of tax chargeable on each source of income.

Trust is discretionary

The settlor shows the whole of the income arising to the trust on the 'Trusts etc' supplementary pages. The settlor does not deduct trust management expenses. All the income is chargeable under the Part XV legislation. That is why the settlor does not show overseas trust income on the Foreign pages.

10.21 Taxation of trustees of settlement within s.660A

10.21.1 *Rates of tax: terminology*

Discussion is made more difficult by the multitude of rates of tax. Trustees are in principle liable at the basic, lower or Schedule F ordinary rates. For current purposes it makes no difference, so I shall refer to those as the ordinary rates. If s.686 ICTA 1988 applies trustees are taxed at either the Schedule F trust rate or the "rate applicable to trusts". Again, for current purposes it makes no difference which, so I shall refer to these rates as the DT (i.e. discretionary trust) rate. This is higher than the ordinary rate.

"Income within s.660A" is income arising under a settlement if the settlement is within s.660A.

10.21.2 *The DT trust rate*

Section 686(1) ICTA applies the DT trust rate to "income to which this section applies" which takes us to s.686(2):

> This section applies to income arising to trustees in any year of assessment so far as it—
>
> (a) is income which is to be accumulated or which is payable at the discretion of the trustees or any other person (whether or not the trustees have power to accumulate it); and
>
> (b) is not, before being distributed, either—
>
> (i) the income of any person other than the trustees, or
>
> (ii) treated for any of the purposes of the Income Tax Acts as

> the income of a settlor...[17]

The effect of s.686(2)(b)(ii) is that income to which s.660A applies is not subject to the DT trust rate.

However, if the settlor is within the s.660A foreign domicile defence, or s.660A non-residence defence, the income is not "income arising under the settlement" and therefore subject to tax at the DT additional rate. This rule makes perfect sense.

Suppose:

(1) the settlor is UK resident but not domiciled in the UK;

(2) foreign income arises to the discretionary trust; and

(3) the income is remitted to the UK.

In practice this should be rare. What would the tax position be? It is suggested that if the income is remitted in the tax year of receipt, it is not within the scope of the DT trust rate. If it is remitted subsequently it is subject to the DT trust rate. I would expect the Revenue to allow a credit, notwithstanding the absence of any statutory provision to that effect.

10.21.3 *Ordinary rates: position of trustees*

Income within s.660A is treated as income of the settlor and not as the income of any other person. So at first sight the trustees should not be chargeable to tax. However, s.660D(3) provides:

> Nothing in this Chapter shall be construed as excluding a charge to tax on the trustees as persons by whom any income is received.

This links in with s.59 ICTA 1988:

> (1) ... income tax under Schedule D shall be charged on and paid by the persons receiving or entitled to the income in respect of which the tax is directed by the Income Tax Acts to be charged.

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17 A third condition excludes charitable trusts and certain pension arrangements and is not discussed here.

The Revenue are entitled to collect tax at the ordinary rates on trust income from trustees (where there is no tax credit or deduction at source).

Where UK resident trustees receive non-UK source income, and there is a non-domiciled UK resident settlor not excluded from benefit, the trustees are still liable under s.660D(3) on the arising basis, whilst the settlor is taxable effectively on a remittance basis. There is no machinery to credit the tax paid by the trustees against the settlor's liability, but I understand that it is Revenue practice to allow a credit notwithstanding the absence of any statutory provision to that effect.[18] A practical solution may be to appoint foreign domiciled trustees who will also enjoy the remittance basis.

10.21.4 *Position of non-resident trustees*

Non-resident trustees will not pay tax on foreign source income. For UK source income their position is the same as UK resident trustees as set out above.

10.22 Taxation of life tenant (not settlor) of settlement within s.660A

Suppose a settlement to which s.660A applies under which a beneficiary ("B", not the settlor) has an interest in possession. Income within s.660A is treated as the income of the settlor and not of any other person, so that B cannot be taxable on it. B is in principle taxable on income not within s.660A, that is, income within the s.660A non-resident defence or the s.660A foreign domicile defence.

10.23 Settlor's indemnity

Section 660D provides:

> **Adjustments between settlor and trustees, etc**
> (1) Where by virtue of this Chapter income tax becomes chargeable on and is paid by a settlor, he is entitled—
> (a) to recover from any trustee, or any other person to whom the income is payable by virtue or in consequence of the settlement, the amount of the tax so paid...

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18 I am grateful to David Rothenberg for this observation.

10.24 Income taxed under section 660A subsequently paid to beneficiary

Suppose:

(1) S makes a discretionary settlement, within s. 660A.

(2) S is charged under s.660A on income arising under the settlement (the exemption for foreign domiciled settlor not applying).

(3) Income is distributed to a beneficiary.

There is no further income tax charge when the trust income is paid to S or to any other beneficiary in the exercise of the trustees' powers over income. The Revenue accept this.[19] The reason is that s.660A deems the income of the trustees to be the income of the settlor "and not the income of any other person". It follows that it is impossible for the purposes of income tax to say that the beneficiary receives anything which springs from a right of action against the trustees, in respect of their income.[20]

10.25 Interaction of s.660A and s.739

Where s.739 applies as well as s.660A, it is a moot point which has priority. Section 739 originated in the FA 1936, section 660A originally in the FA 1938. But there is no reason why that distant historical priority should determine the issue. Income within s.660A is treated as income of the settlor "*and not as the income of any other person*". Section 739 lacks

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19 The Consultation Paper (Modernising the Tax System for Trusts, 10 December 2003) para 38 provides:

> "Any payment to a beneficiary out of the income of a discretionary trust is an annual payment even where the trust is settlor-interested, and so is taxed on the beneficiary. The settlor is also taxable on the trust income in that capacity. To avoid this double charge we treat payments of income out of the trust to beneficiaries, though not of course to the settlor themselves, as a gift by the settlor to the beneficiary."

The payment to the beneficiary is not of course a gift by the settlor. The payment is "treated as a gift" in the sense that, just as a gift by the settlor would not be subject to income tax, so here the payment from the trust is not subject to income tax. A similar point is made in TSEM 4570.

20 This is supported by an obiter comment in *Perry v Astor* 19 TC 255 at 282.

those additional words. So it is suggested that s.660A has priority over s.739. It will not matter much in practice, except in relation to the settlor's indemnity. The settlor/transferor cannot be taxed twice on the same income.

CHAPTER ELEVEN

TRANSFER OF ASSETS ABROAD: INTRODUCTION

11.1 Introduction

The territorial limitation of income tax presents an obvious means of income tax avoidance. The Revenue's first answer to this is Chapter III Part XVII ICTA 1988, entitled "Transfer of assets abroad". There are two charging provisions: ss.739 and 740. This chapter considers the requirements they have in common. The next two chapters consider them individually.

11.2 The transfer of asset conditions

11.2.1 *Transfer of asset conditions in s.740*

Section 740(1) comes into effect if two sets of conditions are satisfied. The first, which is the subject of this chapter, is this:

> (a) [1] *by virtue or in consequence* of a *transfer of assets,* either alone or in conjunction with associated operations,
>
> [2] *income becomes payable* to a person resident or domiciled outside the United Kingdom ...
>
> (Emphasis and paragraphing added)

This sets out three basic conditions:

(1) *A transfer of assets*: limb [1]

(2) *Person abroad receives income:* Income becomes payable to a non-resident or non-domiciled person: limb [2]. I refer to the non-resident or non-domiciled person as a "person abroad"; this is the usage of s.743(5), which can be traced back to the side note to s.18 FA 1936.

(3) *Causation*: Condition (2) is caused by:

(a) the transfer alone; or

(b) the transfer in conjunction with associated operations.

See limb [1].

These three basic conditions are here called the "transfer of asset conditions". They are the subject of this chapter. It must be stressed that the fact that the three transfer of asset conditions are satisfied does not in itself cause a tax charge. The further conditions of s.739 or s.740 must be satisfied. These are the subjects of the next two chapters.

11.2.2 *Transfer of asset conditions in s.739*

Section 739(1) uses more challenging language and must be split up into its separate limbs in order to distil the sense:

> [a] ... the following provisions of this section shall have effect
>
> [b] for the purpose of preventing the avoiding by individuals ordinarily resident in the United Kingdom of liability to income tax
>
> [c] by means of *transfer of assets*
>
> [d] *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 United Kingdom.*
>
> (Paragraphing and emphasis added)

It is easy to see here the same three basic conditions that have just been identified in s.740:

(1) a transfer of assets – limb [c]

(2) person abroad receives income – limb [d]

(3) causation – limb [d]

Indeed, it is plainly from these words that the drafter of s.740 has drawn his text.[1]

Thus the three "transfer of asset conditions" are the common requirements of ss.739 and 740.

11.3 A "transfer" of "assets"

Section 742(9) (b) provides:

> For the purposes of sections 739 to 741—
> ...
> (b) "assets" includes property or rights of any kind and "transfer", in relation to rights, includes the creation of those rights;

Rights under a contract of employment are an "asset". Entering into a contract of employment is a "transfer" of assets:. Thus an arrangement under which an individual enters into a contract with a non-resident person satisfies the transfer of assets condition. See *IRC v Brackett* 60 TC 134.

Note that there may be a "transfer of assets" in circumstances where there is no individual who is the "transferor".

11.4 Income becomes payable to person abroad

The condition here is that income becomes payable to a non-resident or non-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 domiciled: *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.

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1 A further element in s.739(1), omitted in s.740, is limb [b], the reference to "avoiding by individuals ordinarily resident in the UK of liability to income tax". So this is discussed in the next chapter.

In *Latilla v IRC* 25 TC 107 a partnership share was transferred to a company abroad which received its share of the partnership profits. It was argued that trading profits could not be described as income *payable* to the company. The House of Lords refused to accept this distinction and held that the section applied to trading profits as well as investment income. It seems amazing today that this technicality was thought arguable, so far has the pendulum swung from literal to purposive construction.

11.4.1 *Foreign incorporated company*

Section 742(8) provides:

> For the purposes of sections 739 to 741, any body corporate incorporated outside the United Kingdom shall be treated as if it were resident outside the United Kingdom whether it is so resident or not.

This is otiose because even in the absence of this provision a foreign incorporated company would be "domiciled" outside the UK[2] and so regarded as a person abroad. This rule made sense before the introduction of corporation tax in 1965; until then, foreign incorporated companies were taxed on the remittance basis. Now it is unnecessary because a UK resident company pays tax on all its profits on an arising basis.

One situation in which this arises is where a foreign incorporated company is accidentally UK resident, because of a failure to ensure that it is managed and controlled outside the UK. Another situation is where one deliberately uses a UK resident but foreign incorporated company. This may be done in order to obtain the CGT or IHT advantages of foreign situate property; see 17.12.2 (CGT planning for UK situate shares). On the Revenue practice here, see 14.1 (Double taxation on transfer to foreign incorporated UK resident company).

11.5 Transfer from one person abroad to another

Suppose assets are transferred from one person abroad to another, e.g. from offshore trustees to an offshore company. Can one argue that the transfer of asset conditions are not satisfied because one cannot say that income *becomes* payable to a person abroad? It was payable to a person

2 See 2.15 (Domicile of company).

abroad even before the transfer! The argument is linguistically possible, but the context shows that it is wrong. If the argument was right then the transfer of asset conditions would never apply to a transfer by a non-resident or foreign domiciled transferor, which is certainly not the case.

11.6 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.

11.7 Transfer for full consideration

The transfer of asset provisions (unlike the settlement provisions)[3] can apply when there is a transfer for full consideration and no "bounty".

11.7.1 *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. This may well be full consideration. It is nevertheless an archetypal s.739 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.

11.7.2 *Transfer for cash or assets (not issue of shares or debentures)*

Suppose T sells an asset to a person abroad for a purchase price. At first glance, the transfer of asset conditions are satisfied. However, it is tentatively suggested that this is not the case if the purchase price given to T:

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3 See 10.3 ("A settlement").

(1) represents full consideration to T; and

(2) represents an asset which would otherwise have yielded income to the person abroad.[4]

In these circumstances, the person abroad acquires the income of the asset T transfers to him, but he loses the income from the purchase price which he pays to T. If the two (broadly) cancel each other out, it cannot be said that "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 a non-resident person. That would be a sensible result. If T sells assets to an offshore trust, say, or to an offshore company, it would be surprising if his only defence to an assessment under s.739 was to claim the motive defence.[5]

John Avery Jones said in [1998] BTR 392:

> I was hoping that filling in this year's tax return was going to be easier but I am having difficulty in answering part of question 6 on page 2:
>
> > Have you at any time made, or been associated with, a transfer of assets which has resulted in income becoming payable to a foreign entity ... ?
>
> My first thought was no, I have not made any foreign trusts, etc., ... But then I thought: what about
>
> [1] buying a ticket from a foreign airline, buying a meal or paying for a hotel room when abroad? There is a transfer of assets and it is clear that "income becoming payable" includes the receipt of sums which form part of the recipient's trading profits. Oh, and there is my IFA subscription, my subscription to *European Taxation*, my purchase of that overpriced new edition of *OECD Model Tax Convention*, and the new edition of *Klaus Vogel on Double Taxation Conventions* direct from the publisher. Foreign entities all of them. I expect if I think for a moment I shall think of lots more. What about my

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4 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.

5 In such cases T would often have "power to enjoy". Unless this is right, there is double taxation. T may be liable under s.739 for income tax on the income arising from the asset sold to the person abroad. T is also liable to income on income arising from the proceeds which he receives on the sale of the same asset.
If my tentative view is wrong, then the motive defence should be generously applied in cases of a sale for full consideration.

(foreign) car? Did I buy it from an agent for the manufacturer or from a United Kingdom subsidiary, and does it make any difference anyway?

[2] And then there is my life insurance policy with an Australian company? Did I take up a rights issue with a foreign company?

That was just last year; the question asks whether I have made such transfers *at any time* during my life. ... So it seems that the answer must be yes, as it may surely be for nearly all taxpayers. ...

It occurred to me to wonder whether Parliament had really authorised the asking of such a *[word deleted – ed.]* question. ...

(Paragraphing added)

If I am right, John Avery Jones should have replied "no" in relation to almost all the purchases in [1].[6] Only his payment of the premium to the foreign life insurance company, and the rights issue with the foreign company, would require a yes answer. If this is right, it would not be the case that "nearly all taxpayers" would have to answer "yes".[7]

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6 Strictly, this assumes (perhaps optimistically) that if John Avery Jones had not purchased the goods or services, someone else would have done so. Of course in practice considerations of materiality might also justify a 'no' answer.

7 Contrast the comment of Sir John Foster in a Parliamentary debate on the FA 1969:

> "I know one case where a person was asked this question with regard to foreign settlements, "Have you ever made a transfer of assets to any partnership or individual abroad?" The person who was asked this question happened to have been abroad, so he has begun by describing how, when he was five or six, he used to buy an ice from a partnership. It was a transfer of assets from himself to the person who sold him the ice. He has now got as far as the age of 10 and as he is in his seventies and has lived abroad for several years, travelling a great deal, he has a good way ahead of him to answer all these questions.
>
> I use that example to counter the right hon. Gentleman if he says that the Revenue is always sensible. It cannot be sensible to ask somebody if he has ever made any transactions of that kind. That is the danger of Section [739], because people with enthusiasm who suspect that something has gone wrong can abuse the position."

Hansard 17 July 1969, vol 787, col 950. Sir John Foster QC (1904–1982) was Conservative MP 1945–1974 so when he made this fine speech (worth reading in full) he was in opposition. The Government did not answer the point made, for the good reason that there is no answer. But the question Sir John was considering was a different (and much wider) question from that posed by the transfer of asset conditions and in John Avery Jones' tax return.

11.8 "By virtue or in consequence": causation

The transfer of asset conditions are not satisfied merely because there has been a transfer of assets and income has become payable to a person abroad: the income must become so payable:

> by virtue or in consequence of [the transfer] either alone or in conjunction with associated operations.

The test is one of causation. The phrase "by virtue or in consequence of" is a composite phrase with a single meaning. There are not two distinct tests or concepts ("by virtue of" or "in consequence of"). The two have the same meaning (like the popular "null and void"). "By means of" in s.739(1) has the same meaning.[8] In this book I shall for brevity abbreviate "by virtue or in consequence of" to "in consequence of".

11.8.1 *Purchase of secondhand company*

Suppose T uses his assets to buy the shares of an already existing non-resident company from a UK resident and domiciled person. Undoubtedly the sale is a transfer of assets and income accrues to a person abroad (the company). However, it cannot be said that the income became payable to the company in consequence of the 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 own shares. The transfer of asset conditions are not satisfied. If the vendor of the shares is a person abroad, then of course the transfer of asset conditions may be satisfied, as the vendor would invest the proceeds of sale and receive income in consequence of the sale. However, the income arising in consequence of the sale would be the income accruing to the vendor, not the company's income.

11.9 Associated operations: definition

Section 742(1) provides the widest definition the drafter could devise:

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8 *Congreve v IRC* 30 TC at 204.

> For the purposes of sections 739 to 741 "an associated operation" means, in relation to any transfer, an operation of any kind effected by any person in relation to
> [1] any of the assets transferred or
> [2] any assets representing,[9] whether directly or indirectly, any of the assets transferred, or
> [3] to the income arising from any such assets, or
> [4] to any assets representing, whether directly or indirectly, the accumulations of income arising from any such assets.
>
> (Paragraphing added)

An associated operation does not exist in isolation, it exists in relation to another transfer. There are two requirements:

(1) It must be an "operation".

(2) It must be "effected in relation to" items [1] to [4]; I describe this as being "associated" with a transfer.

The term "associated operations" is also used in the IHTA 1984, but there are significant differences in the definition. Accordingly, only limited assistance can be drawn from IHT cases.

11.9.1 *"Operation"*

"Operation" is not defined. It includes a company becoming non-resident[10] and an individual making a will (but not death).[11] It is slightly

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9 "Representing" is itself defined in s.742(9)(e):

> "references to assets representing any assets, income or accumulations of income include references to shares in or obligations of any company to which, or obligations of any other person to whom, those assets, that income or those 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 a trust, the two transfers are "associated operations". This would not have been clear without the definition.

10 *Congreve v IRC* 30 TC 163.

11 *Bambridge v IRC* 36 TC 313. This case contains Harman J's aphorism: "Death, as we know, is an awfully big adventure, but even the Crown admits that it is not an associated operation."

wider than "disposition".

11.9.2 *"Associated"*

An operation may be associated with a transfer even if the two were not part of any plan and many years apart. Suppose:

(1) A transfers an asset to B (who is UK resident) in 1970; and

(2) B transfers the asset in the year 2000 to an offshore trust under which A may benefit.

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 transfer which satisfies the three transfer of asset conditions;

(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 carrying out 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 *Fynn v IRC* 37 TC 627:

(1) in 1948 T transferred assets to an Irish company;

(2) in 1952 T lent money to the company.

The loan was not an associated operation in relation to the earlier transfer, because it was not effected "in relation to" the assets transferred.

RI 201 provides:

> The wording of s742(1) 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.

While this seems correct, I cannot think of a practical case where it would apply.

11.10 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 many places in the transfer of asset provisions:

(1) Transfer of asset conditions
739(1) and 740(1)(a): Income becomes payable to person abroad in consequence of transfer and associated operations.[12]

(2) Section 739
- (a) 739(2): Individual has 'power to enjoy' in consequence of transfer and associated operations; 742(2)(c): Power to enjoy.
- (b) 739(3): Individual receives capital sum connected with transfer and associated operations.

(3) Section 740
- (a) 740(1)(b): Individual receives a benefit in consequence of the transfer or associated operations.
- (b) 740(3): "Relevant income" is income arising to person abroad and which in consequence of the transfer of assets or associated operations referred to in 740(1) can be used for providing a benefit.

(4) Section 741 Motive Defence
Test (a) and test (b) must apply to the transfer and any associated

12 See 11.11 (Person abroad receives income indirectly).

operations.

11.11 Person abroad receives income indirectly

In the words of s.740(1)(a):

> [1] by virtue or in consequence of a transfer of assets, either alone *or in conjunction with associated operations*,
> [2] income becomes payable to a person resident or domiciled outside the United Kingdom ...
>
> (Paragraphing and emphasis added)

11.11.1 *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 UK resident) ("A's transfer"); and

(2) in 2000 B transfers the asset to an offshore trust ("B's trust") under which A may benefit ("B's transfer").

(3) A's transfer and B's transfer are not part of a single arrangement and A is unaware of B's transfer.

B's transfer obviously satisfies the transfer of asset conditions. The question is whether A's transfer does likewise.

A's transfer alone does not satisfy all three transfer of asset conditions. There is a transfer of assets, and (from 2000) income becomes payable to a person abroad. But the causation condition is not satisfied, that is, it is not in consequence of A's transfer alone that income has become payable to the offshore trustees. However, B's transfer is an "associated operation" in relation to A's transfer. Is it the case that income becomes payable to the trustees in consequence of A's transfer, in conjunction with the associated operation (B's transfer)?

It is certainly not the intention, and surely cannot be the case, that A is a transferor and within s.739, and taxable on the income of B's trust. The motive defence is not a satisfactory solution to this problem:[13] one must conclude that A's transfer does not satisfy the transfer of asset conditions. How do we reach this result?

One might possibly reach this result by understanding the reference to "associated operations" to mean only those forming part of a single arrangement.[14] 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.[15] B's transfer as an independent act will "break the

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13 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 15.37 (Associated operations and the motive defence).

14 Contrast the approach to "disposition by associated operations" in *IRC v Brandenburg* [1982] STC 555, where Special Commissioners added a gloss that the associated operations (for the purposes of s.272 IHTA 1984) must be those "put in train" by one person: see "Gifts by Associated Operations", Robert Venables QC, PTPR, Vol. 5, page 11.

15 The seminal work on this topic is Hart and Honoré, *Causation and the Law*, 2nd ed., 1985, p.42. See too the lecture "Common Sense and Causing Loss" which Lord Hoffmann delivered to the Chancery Bar Association in Lincoln's Inn on 15 June 1999:-

> "The argument over causation is almost always an argument over the law. It is an argument over the true scope of the rule which imposes liability. In particular, there are two kinds of questions about the rule which have to be answered before you can properly formulate the question of fact about causation. The first is to identify the grounds upon which the rule imposes liability. The second is to identify the kind of loss for which it provides compensation. Once these questions have been answered, the question of causation does indeed become a question of fact and usually a pretty obvious one at that."

Lord Hoffmann considered the hypothetical case of a doctor who gave wrong advice about a bad knee to a mountaineer who then suffered a climbing injury which had nothing to do with the knee. If proper advice had been given, he would have decided not to climb:

> "The doctor did not cause the mountaineer's injury. That is perfectly true. We would say that for the purposes of the law of negligence, the doctor did

chain of causation". That is, the reference to words of causation requires one to identify the effective or real or operative cause of the fact that income accrues to a person abroad (in this case, B's transfer).

11.11.2 *Transfer from A to UK trust followed by appointment of offshore trustees*

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 satisfies all three transfer of asset conditions. (The appointment of foreign trustees is accompanied by a transfer to the new trustees, in consequence of which income accrues to the non-resident trustees.) The question is whether A's transfer does likewise.

> not cause the mountaineer's injury. But why not? It would not have happened if the doctor had not given bad advice. The reason why we say that he did not cause the mountaineer's injury is because of the view which we have formed about the scope of the duty. It is only because we do not think that the doctor should be liable for the consequences of his having gone up the mountain, even though he would not otherwise have gone, but only for the consequences of his having gone with a bad knee, that we can say that the doctor did not cause his injury. But assume that liability is under some other rule, such as fraud. The doctor, for his own purposes, because he wants the mountaineer to go on the expedition so that he can have an assignation with his wife, fraudulently assures him that his knee is fit. Why should the doctor not be responsible, as in other fraud cases, for all the consequences of the victim doing whatever he was fraudulently induced to do? In such a case, therefore, we might well say that the fraud did cause his injury even though it had nothing to do with his knee. The answer to the question of what caused what depends, not on common sense, but upon law; on a careful assessment of the reach of the substantive rule on which liability is based."

Lord Hoffmann took the opportunity to express these views judicially in *Fairchild v Glenhaven* [2003] 1 AC 32.

A's transfer alone does not satisfy all three transfer of asset conditions. There is a transfer of assets, and (from 2000) income becomes payable to a person abroad. But the causation condition is not satisfied, that is, it is not in consequence 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. It is suggested that the transfer in conjunction with the associated operation do together satisfy the causation condition. That is, it *is* in consequence of the transfer and associated operation that the income accrues to the foreign trustees. This is so even if the appointment was not envisaged at the time of the transfer to the original settlement. The position in 11.11.1 (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.[16]

11.11.3 *Transfer from A to trust followed by transfer from trustees to offshore company*

This is exactly the same as 11.11.2 (Transfer from A to UK trust followed by appointment of offshore trustees).

11.12 Income of person abroad

The concept of income of the person abroad is relevant for several purposes of the transfer of asset provisions:

(1) The transfer of asset condition is only satisfied if "income becomes payable" to a person abroad. If *no* such income becomes payable then one of the essential transfer of assets conditions is not satisfied and neither s.739 nor s.740 can come into effect.

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16 This view is also supported by obiter dicta in *Congreve v IRC* 30 TC at 205. This concerned a gift to a UK company which became non-resident. This satisfied the transfer of asset conditions without the association operations rule. But if it had not done so, the House of Lords would have held that the company becoming non-resident was an associated operation; and (by inference) income arose to the company in consequence of the transfer and associated operation. The Revenue would have a further argument, if necessary, based on *Muir v Muir* [1943] AC 468.

(2) The *identity* of the income which becomes payable to the person abroad in consequence of the transfer is relevant:

(a) for s.739, as one must ask whether the transferor has power to enjoy that income;

(b) for s.740, as one must ask whether that income can be used to benefit an individual.

(3) The *amount* of income which becomes payable to the person abroad in consequence of the transfer is relevant:

(a) for s.739, as that is in principle the amount on which tax is charged under s.739;

(b) for s.740, as ascertaining that amount is the first step in computing relevant income.

11.13 The amount of income of person abroad

The next task is to measure the amount of the income arising to the person abroad in consequence of the transfer and associated operations.

11.13.1 *Schedule F income: net or gross?*

In order to follow the discussion one needs to bear in mind the usual rules for taxing a UK dividend or other Schedule F distribution.

Section 20(1) ICTA 1988 provides for grossing up a UK dividend (or other Schedule F distribution) by the amount of the tax credit:

> any [schedule F] distribution in respect of which a person is entitled to a tax credit shall be treated as representing income equal to the aggregate of the amount or value of that distribution and the amount of that credit...

A non-resident does not usually qualify for a tax credit. This allowed one taxpayer to argue that the measure of income for s.739(2) is the net dividend only:

> 100. [The Revenue] contended that the income which the section deems to be income of the taxpayer is the dividends. Section 743(2) provides that:
>
> > 'In computing the liability to income tax of an individual chargeable by virtue of section 739, the same deductions and reliefs shall be allowed as would have been allowed if the income deemed to be his by virtue of that section had actually been received by him.'
>
> It follows that the position is the same as if the taxpayer had actually received those dividends. They would be grossed-up by the amount of the tax credit and he would be entitled to the benefit of the tax credit. The position is just as if International Holdings [the person abroad] had never existed.
>
> 101. [The taxpayer] contended that the income which was deemed to be the taxpayer's was the net income of the company from all sources after deduction of any reliefs which would have been available to an individual in a comparable position. The income lost its original characteristics and became charged under Case VI of Sch D. ...The effect of this approach is that because [the person abroad who received the dividend] is not entitled to the tax credit, the income is not grossed up but is not charged to income tax at the lower rate.
>
> 102. It is not necessary for me to decide this point but I find [the Revenue's] approach more attractive particularly as it precisely gives effect to counteracting the advantage of the transfer.

Carvill v IRC [2000] STC (SCD) 143. This is certainly right.

For s.740 purposes, the amount of a dividend is the net amount without the tax credit.

11.13.2 *Deductions of investment and collection 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 section 739 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.739 purposes.

The Revenue 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.

11.13.3 *Trading income and trading losses*

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.74 or s.577 ICTA 1988 would not apply, and depreciation would in principle be allowed; or

(2) by normal tax principles applicable to calculating profits under Schedule D Case I.

The approach of *Chetwode* suggests that the second is the correct view. For losses, RI 201 provides:

> The Revenue's practice is only to allow trading losses to be carried forward and set against future trading profits. They cannot be offset against investment income of the same, previous or future years.

This is consistent with the position for rental income.

11.13.4 *Rental income*

The rules for measuring rental income are the same as for s.660A ICTA 1988; see 10.4.4 (Rental income). Transfer pricing may also be an issue here: see *Taxation of Non-UK Companies and their Shareholders*, Stephen Brandon QC, Key Haven Publications, 2002, para.4.2.6.

CHAPTER TWELVE

TRANSFER OF ASSETS ABROAD: SECTION 739

12.1 The statute

Section 739 must be split up into its separate limbs in order to distil any sense from it and subsections (1) and (2) must be read together:

(1) [a] ... the following provisions of this section shall have effect

[b] for the purpose of preventing the avoiding by individuals ordinarily resident in the United Kingdom of liability to income tax

[c] by means of transfer of assets

[d] 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 United Kingdom.

This has been discussed in the last chapter as the source of the transfer of asset conditions. The section continues:

(2) Where

[a] by virtue or in consequence of any *such transfer*, either alone or in conjunction with associated operations,

[b] *such an individual* has, within the meaning of this section, power to enjoy, whether forthwith or in the future, any income of a person resident or domiciled outside the United

Kingdom

[c] which, if it were income of that individual received by him in the United Kingdom, would be chargeable to income tax by deduction or otherwise,

[d] *that income* shall, whether it would or would not have been chargeable to income tax apart from the provisions of this section, be deemed to be income of that individual for all purposes of the Income Tax Acts.

(Paragraphing and emphasis added)

12.2 "Such transfer": which transfer?

The first condition is s.739(2)[a]. It requires that "such transfer" must have been made. In the context the word "such" refers back to s.739(1)[c] and [d]. It means a transfer which satisfies the three transfer of asset conditions, discussed in the last chapter. In what follows I shall assume that "such transfer" has been made.

12.3 "Such an individual": which individual?

The next condition is s.739(2)[b]. It requires that "such an individual" exists. The reference to "such an individual" refers back to s.739(1)[b]. There are different views possible of how much of s.739 is incorporated into the requirement that the individual to be taxed under s.739(2) must be "such an individual". The wise words of Garner are worth quoting here:

> *Such* is a deictic (pointing) term that must refer to a clear antecedent.[1]

The drafter's failure to observe Garner's point – obvious though it may seem – has given rise to a good deal of litigation. What, then, is the reference implied by the expression "such an individual"?

On any view, it refers only to an individual ordinarily resident in the UK. Further, it is now settled that the section applies:

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1 *A Dictionary of Modern Legal Usage*, 2nd edition, entry under "Such".

> only where the person sought to be charged made or, maybe, was associated with, the transfer.

"Such an individual" refers to this specific individual: "the transferor"; see *Vestey v IRC* 54 TC 503 at 587. So s.739 only imposes a charge on person who is

(i) an individual; and

(ii) ordinarily resident in the UK; and

(iii) who is a transferor.

12.4 Who is the transferor?

The problem which then arises is to identify the transferor (if there is one) in relation to any transfer. The problem hardly arose before *Vestey*, and there is little authority to guide us.

12.4.1 *Transfers by individuals*

In a simple case where one individual transfers one asset to a person abroad, no problem arises. If A and B own an asset as tenants in common, and together transfer their interest to a person abroad, each is transferor of his share. If A and B own an asset jointly the same applies: one can separate out their interest as being equal. RI 201 provides:

> Where the same assets are transferred by several individuals, the Revenue's practice is to assess the transferors in proportion to their share of the assets transferred. Thus, where, for example, shares of a UK company are held by three shareholders in the proportion 40%, 40% and 20% and there is s.739 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.

12.4.2 *Transfers by companies*

IRC v Pratt 57 TC 1 decided that a person who did not make the transfer may be within s.739 if he "procured" the transfer. Such a person may be called a "quasi transferor". An easy example is if T owns all the shares in the company and he procures the company to make the transfer.

> 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 [739] 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.[2]

Although Walton J expresses himself tentatively, that is thought to be the law. The position would be different if shareholders had different classes of shares with different interests. In that case it may not be possible to separate out their interests and the shareholders would not be transferors.

The facts of *Pratt* were that the taxpayers (i) were three directors out of eight; and (ii) held 30% of the company. They had no control at director or shareholder level. They could not "procure" the transfer of assets made by the company, and so they were not even "quasi transferors" in relation to it. So they were outside the scope of s.739. Of course a person who is not a transferor (such as the successful appellants in *Pratt*) might fall within s.740 if he received benefits.

The Revenue say in RI 201:

> Section 739 can potentially apply not only to an individual who transfers assets but to someone who is "associated with" a transaction (according to the decision of the Courts in *Vestey v IRC*). The Revenue regard this as including anyone who procured the transfer of assets.

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2 *IRC v Pratt* 57 TC at p.50.

The first sentence correctly quotes *Vestey* but omits the "maybe"! The second sentence is correct but in practice this probably arises only in the context of transfers by companies.

Note the potential for double taxation in quasi transferor cases.

12.5 Must the transferor have avoided income tax?

In *McGuckian v IRC* 69 TC 1 it was argued from s.739(1)[b] that s.739 only applied if (in the absence of the section) income tax would be avoided. The argument was politely but firmly rejected: see pp.77E, 82.

12.6 Must the transferor have had the purpose of avoiding income tax?

The reference to "such an individual" in s.739(2)[b] might further refer only to an individual who has had the purpose of avoiding income tax by means of a transfer of assets. Before the FA 1997 it was therefore arguably a requirement of s.739 that the purpose, or one of the purposes, of the transfer (or of the transferor) had to be the purpose of avoiding income tax. This point was never decided.[3] But now s.739(1A) provides:

> Nothing in subsection (1) above shall be taken to imply that the provisions of [s.739] apply only if—
>
> ...
>
> (b) the avoiding of liability to income tax is the purpose, or one of the purposes, for which the transfer was effected.

This applies to income arising on or after 26th November 1996. The date of the transfer or associated operation is irrelevant. This does not affect the operation of the motive defence, discussed at 15.1 (Motive defence).

12.7 Transferor not ordinarily resident

Section 739 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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3 The arguments are set out in *Botnar v IRC* [1998] STC 38 at p.63ff.

12.7.1 *Transferor not ordinarily resident when income accrues*

Section 739 does not apply to income which accrues while the transferor is not ordinarily resident in the UK. This was assumed in *Herdman v IRC* 45 TC 39. A non-resident individual can transfer UK land to an offshore company in order to avoid higher rate income tax. (It is not usually necessary for an individual to transfer other assets to a company in order to avoid higher rate tax since s.128 FA 1995 provides relief.)

A person who is UK resident but not ordinarily resident may wish to transfer land and other UK sources of income to a company to avoid higher rate income tax. He may also wish to transfer foreign sources of income to a company in order to avoid tax on the remittance basis. The pre-1936 planning of a sale to an offshore company in return for debentures may be suitable.

12.7.2 *Transferor not ordinarily resident when transfer made*

The intention of those who were responsible for the legislation was that s.739 should only apply if the transferor was ordinarily resident in the UK at the time of the transfer.[4] The court reached the opposite conclusion in *Herdman v IRC* 45 TC 394, but this was reversed in *Willoughby v IRC* 70 TC 57.

The position now is now governed by s.739(1A):

> Nothing in subsection (1) above shall be taken to imply that the provisions of [s.739] apply only if—
>
> (a) the individual in question was ordinarily resident in the United Kingdom at the time when the transfer was made.

Thus non-residence at the time of the transfer is not a defence: s.739 may apply to any person after he becomes ordinarily resident, regardless of residence at the time of the transfer. This applies to income arising from 26 November 1996.

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4 "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*.

12.8 Power to enjoy

Once one has identified the transferor one asks whether he has "power to enjoy" any income of the person abroad; see s.739(2)[b]. "Power to enjoy" is elaborately defined and has given rise to a large case law. But in practice there is not often an issue here. In short, the transferor has "power to enjoy" if he may possibly enjoy any of the income of the person abroad, or if he is able to control the application of the income to others. A transferor has no power to enjoy if he and his spouse are excluded from all benefit and have no power of control. A widow of the settlor may be included as a beneficiary.

The test is slightly wider than that of s.660A ICTA 1988,[5] though for most practical purposes they are the same. It is hard to see the reason for the distinction, but there it is.

On a transfer from a UK domiciled person to his foreign domiciled spouse, see 30.14 (Income tax planning for mixed marriages).

There are five heads of "power to enjoy".

12.8.1 *Head (a): income in fact dealt with to benefit T*

> The income is in fact so dealt with by any person as to be calculated, at some point of time, and whether in the form of income or not, to enure for the benefit of the individual
> (S.742(2)(a))

The nuance of this rather unlawyer like language was discussed by the Special Commissioners in *Botnar v IRC*:

> 222. Section 742(2)(a) is concerned with how particular income is dealt with when it arises. Mr. Park 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

5 See 10.5 (Property in which the settlor has no interest).

> "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 be so enure and that it would be seen objectively as likely to so enure.

12.8.2 *Head (b): income increases value of T's asset*

> The receipt or accrual of the income operates to increase the value to the individual of any assets held by him or for his benefit
> (S.742(2)(b))

First one must identify assets held by T or "for his benefit". Having identified the assets, one asks whether the receipt or accrual of the income operates to increase the value of those assets.

The concept of assets held by T is straightforward but what about assets held "for his benefit"? In *Howard de Walden v IRC* 25 TC 121 a promissory note held by trustees on trust for T for life was considered to be held "for his benefit". One could have reached the same result by a different route since T's life interest in the note was itself an "asset". If the asset is held on a discretionary trust under which T is merely a beneficiary, it is probably not held "for his benefit". What if the asset is held on interest in possession trusts for T subject to an overriding power of appointment?

The second condition is that the receipt or accrual of income must increase the value of the asset. This also arose in *Howard de Walden v IRC*. Here T transferred assets to offshore companies and held (1) a life interest in promissory notes issued by the companies and (2) the benefit of debt due from the companies (T had lent money to the companies).[6] 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...

6 In some but not all cases T also held a few shares in the companies. The Court of Appeal ignored this because if it had held that T was caught only by virtue of these shares, T would not have been assessable on the income of all the companies.

But it is a question of fact in each case.[7] If a debt is sufficiently covered by existing assets of a company, the receipt of further income by the company does not increase the value of the debt.

It would be different if T held shares in the company. The receipt of income by the company would in principle increase the value of the shares.

12.8.3 *Head (c): individual receives benefit*

> The individual receives or is entitled to receive, at any time, any benefit provided or to be provided out of that income or out of moneys which are or will be available for the purpose by reason of the effect or successive effects of the associated operations on that income and on any assets which directly or indirectly represent that income.
> (S.742(2)(c))

This again arose in *Howard de Walden*. The Court of Appeal said:

> ... the payments made and to be made in respect of the notes and deposits are "benefits" within the meaning of (c) since "benefit" as defined by ... includes a payment of any kind.

There are two issues here. Firstly, is the repayment of the debt to T (or repayment of the promissory note) a "benefit" in the general sense? The Court of Appeal rightly thought it was not, since they relied on the definition clause. Secondly, does the definition clause extend the meaning of benefit to include a payment that is not a benefit in the normal sense? The Court of Appeal held that it did, but this was before s.743(5):

> In any case where an individual has for the purposes of that section [739] power to enjoy income of a person abroad by reason of his receiving any such benefit as is referred to in section 742(2)(c), then ... the individual shall be chargeable to income tax by virtue of section 739 for the year of assessment in which the benefit is received on the whole of the amount or value of that benefit except in so far as it is shown that the benefit derives directly or indirectly from income on which he has already been charged to tax for that or a previous year of assessment.

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7 *IRC v Brackett* is another example.

This was introduced in the FA 1969 and upsets the reasoning of *de Walden* on head (c). Since the charge is now on the value of the benefit, and the value of a payment for full consideration (such as the repayment of a debt) is nil, s.739 does not now operate here.

In *Botnar* the Special Commissioners said:

> 245. ... Where the power to enjoy arises the tax is charged not on the income which the taxpayer has power to enjoy but on the value of the benefit. This may bear no relationship whatsoever to the income of the non-resident as long as it originated from it even indirectly. We do not accept that s 743(5) only operates where the benefit received in a year exceeds the relevant income. It seems to us that the words "notwithstanding anything in subs (1) above" would have been better placed later in the subsection perhaps after "the amount or value of that benefit".

12.8.4 *Head (d): possibility of benefit*

> The individual may, in the event of the exercise or successive exercise of one or more powers, by whomsoever exercisable and whether with or without the consent of any other person, become entitled to the beneficial enjoyment of the income.
> (s.742(2)(d))

This would apply to a discretionary trust where T was a beneficiary (or could be added to the class of beneficiaries).

12.8.5 *Head (e): control*

> The individual is able in any manner whatsoever, and whether directly or indirectly, to control the application of the income.
> (s.742(2)(e))

Control means non-fiduciary control and so does not include the powers of control of a trustee or a protector with fiduciary powers. *IRC v Schroder* 57 TC 94, at 121 and 125:

> It is one thing to say that a settlor is in a position to influence or even in the absence of any other considerations which ought properly to be

> taken into account by the trustees he is in a position to exercise a decisive influence on the exercise by the trustees of their fiduciary powers: it is quite another to say that he is in a position to control the exercise of those powers...
> The question is whether he was able to control the application of the income, and to answer that question affirmatively it must in my judgment be possible to say at least that he was in a position to ensure that the trustees would act in accordance with his wishes without themselves giving any independent consideration and accordingly to act in disregard of their fiduciary duty.

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 s 478(5)(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* (1941) 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 Mr. Munby, 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 Mr. Munby's submission that Mr. Botnar wished to ensure that the shares in DUK later NUK would remain in friendly hands. In a sense it could be said that he did in fact control the settlement and the Companies because in fact Dr. Lenz did comply with his wishes: there was no evidence of any action by Dr. Lenz which was

> contrary to Mr. Botnar's wishes. That is not however the same as Mr. Botnar having the ability, even indirectly, to ensure that the income would be applied in accordance with his wishes.

In practice it is unlikely that there will be a case where head (e) applies and none of the other four heads would apply, though *Lee* (non-fiduciary power to appoint and dismiss directors) offers a theoretical example. If T transferred assets to a company under which his only interest was management shares conferring votes but no dividends or capital, he would fall within head (e) (but the shares would also probably be within head (b) – as company income would tend to increase the value of the shares (voting shares would have some value).

12.9 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. The individual must have the power to enjoy in consequence of the transfer, either alone or in conjunction with associated operations.

Suppose:

(1) Year 1: A transfers an asset to a non-resident company wholly owned by B, who is not UK resident ("A's transfer").

(2) Year 2: B transfers the company to an offshore trust under which A may benefit ("B's transfer").

A's transfer satisfies the transfer of asset conditions. However, in year 1 A is not within s.739 since he does not have "power to enjoy" the income of the company.

From year 2 onwards, A does have "power to enjoy". He does not have that power in consequence of his transfer alone. However, A's transfer and B's transfer are associated operations: see 11.9 (Associated operations). So the question is whether A has power to enjoy in consequence of A's transfer and the associated operation. This raises questions of causation similar to those discussed in paragraph 11.11 (Person abroad receives income indirectly). If B's transfer is an independent act, it will "break the chain of causation" and A's transfer will not be one of the operative causes, it will merely be a matter of history.

12.10 The income to be charged[8]

12.10.1 *Power to enjoy part of income of person abroad*

Suppose T transferred assets to an offshore company in which he held 1% of the shares. The individual has power to enjoy the income of the company within head (b). He has power to enjoy all the income within that head since all the income increases the value of his shares (even though the amount of the increase is much less than amount of the income). In such a case T is taxed on all the income: *Howard de Walden v IRC.*

Suppose T only had power to enjoy part of the income. In such a case T is only taxed on the income which he has power to enjoy. As Cohen LJ said in *Congreve* 30 TC at p.199:

> 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.

12.10.2 *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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8 See "Requiem for a man of straw" [1980] BTR 442.

We must once again return to sections 739(1), (2) set out at 12.1 (The statute) and not repeated here. The key subsection now is 739(2)[d]:

> *that income* shall, whether it would or would not have been chargeable to income tax apart from the provisions of this section, be deemed to be income of that individual for all purposes of the Income Tax Acts.

What is the reference to which the words "that income" relate? The drafter has again[9] overlooked the elementary point that the deictic (pointing) term *that* should refer to a clear antecedent. The choice lies between:

(1) "That income" refers to section 739(2)[b], "any income" of the person abroad.

(2) "That income" refers to section 739(1)[d], only the income which arises in consequence of the transfer of assets (either alone or in conjunction with associated operations).

On this occasion there need be no litigation to find the answer. 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 CIR* 54 TC 503) to assess on the second of these two possible bases.

This must be so. Anything else would be "quite ridiculous".[10]

12.11 Capital receipts deemed to be income

To fall within s.739 the receipt of the person abroad must be "income".

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9 See 12.3 ("Such an individual": which individual?).

10 Walton J in vehement form in *Vestey v IRC* 54 TC at 562, followed in *Carvill v IRC* [2000] STC (SCD) 143. The point had been left open in *Howard de Walden v IRC* 25 TC 119.

Of course, this means "income for income tax purposes" which is a different concept from "income for trust law purposes" or "income for accountancy law purposes".[11]

Schedule F para.1 provides that income tax under Schedule F shall be chargeable:

> in respect of all dividends and other distributions in that year of a company resident in the United Kingdom which are not specially excluded from income tax, *and for the purposes of income tax all such distributions shall be regarded as income however they fall to be dealt with in the hands of the recipient.*
>
> (Emphasis added)

This applies for the purposes of s.739 and s.660A so the distribution on a purchase of own shares, for instance, is income for s.739 and s.660A purposes[12] even though it is a capital receipt for (say) trust law purposes. Likewise income deemed to accrue on a stock dividend under s.249 ICTA 1988 and a gain deemed to be income under s.776 ICTA 1988 (transactions in land) and gains from offshore funds: see 20.8 (Gains accruing to non-residents). On the issue of whether s.703 ICTA 1988 produces "income" for s.739 purposes, see Stephen Brandon QC's *Taxation of Non-UK Resident Companies and their Shareholders*, Key Haven, 2002, para. 5.1.4.4.7.

12.11.1 *Gains from life policies*

A gain from a life policy held by a non-resident trust or company is not the income of the non-resident, and is not deemed to be income, and so is outside s.739: see 19.3.2 (Policy held by non-resident trust) and 19.4 (Policy held by "foreign institution").

12.12 The measure of income within s.739

See 11.13 (Measure of income of person abroad).

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11 See 6.2 (Why does "capital v. income" matter?)

12 This is assumed to be the case in the drafting of s.686A(4)(b) ICTA 1988.

12.13 Rates of tax on income within s.739(2)

See 16.8 (Rates of tax on transferor).

12.14 Receipt of capital sum

Section 739(3) is an independent charging section. Like subsection (2), it needs to be split up into its parts in order to follow it:

> Where,
> [1] whether before or after any such transfer,
> [2] such an individual
> [3] receives or is entitled to receive
> [4] any capital sum
> [5] the payment of which is in any way connected with the transfer or any associated operation,
> [6] any income which, by virtue or in consequence of the transfer, either alone or in conjunction with associated operations, has become the income of a person resident or domiciled outside the United Kingdom shall, whether it would or would not have been chargeable to income tax apart from the provisions of this section, be deemed to be income of that individual for all purposes of the Income Tax Acts.

Lord Greene correctly explains the purpose of s.739(3) in *Howard de Walden v IRC* 25 TC at p.135:

> The provision was made ... to meet devices by which a transferor took care to give himself no "power to enjoy" any income of a non-resident transferee company within the meaning of Section [739(2)], but obtained the money he required, for example, by borrowing from the company, all the shares being vested (for example) in his children.

In practice it is rare for s.739(3) to apply in a case where s.739(2) does not, that is, the transferor receives a capital sum without having power to enjoy. An example would be a trust making an (arm's length) loan to a settlor who was excluded from benefit. This might be useful planning to prevent the application of s.740: see 13.13 (Is income within s.739 "relevant income"?).

12.14.1 *"Such transfer", "Such an individual"*

These words bring in the three transfer of asset provisions and restrict s.739(3) to the transferor, just as s.739(2).

12.14.2 *"Receives"*

"Receives or is entitled to receive" is defined in subsection (5):

> For the purposes of subsection (3) above, there shall be treated as a capital sum which an individual receives or is entitled to receive any sum which a third person receives or is entitled to receive at the individual's direction or by virtue of the assignment by him of his right to receive it.

12.14.3 *"A capital sum"*

"Capital sum" is defined in section 739(4):

> In subsection (3) above "capital sum" means, subject to subsection (5) below—
> (a) any sum paid or payable by way of loan or repayment of a loan,[13] and
> (b) any other sum paid or payable otherwise than as income, being a sum which is not paid or payable for full consideration in money or money's worth.

In *Botnar v IRC* 72 TC 205 at para.266 the Special Commissioners say:

> In our judgment the entitlement to use the flat is not a capital sum within the definition in s.739(4); in particular we hold that the entitlement to use was not a "sum" within any normal use of English.

Note section 739(6):

> Income shall not by virtue of subsection (3) above be deemed to be that of an individual for any year of assessment by reason only of his having received a sum by way of loan if that sum has been wholly repaid before

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13 'Loan' is a fairly narrow term and does not include a purchase price left unpaid: *Ramsden v IRC* 24 TC 515.

the beginning of that year.

12.14.4 *"Connected with the transfer"*

In *Fynn v IRC* 37 TC 627:

(1) In 1948 T transferred assets to an Irish company ("the transfer of assets").

(2) The company charged the asset for a debt ("the charge").

(3) In 1952, T lent the company £12,000 ("T's loan")

T was entitled to receive a capital sum (repayment of T's loan). However, this had no "connection" with the transfer of assets or the charge (an operation associated with the transfer). So s.739(3) did not apply.

This is the only use of the word "connected" in the transfer of asset provisions (though in the definition of associated operations we have the comparable concept "in relation to").

12.15 No indemnity for transferor

The transferor has no express statutory indemnity against the transferee for the tax he pays under s.739. It is suggested that no indemnity can be implied.

12.16 Section 739 foreign domicile defence

Section 743(3) provides:

> An individual who is domiciled outside the United Kingdom shall not be chargeable to tax in respect of any income deemed to be his by virtue of that section if he would not, by reason of his being so domiciled, have been chargeable to tax in respect of it if it had in fact been his income.

This applies the same test as the "first counterfactual question" of the settlement provisions. The discussion on the Settlement Provisions is equally applicable here; see 10.8 (Foreign domicile defence to s.660A). In short, where the transferor is UK resident but not UK domiciled, foreign income received by the person abroad is in the first instance outside s.739.

Is there a charge under s.739[14] if that income is remitted to the UK by the person abroad who receives it or by the transferor if he receives it outside the UK? It is considered that income subsequently received in the UK is tax free. Section 743(3) has no equivalent of the proviso to s.660G(4): see 10.12 (The 660G proviso). The whole purpose of the proviso is to deal with this situation. Michael Flesch QC agrees:[15]

> When considering the section 739 liability of a foreign domiciliary in respect of non-UK source income one must test the position either at the time of actual receipt of the income in question by the non-resident entity or, at latest, at the end of the year of assessment in which the income arises to the non-resident entity. There is in my view nothing in section 739 itself, or in section 743(3), that tells us that a subsequent remittance of that income can affect the situation.

At first sight it seems an attractive argument that the Court should apply a purposive construction and hold that s.743(3) imposes a charge in these circumstances. One would construe s.743(3) to read:

> An individual who is domiciled outside the United Kingdom shall not be chargeable to tax in respect of any income deemed to be his by virtue of that section if *and so long as* he would not, by reason of his being so domiciled, have been chargeable to tax in respect of it if it had in fact been his income.

It would follow that the s.660G(4) proviso is otiose but this is not a fatal objection. The true objection is that this purposive argument assumes (which is far from evident) that the purpose of Parliament is to impose a charge on a remittance by the person abroad who receives the foreign income. But on reflection that is a pretty daft state of affairs, for the reasons given in 10.14 (Critique of s.660G proviso).

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14 There may, of course, be a charge under s.660A ICTA 1988 in these circumstances.

15 *GITC Review* Vol 1, Issue 2, page 13 accessible on *www.taxbar.com*.

12.16.1 *Tax planning for foreign income within section 739 foreign domicile defence*

In summary:

(1) Capital may be remitted.

(2) A foreign domiciliary may use income within s.739 abroad to meet his foreign expenditure.

(3) He may use the income to make a gift. If the gift is completed abroad, the donee may remit the income without any charge. However, a gift to a spouse would not count for this purpose: see s.742(9)(a).

(4) Income from a source which has ceased to exist may also be remitted.

CHAPTER THIRTEEN

TRANSFER OF ASSETS ABROAD: SECTION 740

13.1 Introduction

Section 740 comes into effect if two sets of conditions are satisfied. The first set is the three "transfer of asset" conditions.[1]

The second set of conditions is found in s.740(1)(b) and is easier to follow if set out in separate limbs:

[1] an individual ordinarily resident in the United Kingdom
[2] who is not liable to tax under section 739 by reference to the transfer
[3] receives a benefit
[4] provided out of assets which are available for the purpose
[5] in consequence of the transfer or of any associated operations.

13.2 Ordinary residence at time of receipt of benefit

Section 740 only applies if the individual is ordinarily resident at the time he receives the benefit. If he receives a benefit but is not ordinarily

1 Found in s.740(1)(a):

> "by virtue or in consequence of a transfer of assets, either alone or in conjunction with associated operations, income becomes payable to a person resident or domiciled outside the United Kingdom."

See 11.2 (Transfer of asset conditions).

In this book I shall only consider the situation where the person abroad (the person resident or domiciled outside the UK to whom income becomes payable) is a non-resident trust or company. Where the transfer of asset conditions are satisfied, and the motive defence and s.739 do not apply, I shall describe this trust or company as being "within section 740".

resident at that time there is no charge under s.740 in relation to that benefit.

It might be possible to have the status of non-UK resident but at the same time be ordinarily resident in the UK. A benefit received by such a person is within the scope of s.740. But for convenience I shall refer below to a non-resident individual as outside the scope of s.740, and leave "ordinary" residence to be understood.

Example 1

(1) Year 1: B is ordinarily resident in the UK. Relevant income arises but B receives no benefit, so there is no s.740 charge.

(2) Year 2: B is not ordinarily resident in the UK, but he receives a benefit.

There is no charge under s.740 in relation to this benefit, and this remains the case even if B later becomes UK resident again.

Example 2

Now reverse the facts:

(1) Year 1: B is not ordinarily resident in the UK and relevant income arises.

(2) Year 2: B is ordinarily resident in the UK and receives a benefit.

The benefit is in principle[2] subject to tax by reference (if need be) to the relevant income of year 1.

Example 3

(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 the benefit is not subject to tax under

2 Assume that the s.740 foreign domicile defence does not apply.

s.740.

(2) Year 2: B is not UK resident or ordinarily resident but "relevant income" arises.

The benefit is in principle treated as income of B in year 2. It is arguable that this deemed income is not subject to tax by virtue of the implied territorial limitation of UK taxation; see 6.4 (Situs of source). The position is not clear however.

13.3 Transferor's s.740 exemption[3]

Section 740 does not apply if the individual who receives the benefit is

> *liable* to tax under section 739 by reference to the transfer.
>
> (s.740(1)(b)[2], emphasis added)

I refer to this as the transferor's s.740 exemption.

13.3.1 *UK resident foreign domiciled transferor*

The Revenue say (RI 201):

> A non-UK domiciled individual who transfers assets but is outside the charge to tax under Section 739 by virtue of the provisions of Section 743(3),[4] is not assessed under Section 740.

The reason is this. Section 743(3) provides that a transferor who qualifies for the s.739 foreign domicile defence is not *chargeable* to tax under s.739. Such a person is nevertheless regarded as being "*liable* to tax under s.739 by reference to the transfer", within the meaning of s.740(1)(b)[2]. This is for one of two reasons:

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3 For the position of non-transferors where s.739 applies, see 13.13 (Is income within s.739 "relevant income"?).

4 See 12.16 (s.739 foreign domicile defence).

(1) A general distinction is drawn between "chargeable" and "liable"[5]; or

(2) a transferor who qualifies for the s.739 foreign domicile defence remains "liable to tax under s.739" because of the possibility of a charge under that section if the income is remitted to the UK.

This view is also supported by the title of s.740 ("Liability of non-transferors"). Whatever the reason, this is a sensible result. There is no need to apply s.740 to a transferor to whom s.739 applies. The application of s.739 gives the Revenue all they need.

13.3.2 *Transferor ordinarily resident when transfer made, before 26 November 1996*

It has never been a condition for s.740 that the transferor was resident at the time of the transfer, but this was formerly a condition for s.739.[6]

RI 201 provides:

> Similarly, a transferor of assets who is outside the charge to tax under Section 739 in respect of income arising before 26 November 1996 through being not ordinarily resident in the UK at the time of the transfer, is not assessed under Section 740.

This is looking at a transferor "T" (wherever domiciled) who:

(1) is not UK ordinarily resident when he made the transfer;

(2) later becomes UK ordinarily resident before 26 November 1996.

Such a person was not taxed under s.739 until 26 November 1996. I refer to income arising before that date as "pre-1996 income". If such a person

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5 This might not seem to accord with the natural meaning of those words; but it is consistent with the generally accepted view that a charity within the charity exemption is "liable" but not "chargeable" to tax for the purposes of DTTs; see *Venables & Kessler on the Taxation of Charities*, 4th ed., Chapter 12. *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, should not count for much.

6 See 12.7.2 (Transferor not ordinarily resident when transfer made).

receives a benefit after 26 November 1996[7] he is not taxed under s.740. It is right that T qualifies for the transferor's s.740 exemption. The exemption does not apply to *income* "liable to tax under s.739". It applies to an *individual* "liable to tax under s.739". In the example, T (once ordinarily resident and after 26 November 1996) becomes an individual who is "liable to tax under s.739". This is something of a windfall for T, but of course non-transferors may be taxed as the pre-1996 income is relevant income.

13.3.3 *Transferor not ordinarily resident at other times*

RI 201 does not address the situation where T is outside the scope of s.739 only because he is not ordinarily resident for a period. For instance, if:

(1) T is ordinarily resident when he makes the transfer;

(2) T is non-resident for a period ("the non-resident period");

(3) T returns to the UK.

The reasoning above shows that such a person is also outside s.740; he too qualifies for the s.740 transferor's defence even in relation to income of the non-resident period.

13.4 "Benefit"[8]

The word "benefit" is used for two main purposes in the transfer of asset provisions:

(1) Section 740 applies if the individual receives a "benefit" and the charge is by reference to the amount or value of that benefit.

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7 I need not now consider the position if the benefit was received before 26 November 1996 but the result was probably the same.

8 "Benefit" is a word used in many areas of tax and general law. The discussion in Venables, *Non-Resident Trusts*, 8th ed., on the meaning of "capital payment" in s.87 TCGA 1992 is relevant here; likewise some of the discussion in *Drafting Trusts and Will Trusts*, James Kessler QC, 6th ed., para. 12.10 (Settlor exclusion clause).

(2) Section 739: the word "benefit" is used three times in the definition of "power to enjoy".

It is well established that "benefit" is a word of wide import. There are no express valuation provisions,[9] so value means market value.

Section 742(9)(c) states that "benefit" includes a payment of any kind. "Payment" strictly means payment of money, though the context here suggests that the word means transfer of assets. But whatever payment means here, it is difficult to think of a payment which is not a "benefit" in the ordinary sense of the word which becomes a "benefit" by virtue of the definition.

A payment made to an individual under a bargain for which the individual gives full consideration (e.g. a sale to or from a trust or company within section 740) is not a "benefit" at all in the normal sense.[10] Is it deemed to be a "benefit" by virtue of this definition? If it is, it makes no difference in s.740 because the value of the benefit is nil. The definition supports the conclusion which the author reaches at 13.4.5–6 (Benefits to which a beneficiary becomes entitled under terms of trust or on company liquidation).

Of course the original drafter had in mind the use of the word "benefit" in the s.739 context (definition of power to enjoy), not s.740. The definition goes back to 1936, whereas s.740 was introduced in 1981. At first sight it is difficult to see the purpose of the definition in that context. In an earlier edition I speculated that the drafter merely felt that it might conceivably be helpful in circumstances which he did not precisely formulate. But the Notes on Clauses state that the purpose was that capital payments as well as income payments will be taken into account.

13.4.1 *Receipt or sale of equitable interest*

RI 201 states:

> For the purposes of Section 740(1)(b) a benefit is treated as not including

9 Contrast the charge on benefits for employees, where there are elaborate valuation rules; this is another manifestation of the patchwork nature of IT.

10 This is self-evident; but if authority is needed, see *IRC v Lactagol* 35 TC 230.

[1] either the giving[11] 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).[12] If the interest is not revocable, then its receipt is a benefit, but this is still outside the scope of s.740 because such a benefit is not "provided out" of trust assets, and to tax such a benefit is outside the scheme of the Act.

Point [2] (receipt of proceeds of sale of a life interest) is outside the scope of s.740 for those reasons, because a sale at market value is not a "benefit" to the vendor, or because the value of the "benefit" (if there was one) is zero.[13]

Although RI 201 refers to a life interest, the same reasoning must apply to any equitable interest.[14]

The same reasoning should apply on the sale of shares or securities in a company within s.740.

13.4.2 *Interest free loan and enjoyment of asset in kind*

RI 201 continues:

> But it ["benefit"] is otherwise treated as including all benefits taken into account in determining whether an individual has power to enjoy income for the purposes of Section 739. It therefore includes for example receipt of a loan at less than a commercial rate of interest, and the use of trust property at less than an open market rental.

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11 "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.

12 A similar conclusion was reached by the Special Commissioners in the context of (what is now) s.201 ITEPA 2003: *Dextra Accessories v Macdonald* [2003] STC 749. The point was not appealed.

13 The drafter of FA 1984 Sch 14 para. 5(4) reached the same conclusion for the purpose of what is now s.87 TCGA 1992.

14 On a sale of an equitable interest, watch:
(1) CGT on the disposal of the interest; and
(2) TCGA 1992 Schedule 4A.
On the planning possibilities, see 13.30.2 (Sale of equitable interest scheme).

The Revenue view that interest free loans and use of property at less than full rent are benefits within s.740 is now confirmed by *Billingham v Cooper* [2001] STC 1177. The only issue is valuation of the benefit: on which see "Loans to Beneficiaries of Offshore Trusts – The Value of the Benefit", David Williams, OTPR Vol 1, issue 3, p.35 and *IRC v Botnar* [1998] STC at p.81–85.

13.4.3 *Loan at commercial rate*

A simple way of avoiding s.740 is:

(1) to make a loan at a market rate of interest;

(2) 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,[15] and watch *Furniss v Dawson*. The same can be done with the use of other property provided the property is not in the UK.

What if interest is rolled up unpaid? There is no tax charge on unpaid interest. In principle the position is the same but if the intention is that the interest should never be paid, the provision for payment of interest is a sham and ineffective for tax purposes.

13.4.4 *Interest bearing loan to life tenant*

It is impossible to have an interest bearing loan to a life tenant, under a transparent English law type trust, because a person cannot pay interest to himself. Accordingly one cannot avoid a charge on a benefit in kind by purporting to pay such interest. It would be different if the trust was a New York type non-transparent trust.[16]

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15 See 6.10 (Situs of source of interest).

16 See 6.12 (Income from trusts).

13.4.5 *Benefit to which a beneficiary becomes entitled under terms of trust*

Suppose:

(1) A beneficiary is entitled to trust property absolutely subject to satisfying some contingency (e.g. attaining the age of 25).

(2) The contingency is satisfied (the beneficiary reaches 25 and becomes entitled to the trust property).

There is a "capital payment" for the purposes of the CGT offshore beneficiary provisions: see section 97(2) TCGA 1992. There is no equivalent provision in the transfer of asset rules. However, it is suggested that in the example the beneficiary does receive a "benefit" and the value of the "benefit" is equal to the value of the trust fund. The word "benefit" can be stretched wide enough to support this conclusion and any other view would be inconsistent with the scheme of the provisions.[17]

13.4.6 *Benefit on liquidation or redemption of shares or securities*

Suppose:

(1) A shareholder is entitled to shares in a company within section 740.

(2) The shareholder receives assets of the company on the liquidation of the company or on the redemption of its shares.

It is arguable that the shareholder does not receive a "benefit" since he merely receives the property to which he is entitled in the liquidation or redemption; or (which comes to the same thing) that the value of the "benefit" is nil. After all, a sale of the shares would not be a benefit, but is commercially very similar. However, once again, the better view, consistent with the scheme of the Act, is that the receipt of funds from the company is a "benefit". Similar points apply to securities.

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17 Contrast *R v Allen* [2000] 1 Cr App R(s) 497, where the Court of Appeal stretched the word in a comparable way in order to make a criminal law confiscation order.

13.4.7 *Reimbursement of tax under statutory indemnity*

The Revenue accept that the reimbursement of tax under a statutory indemnity such as section 660D ICTA 1988 or paragraph 6 of Schedule 5 TCGA 1992 is not a benefit: see the correspondence published at 13.16 (Trust and company expenses).[18] The Revenue have suggested that this does not apply if the reimbursement is made before the settlor has paid the tax for which he seeks reimbursement. But it is submitted that there is never a benefit (or the value of the benefit is nil) when trustees pay a sum to a settlor in a *bona fide* settlement of a claim or prospective claim for reimbursement.

13.4.8 *Benefit of use of asset owned jointly by individual and person abroad*

On this topic see 31.20 (Co-ownership defence).

13.5 Who is the recipient of a benefit?

It is important to identify the recipient of a benefit because the individual who receives the benefit is the one who is taxable. It is especially important where some beneficiaries are and others are not UK resident or domiciled, because then the identity of the recipient may affect not only who pays the tax but whether any tax is payable at all.

For CGT purposes, the concept of 'receipt' is explained by s.97(5) TCGA 1992.[19] There is no statutory equivalent here but it is suggested that the same rules apply: s.97(5) is merely an explanation of the natural meaning of 'receipt'.

Suppose trustees pay school fees for an individual's minor children. The children receive the benefit. The parent merely receives an intangible, non-financial advantage which is not a "benefit" for the purposes of s.740. Where the parent is under a direct legal obligation to maintain and pay

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18 In practice this is more of an issue for CGT than for s.740 purposes.

19 "For the purposes of sections 86A to 90 ... a capital payment shall be regarded as received by a beneficiary from the trustees of a settlement if—
(a) he receives it from them directly or indirectly, or
(b) it is directly or indirectly applied by them in payment of any debt of his or is otherwise paid or applied for his benefit, or
(c) it is received by a third person at the beneficiary's direction."

school fees for his children (such as may arise on a divorce or in other family law proceedings) there is a "benefit" to the individual but the benefit is outside the scope of s.740 because it is merely incidental.[20] It is suggested that the same analysis applies where a house is provided to a life tenant who then allows his spouse or partner or children to live there. The indirect benefit which the spouse or partner or children receives is not a "benefit" for the purposes of s.740, or, alternatively, it is not one which is provided "in consequence of the transfer or any associated operations".

Where a married or unmarried couple of mixed domicile are both beneficiaries under a trust, there is considerable scope for tax saving by arranging that the non-domiciled beneficiary receives the benefit (and so can qualify for the s.740 foreign domicile exemption). The trust documentation in these circumstances is very important.

A similar issue arises where a benefit (say, cash) is given to A and A of his own free will passes the benefit to B. In these circumstances B certainly receives a benefit: the only issue is whether he has received it in consequence of the transfer and associated operations: as to which see 11.8 (Causation).

13.6 Benefit received indirectly

Not every benefit that an individual receives falls within s.740. The second set of s.740 conditions[21] requires that an individual:

> [3] receives a benefit
> [4] provided out of assets which are available for the purpose[22]
> [5] in consequence of the transfer or of any associated operations.

Does limb [5] govern limb [3] or limb [4]? Or both? That is, does it refers to an individual who:

> [3] receives a benefit in consequence of the transfer or any associated operations

20 Similar issues arise in relation to a settlor exclusion clause which prevents trustees from applying property for the "benefit" of the settlor, and the authorities are reviewed in *Drafting Trusts and Will Trusts*, James Kessler QC, 6th ed., para. 12.10.

21 See 13.1 (Introduction).

22 This must mean, for the purpose of providing benefits to the individual.

[4] provided out of assets which are available for the purpose

Or does it refer to an individual who:

[3] receives a benefit
[4] provided out of assets which are available for the purpose in consequence of the transfer or any associated operations

Or does it refer to an individual who:

[3] receives a benefit in consequence of the transfer or any associated operations
[4] provided out of assets which are available for the purpose in consequence of the transfer or any associated operations

It is the familiar problem of an overlong sentence wallowing in subsidiary clauses, something to which the drafter of the transfer of assets provisions was particularly inclined.[23] Grammar does not provide an answer: the solution must be found (if at all) from context. I am inclined to think it does not make much if any difference since the three readings overlap; the plastic expression "in consequence of" can bring the same result wherever it is placed.

I describe assets which meet this condition as "tainted assets". I describe a benefit which meets these conditions as a "relevant benefit".

Suppose:

(1) A discretionary trust within s.740 has a pool of "relevant income".

(2) A non-resident beneficiary ("B1") receives a trust asset ("B1's asset"). So B1 receives a benefit however, being non-UK resident, B1 does not pay tax under s.740.

(3) B1 then (independently and not as part of a prior arrangement) gives the asset to another beneficiary ("B2") who is UK resident.

B2 has received a benefit, but not a relevant benefit and is not subject to

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23 Compare "My client has discussed your proposal to fill the draining ditch with his partners": *State of the Language*, ed Leonard & Ricks, 1980.

tax under s.740. This must be the case if steps (2) and (3) are many years apart. Any other rule would be absurd. It is necessarily part of the scheme of s.740 that when one beneficiary ("B1") receives a benefit, and uses the benefit to benefit another ("B2") only the first benefit counts. Otherwise what might 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. But why is it the case? There are two technical arguments.

13.6.1 *Available for the purpose*

The first argument focuses on the words "available for the purpose". The benefit to B2 is not provided out of assets "available for the purpose". Any individual may use any of his assets to make gifts to anyone in the world, but one would not in usual language say the assets were "available for the purpose". The word "purpose" implies a mental state:[24] a scheme or arrangement whose object is (or includes) the provision of the benefit to B2.

13.6.2 *Benefits and causation*

The second argument accepts that B1's asset is "available for the purpose" (of benefiting B2). This argument focuses on the causation test implied in the words "in consequence of the transfer". "The transfer" is the gift to the trust by the settlor. If B1's asset is "available for the purpose" it is nevertheless not so available in consequence of the transfer to the trust by the settlor. True, it would not have been so available *but for* that earlier transfer. However, the only true cause that the asset is "available" (if it is available) is in consequence of B1's independent decision to benefit B2. So the asset is not available in consequence of the transfer by the settlor. It is available for other reasons. An independent act by B1 will break the chain of causation. The argument is the same as in 11.11 (Person abroad receives income indirectly).

Consider a settlement where the settlor is a beneficiary and the settlor wishes to make a payment to another beneficiary, not the settlor. A direct payment from the trustees to that beneficiary may be within the scope of

24 Contrast 15.9 (Foresight and purpose).

s.740.[25] In that case the solution may be to make regular payments to the settlor who may subsequently and independently make a gift to the beneficiary.

13.7 Benefit chargeable to IT defence

Section 740 does not apply if the benefit is:

> otherwise chargeable to income tax in the hands of the recipient.
>
> (Section 740(2))

I refer to this as the "benefit chargeable to IT defence".

It is considered that unremitted foreign income of a UK resident is "chargeable" to income tax. The statute draws a distinction between a "charge" and a "computation" and unremitted income is "chargeable" even though ignored in the computation of the charge. See 10.9 ("Chargeable"). The question arises where an individual receives foreign income and (for one of two reasons) the s.740 foreign domicile defence does not apply.

13.7.1 *Unremitted income and non-excluded relevant income*

Suppose:

(1) A non-resident discretionary trust within s.740 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 in principle on the unremitted foreign trust income under Schedule D Case V but the income is not remitted, so no tax is due.

Can the Revenue argue that B is subject to tax on the unremitted foreign

25 See 13.13 (Is income within s.739 relevant income?).

trust income under s.740?[26] The answer is, no, because the income is a benefit "otherwise chargeable to income tax". By contrast, if B had received capital instead of income from the same trust, he would have been subject to tax on the benefit under s.740!

Of course, the word "chargeable" (like all words) takes its meaning from the context. So perhaps here the Revenue may argue that unremitted foreign income is not "chargeable" to income tax under Schedule D Case V, so it is within the scope of s.740. However, it makes little sense to apply s.740 in a situation where the ordinary remittance basis regime applies, because there is no need for it.[27] So it is considered that unremitted foreign income received by a UK resident individual is taxable, if at all, under ordinary Schedule D or E principles and cannot be chargeable under s.740. This result is consistent with the position of transferors; who are taxable under s.739 (if at all) and not under s.740 (see 13.3 (Transferor's s.740 exemption)).

13.7.2 *Income remitted after source ceasing*

The same issue arises in the more common situation, that:

(1) the trustees receive only foreign source income;

(2) as before, B receives income (unlimited foreign trust income) from the trust.

B is not subject to tax on the unremitted foreign trust income because the income is unremitted. B is not subject to tax under s.740 because of (1) the benefit chargeable to IT defence and (2) the s.740 foreign domicile defence. At this stage it does not matter which defence applies. Suppose however:

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26 The s.740 foreign domiciliary defence is not in point because the trustees have received UK source relevant income: see 13.27 (Section 740 foreign domicile defence).

27 A further objection to this Revenue argument is that there may be a double charge to tax:

(1) Tax under s.740 on receipt of the unremitted foreign trust income.

(2) Tax under Schedule D Case V when the foreign trust income was later remitted to the UK.

Arguably, s.744 provides relief here: see 14.5 (s.744 relief).

(3) the trust comes to an end and the income is remitted in a subsequent tax year.

There is still no charge under Schedule D Case V because the remittance basis applies. The benefit is now received in the United Kingdom so the s.740 foreign domicile defence ceases to apply. Could there be a charge under s.740? It is considered that the benefit was "otherwise chargeable to income tax in the hands of the recipient" and so s.740 does not apply.

13.8 Charge limited to lower of value of benefit and "relevant income"

Section 740(2) provides:

> ... the amount or value of any such benefit ... shall:
>
> (a) to the extent to which it falls within the amount of *relevant income* of years of assessment up to and including the year of assessment in which the benefit is received, be treated for all the purposes of the Income Tax Acts as the income of the individual for that year;
>
> (b) to the extent to which it is not by virtue of this subsection treated as his income for that year and falls within the amount of relevant income of the next following year of assessment, be treated for those purposes as his income for the next following year,
>
> and so on for subsequent years ...

In short, where an individual receives a benefit s.740 imposes a charge on the lesser of:

(1) the value of the benefit; and

(2) the amount of "relevant income" of years of assessment up to and including the year in which the benefit is received. Although the subsection does not say so, it clearly means relevant income in relation to that individual.

Contrast s.739, which imposes a charge on the whole of the income accruing to the person abroad.

Tax is charged under Schedule D Case VI.

13.9 Relevant income: the statutory definition

"Relevant income" is a central but perplexing concept. The absence of litigation on the subject is because the Revenue have in practice generally applied s.740 in a way which leads to a sensible result. Section 740(3) provides the definition:

> ... the relevant income of a year of assessment, in relation to an individual, is any income which
> [a] arises in that year to a person resident or domiciled outside the UK and
> [b] which by virtue or in consequence of the transfer or associated operations referred to in subsection (1) above can directly or indirectly be used
> [i] for providing a benefit for the individual or
> [ii] for enabling a benefit to be provided for him.[28]
>
> (Sub-paragraphing added)

The condition in limb [a], income arising to an individual, is the same as s.739; see 11.4 ("Person abroad" receives income).

The term is not "relevant income" (in isolation). It is relevant income *in relation to an individual*. There may be relevant income in relation to anyone in the world (e.g. income of a discretionary trust with a power to benefit anyone in the world). There may be relevant income in relation to A which is not relevant income in relation to B (e.g. income of a discretionary trust under which A can benefit and B cannot). In this book, for ease of exposition, I do sometimes refer just to "relevant income" and leave the words "in relation to the individual" to be understood. One should only take that shortcut where the context is clear.

13.10 Capital receipts deemed to be income

To qualify as "relevant income" the receipt of the person abroad must first

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28 The words in [b][ii] are so obviously otiose that one must reluctantly conclude that the drafter did not care much about his use of language.

of all be income and not a capital receipt.[29]

13.10.1 *Purchase of own shares*

The receipt by the shareholder of a payment from a UK company for the purchase of its own shares is deemed to be "income" for income tax purposes generally and such a receipt may therefore constitute relevant income.[30]

13.10.2 *Stock dividend received by offshore trust*

Suppose non-resident trustees receive a stock dividend within s.249(6). In that case "income of [a certain] amount *shall be treated* as having arisen to the trustees". The amount is certainly "income" for the purposes of s.740, but the better view is that it is not "relevant income". The amount is fictional so one cannot say that it "can" be applied 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 the Revenue insist in a DTT context,[31] and here the distinction between the stock dividend shares and the fictional income is similar but clearer.)[32]

13.10.3 *Gains from policies and offshore funds*

See:

(1) 19.4 (Policy held by "foreign institution").

(2) 20.8 (Gain accruing to non-resident trustees).

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29 See 6.2 (Why does "capital *v* income" matter?).

30 See 12.11 (Capital receipts deemed to be income) and 13.26.2 (Purchase of own shares by UK company).

31 See CG Manual para. 34912.

32 This will need to be reviewed when *Red Discretionary Trustees* Sp C 397 is final.

13.11 Is income of life tenant "relevant income"?

Consider an interest in possession trust: one where the trust income is payable to a beneficiary ("the life tenant").

If the life tenant is UK domiciled and resident, the trust income is not relevant income because it does not meet the condition in s.740(3)[a]. It does not arise to a person resident or domiciled outside the UK.

If the life tenant is not UK domiciled then the condition in s.740(3)[a] is satisfied. Nevertheless, the trust income is not relevant income because it is distributed, see 13.17 (Income of discretionary trust distributed to beneficiary in tax year in which it arises).[33]

There is nothing surprising in this conclusion: there is no need for s.740 in these circumstances, and one would not expect it to apply. If it did apply there could be double taxation – the life tenant being taxed on the income as he receives it, and on other benefits (if he receives any) to the value of the relevant income.

13.12 Is trust income within s.660A "relevant income"?

One must consider s.660A separately from s.739, and one must consider UK resident and domiciled settlors/transferors separately from those who are non-resident or domiciled.

13.12.1 *UK resident and domiciled settlor*

Suppose:

(1) a non-resident discretionary trust within s.740;

(2) a UK resident and domiciled settlor "S" has an interest in the trust;

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33 Even if that were wrong:

(1) The trust income is not relevant income in relation to the life tenant. One would not say in ordinary language that the trust income *can* be used for providing a benefit for the life tenant. The income *is* the property of the life tenant.

(2) The trust income is not relevant income in relation to any other person. Since the income belongs to the life tenant, one cannot say that the income "can" be used for the benefit of anyone else. See 13.14 (Income which "can" be used to benefit another person).

and

(3) all the trust income is accordingly within the scope of s.660A ICTA 1988.

Section 660A(1) provides in such a case:

> Income arising under a settlement during the life of the settlor shall be treated for all purposes of the Income Tax Acts as the income of the settlor *and not as the income of any other person ....*
>
> (Emphasis added)

The trust income is not "relevant income" as it does not meet the condition in s.740(3)[a]: the income is treated by s.660A as accruing to S, so it cannot be regarded as arising to a person resident or domiciled outside the UK.

13.12.2 *UK resident foreign domiciled settlor*

Now suppose:

(1) a non-resident discretionary trust within s.740;

(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.660A ICTA 1988 (the s.660A foreign domicile defence does not apply).[34]

In this case the condition in s.740(3)[a] is satisfied since even applying s.660A(1) the income is treated as accruing to S. However, it is submitted that the condition in s.740(3)[b] is not satisfied: if the income is treated as that of S, and of no other person, it is not income which "can be used for providing a benefit" for anybody else. So the income is not "relevant income".

The position is different if and to the extent that the s.660A foreign

34 See 10.8 (s.660A foreign domicile defence).

domicile defence applies. Section 660A does not apply to income within that defence: see 10.8 (s.660A foreign domicile defence). Accordingly the trust income can, in principle, be relevant income for s.740.

What happens then if the income is later remitted, so it becomes taxable on S under s.660A? It is tentatively suggested that the income retrospectively ceases to be relevant income, so that tax paid under s.740 can be recovered by a beneficiary. In practice this could arise only in fairly unusual circumstances, e.g. where:

(1) Year 1: a beneficiary ("B") receives a benefit but does not pay tax as there is no "relevant income".

(2) Year 2: foreign source income arises on which the settlor ("S") is not subject to tax as the foreign domicile exemption for s.660A applies. This is relevant income in relation to B, so B pays tax under s.740.

(3) Year 3: that income is remitted to the UK, so S pays tax under s.660A.

Where s.739 applies (as well as s.660A) see 13.13.

13.12.3 *Non-resident settlor*

Suppose now:

(1) a non-resident discretionary trust within s.740; and

(2) a non-resident settlor ("S") has an interest in the trust.

Section 660A does not apply to foreign source trust income: see 10.19 (Non-resident settlor). Accordingly foreign source income may in principle be relevant income.

Section 660A does apply to UK source income. Here too it is submitted that the condition in s.740(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".

13.13 Is income within s.739 "relevant income"?

The position is subtly different if income falls within s.739 (whether or not it also falls within s.660A). The Revenue say in RI 201:

> Where a non-UK domiciled individual transfers assets but is not chargeable to tax under the provisions of s 739 owing to s 743(3), there is no bar in the Revenue's view on the application of s 740 to others who did not themselves make the transfer but were beneficiaries of it.

In the Revenue view the position is the same as in the s.660A case:

(1) income taxed on the settlor under s.739 is not "relevant income" (this must be right); and

(2) income within the foreign domicile's defence to s.739 is "relevant income".

However, there is a significant difference between s.660A and s.739. The foreign domicile defence to s.660A[35] states that income within the defence is not "income arising under a settlement". Such income is therefore entirely outside the scope of s.660A. It is not deemed to be the income of the settlor. By contrast, the foreign domicile defence to s.739[36] merely states that the transferor "shall not be chargeable to tax" in respect of income within the scope of the defence. This does not undo the effect of s.739(2) which provides that the income of the person abroad *is* deemed to be the income of the transferor.

It appears at first sight, therefore, that the Revenue view is incorrect and, where:

(1) a foreign domiciled individual ("F") makes a transfer of assets abroad; and

(2) F is in principle within s.739(2); but

(3) F is not chargeable to tax under the provisions of s.739 owing to

35 See 10.8 (Foreign domicile defence to s.660A).

36 See 12.16 (Foreign domicile defence to s.739).

s.743(3),

the income within s.743(3) cannot be "relevant income" in relation to any beneficiary.

This argument leads to a sensible result. There is no need to apply s.740 to the situation where s.739 applies, because s.739 gives the Revenue all the protection they need. It is also consistent with the scheme of s.739, which is to put the transferor in the same position as if no transfer had been made.

This also solves the problem which would arise, on the Revenue view, if income within the foreign domicile's defence to s.739 is later remitted, and so (arguably) taxable on F under s.739. In this case it can hardly be correct that the Revenue have a discretion whether to untax F, or untax the beneficiary who has received a benefit and paid tax under s.740.[37]

If this view is right, UK resident beneficiaries are better off if s.739 applies than if it does not. Where the transferor is UK resident but has no power to enjoy, a loan to him would trigger s.739(3) to the advantage of all concerned. See 12.14 (Receipt of capital sum).

The Revenue may raise this objection. Although the income is treated as that of the transferor it also remains the income of the transferee, so it is also relevant income. If the full force of the reasoning in *R v Dimsey and Allen* is carried to its logical conclusion, that must be correct. If the Court was sympathetic to the taxpayer, *Dimsey* may perhaps be distinguished.

13.14 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 s.740(3)[b] that the income "can be used for providing a benefit" for the individual.

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37 This does not mean that s.740 is entirely irrelevant where s.660A or s.739 applies. Suppose:

(1) A non-resident trust to which s.739 applies.

(2) A beneficiary receives a benefit. There is no relevant income in relation to this benefit, so no tax can be charged under s.740 at this stage.

(3) Suppose, however, the transferor then dies, or becomes non-UK resident, so that s.739 ceases to apply. "Relevant income" may subsequently accrue to the person abroad, and the beneficiary may then be subject to tax by reference to the benefit received earlier.

"Can", like most common words, has a variety of meanings, but the meaning here must be:

> Expressing a possible contingency; = May possibly.[38]

One might refer to this as "can contingently".

13.14.1 *Income received by 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 plainly must be ignored or the definition does not work.[39]

13.14.2 *Income received by company owned by individual*

Suppose an individual, T, transfers assets to a non-resident company all the shares of which he owns absolutely. Assume the transfer does not qualify for the motive defence. So long as T remains owner of the company:

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38 *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.

39 The issue is not so much the meaning of the word "can": if income is paid to A it is obvious that it "can" (in the "can contingently" sense of the word) be paid to B if A so directs. The better way to put the issue is: which hypothetical contingencies should be taken into account in order to ask the question whether or not income "can" be used for providing a benefit?
The question is similar to the issue which arises for the purposes of s.660A ICTA 1988, 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 words "can be used for providing a benefit for the individual" by implication mean "can *by virtue or in consequence of the transfer of assets and associated operations* be so used".

(1) The income of the company is relevant income in relation to T (unless it falls within s.739).

(2) The income of the company is not relevant income in relation to any other person.

For the position if T later gives the company to a trust, see 13.22 (Is income of a company held by trust "relevant income"?).

13.14.3 *Income of A&M trust only payable to B on remote contingency*

Now consider this quite common type of Accumulation and Maintenance trust, 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 tentatively 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:

(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.660A, where the issue is whether income "may become payable" to the settlor *in any* *circumstances whatsoever*. It is reasonable to assume that the drafter of the transfer of assets provisions did not copy the language of the settlement provisions because he wanted a different result. Applying (as one should) a purposive approach, this is the fair and just result and consistent with the general scheme of s.740. A settlor or transferor has the opportunity to exclude himself completely in a straightforward manner, and is taxed if he fails to do so. A beneficiary (not the settlor/transferor) has no such opportunity. To tax B on income of A's fund (on the facts of the above example) would not be just or fair.[40]

13.14.4 *Income of discretionary trust*

Conversely, consider a common form discretionary trust. In principle, all trust income "can" contingently be used to benefit any beneficiary, if the trustees exercise their discretion, and that is a contingency which naturally should be taken into account. Trust income is relevant income in relation to all beneficiaries.

Suppose, however, the trustees (perhaps guided by a letter of wishes) regard the fund as divided into (say) two shares for separate families. There is (assume) no practical possibility that more than one half of the income will be used for one particular beneficiary. There is a faint argument that only one half of the income is relevant income in relation to that beneficiary. The Revenue may be more sympathetic than the Courts.

13.15 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);

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40 A similar unfairness does arise for CGT under s.87 TCGA 1992. However, it is at least possible to avoid that by transfers to another settlement.

(b) transferred to another trust (under which B does not benefit); or

(c) retained by the trustees, but on terms under which B cannot benefit.

(2) The converse also sometimes happens: at the moment it arises income cannot be used to provide a benefit for a person, but at a later time it can be so used; for instance:

(a) if the person is not born until later;

(b) if one share of a trust fund accrues to another share (e.g. on the death of a beneficiary);[41] or

(c) where a company within s.740, wholly owned by A, which has accumulated income during A's ownership, is given to a trust under which B can benefit.

So it is often important to ask at what moment in time one puts the question. I refer to this as "the timing issue". There are in principle several possible answers:

(1) the moment that the income arises;

(2) the moment that the benefit is provided, if later than (1);

(3) after a "reasonable" period (whatever that might be);

(4) the end of the tax year in which either (1) or (2) or (3) occurs.

(5) the earlier or later of some combination of the above.

An important consequence of all solutions except (1) is that trustees of an offshore discretionary trust or company within s.740 would usually have some period of time after income has accrued, during which they may:

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41 See 13.14.3 (Income only paid to B on remote contingency).

(1) distribute income; or

(2) apply the income in the payment of expenses.

Then the income will not be relevant income of the beneficiaries because *at the moment where one asks the question* it is no longer income which "can" be applied for the benefit of the beneficiaries.

13.15.1 *The legislation*

Let us return to s.740(3):

> ... the relevant income *of a year of assessment*, in relation to an individual, is any income which arises *in that year* to a person resident or domiciled outside the United Kingdom and which by virtue or in consequence of the transfer or associated operations referred to in subsection (1) above can directly or indirectly be used for providing a benefit for the individual …
>
> (Emphasis added)

The legislation does not refer to "relevant income" in isolation. It refers to relevant income *of a year of assessment* and this is also the usage of s.740(2). This obviously deals 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.740 charge arises in year 2 and not in year 1. That explains the reference to years of assessment but does not answer the timing issue. Section 740 can be read in two ways:

> (3) ... the relevant income of a year of assessment, in relation to an individual, is any income which arises in that year to a person resident or domiciled outside the United Kingdom and which by virtue or in consequence of the transfer or associated operations referred to in

> subsection (1) above can [*at any time in that year* or *at the end of the year*] directly or indirectly be used for providing a benefit for the individual …

or

> (3) the relevant income of a year of assessment, in relation to an individual, is any income which arises in that year to a person resident or domiciled outside the United Kingdom and which by virtue or in consequence of the transfer or associated operations referred to in subsection (1) above can [*asking the question with the benefit of hindsight at the time which matters, which is the time that the benefit is conferred or that the income arises if later*] directly or indirectly be used for providing a benefit for the individual …
>
> [words added to the statute in each case]

The first is the more natural reading. The second is a more sensible result. The author tentatively suggests 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.

This seems to be the most sensible time to ask the question.[42] Or perhaps a better way to put it is that one asks the question with the benefit of hindsight, taking into account facts known at the time that the question matters. This approach appears to be accepted by the Revenue in practice.

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42 This conclusion is perhaps faintly supported by the principle that:

> "Income Tax is, of course, an annual tax, not only in the sense that it is annually imposed by the Finance Act, but in the sense that it is annual in its structure and organisation."

The Luipaard's Vlei Estate and Gold Mining Co v IRC 15 TC 573, Rowlatt J.

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.[43] In other cases it is only possible to ascertain a moment at which income arises, by rules of a somewhat arbitrary kind.[44]

13.16 Trust and company expenses

The Revenue practice is that income used to pay trust or company administration expenses will reduce relevant income. This is consistent with the approach taken above. This applies even to income used for capital expenditure of a trust. This is confirmed by (or at least consistent with) a published exchange of correspondence:

> **CIOT Letter**
>
> ...
>
> It would also be helpful if the Revenue could confirm that if the trustees do in fact make a payment to the settlor in response to a request for reimbursement, either under Part XV ICTA 1988 or under paragraph 6 of Schedule 5 to TCGA 1992, such a payment would not be regarded as:
>
> (a) A capital payment for section 87 TCGA 1992 purposes;
> (b) Taken into account for section 740(1) ICTA 1988 purposes;
> (c) Income of the settlor for Case V Schedule D purposes.
>
> **The Revenue's reply**
>
> ...
>
> Using your lettering ...
>
> (a) already partly covered by paragraph 8 of SP 5/02;
> (b) *it will reduce the relevant income if paid out of income* but will not be a payment [ie not a benefit];
> (c) confirmed.
>
> (*Taxation Practitioner*, April 1996 p.26, emphasis added.)

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43 e.g. trading or rental income.

44 e.g. the rules in ss.18–19 ITEPA 2003 (When general earnings are received).

13.17 Income of discretionary trust distributed to beneficiary as income in tax year in which it arises

Suppose income ("the trust income") accrues to trustees of a discretionary trust within s.740, and is distributed (as income) to a beneficiary, "B1" in the same tax year.

13.17.1 *Position of other beneficiaries*

The trust income is not relevant income in relation to any other beneficiary, since the income was distributed to B1. One cannot say that the income "can" be applied for the benefit of anyone else – if the author's answer to the timing issue is correct. This is significant for the other beneficiaries who receive a benefit within s.740 (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.)

13.17.2 *Position of recipient beneficiary*

It is tentatively suggested that the income is not relevant income in relation to B1: it is not income which *can* be used for his benefit; it is income which *is* used for his benefit.[45] This is significant for B1 if:

(1) B1 is UK resident but not domiciled, and

(2) B1 receives 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 Schedule D remittance basis on the trust income. He is not taxed on the benefit by reference to the distributed income, because it is not relevant income. (B may pay tax on the benefits by reference to other relevant income if there is any.)

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45 The same argument as 13.11 (Is income of life tenant "relevant income"?) but not so strong.

13.18 Income of discretionary trust distributed to beneficiaries as income after the tax year in which it arises

Suppose income accrues to trustees of a discretionary trust, within s.740, and is retained (without being accumulated) in that tax year, but is distributed (as income) to beneficiary B1 in a subsequent year. If:

(1) a UK resident beneficiary ("B2") had received benefits in the past, and

(2) had not paid tax under s.740, for lack of relevant income,

B2 will pay tax under s.740 in the year in which the income arises.

Suppose, however, that there have been no earlier benefits so this is not in point. The position is then the same as in the above paragraph, if the author's answer to the timing issue is correct:

(1) The income is not relevant income of B1.

(2) The income is not relevant income of any other beneficiary.

13.19 Income accumulated

13.19.1 *Income accumulated and retained on wide discretionary trusts*

If trustees of a common form discretionary trust accumulate income, it remains relevant income in relation to all beneficiaries as long as it is retained by the trustees because the trust capital (which represents the income) can be paid or transferred to any beneficiaries.

13.19.2 *Income accumulated and retained on narrower trusts*

The position would be different if under the terms of the trust:

(1) B was in the class of beneficiaries to whom income could be paid; but

(2) B could not benefit in any way from income after it had been accumulated.

Accumulated income would cease to be relevant income in relation to B.

This may happen automatically, e.g. a common form of accumulation and maintenance trust provides:

(1) Income may be used for the benefit of any beneficiary under 25 (B1, B2 or B3).

(2) If not so used, it is accumulated and added to the share of one particular beneficiary ("B1") and can only be used for the benefit of B1 (not B2 or B3).

On receipt the income is relevant income in relation to B1, B2 and B3. After accumulation it is relevant income only in relation to B1.

A similar point arises in relation to a common form discretionary trust. Accumulated income is relevant income in relation to all the beneficiaries. Suppose the trustees exercise their overriding power to exclude B from the accumulated income, not from other trust capital. The income ceases to be relevant income in relation to B. It makes no difference whether this is done in the year of receipt or later.

Similar points arise if the income is transferred to a new trust, or if the income of a company within s.740 is capitalised by the issue of bonus shares.

13.19.3 *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.740 charge). This view gives rise to anomalies:

(1) Some receipts which are trust capital are treated as income for s.740, and these cannot be "accumulated" in the normal trust sense. It would be odd if they were treated differently from ordinary income for s.740 purposes.

(2) Income of a company within s.740 cannot be "accumulated" in the trust sense. It would be odd if companies were treated differently from trusts.

For my part I do not see why the formal process of accumulation should by itself make such a difference to the s.740 position. If income of a common form discretionary trust is accumulated, and later distributed as income to B1, it ceases to be relevant income in relation to other beneficiaries. This only applies if the sum distributed is (or represents) the accumulated relevant income. Intractable tracing problems will arise if income is accumulated, mixed with other trust capital, and then distributed to beneficiaries.

13.19.4 *Income accumulated and distributed as capital to beneficiary*

Suppose income of a common form discretionary trust is accumulated and distributed as capital to a beneficiary, B. It is considered that the income ceased to be "relevant income" in relation to any beneficiary other than B. However, it is relevant income in relation to B so that B is in principle subject to tax under s.740 if he is ordinarily resident in the UK. Any other conclusion would be absurd.

13.20 Distributed income: the Revenue view

RI 201 states:

> For the purposes of Section 740(3) the measure of "relevant income" is treated as not including such part of the income as has already been genuinely paid away to a beneficiary or to a bona fide charity.
> Once relevant income has arisen *and continues to be available to provide a benefit*, it must in the Revenue's view be carried forward year by year until extinguished by such a benefit, even if it is capitalised in the accounts of the overseas person.
>
> (Emphasis added)

This does not address all the permutations set out above, but it seems to be more consistent with the above than with any other interpretation.

13.21 Distributing income: tax planning

A common strategy is:

(1) distribute all income (from discretionary trust and underlying companies within s.740) to a foreign domiciled settlor periodically;

(2) the settlor may re-settle the income on the same trust.

This avoids "relevant income" in the trust or companies and ensures that the settlor receives the benefit of s.743(4) relief; see 14.3 (s.743(3) relief). Of course, it would be better to have an interest in possession trust so income at the trust level will be distributed automatically. It is doubtful whether *Furniss v Dawson* could apply here, but it is best to avoid provocative circuity.

13.22 Is income of company held by a trust "relevant income"?

13.22.1 *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.740 applies.[46] 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.

13.22.2 *Income accruing to company before company is acquired by trust*

Suppose:

(1) T owns all the shares of a company within s.740;

(2) T gives the company to a discretionary or IP 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 then ("old income")? The Revenue say that old income is also relevant income in relation to all the

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46 In practice the motive defence may apply on the transfer to the company; see 15.30 (Transfer from trustees to trust subsidiary).

beneficiaries. The Revenue argument is simple: at the relevant time (when benefits are received) the old income "can" be used for the benefit of beneficiaries. The tax consequences of this are so severe that one feels it cannot be right, but what is the flaw in the argument?

At the time when the old income accrued to the company, that income "can" *only* be used to benefit T, the sole shareholder, so it is not relevant income in relation to anyone else. After the company has been given to the trust the same income "can" be used to benefit others. That is sufficient to meet the "can" condition, if the author's answer on the timing issue is correct.

However, it is not enough that income "can" be used to benefit a person. The definition of relevant income requires that the income can be used to benefit an individual:

> by virtue or in consequence of the transfer or associated operations referred to in subsection (1)[47] above.

Now, in this case there are two transfers:

(1) The transfer of assets to the company.

(2) The transfer of the shares in the company to the trust (an associated operation).

It is tentatively suggested that where the two transfers are not part of a single arrangement, but entirely independent, one cannot say that the individual can receive any benefit in consequence of the transfer to the company and any associated operation. The individual can receive a benefit in consequence of the transfer to the trust alone. The earlier transfer is not an effective real or operative cause. The reasoning is the same as 11.11.1 (Transfer from A to B followed by transfer from B to person abroad).

47 There are two references to "associated operations" in subsection (1). The reference here is to the reference to associated operations in section 740(1)(b)[5] (as set out in paragraph 13.1 (Introduction)).

13.23 Individual not a beneficiary when income arises

13.23.1 *Beneficiary unborn when income arises*

Suppose:

Year 1: a discretionary trust within s.740 receives and accumulates relevant income.

Year 2: a beneficiary is born.

Is the income accumulated in year 1 before the birth "relevant income" in relation to that beneficiary? Robert Venables QC supports the view that it is not.[48] The answer depends on the timing issue. If the author's view is right, undistributed income accumulated before birth can be relevant income in relation to the newborn beneficiary, and that view does make more sense, having regard to the general scheme of the legislation.

13.23.2 *Individual in existence but not a beneficiary when income arises*

Suppose:

Year 1: a discretionary trust within s.740 receives and accumulates relevant income. The class of beneficiaries consists of the issue of the settlor and their spouses.

Year 2: an individual marries a beneficiary and so joins the class of beneficiaries.[49]

Is the income accumulated in year 1 before the marriage "relevant income" in relation to that individual? The answer depends again on the timing issue. If the author's view is right, undistributed income accumulated before the marriage can be relevant income in relation to the individual. Those who take the view that pre-birth income is not relevant

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48 *Non-Resident Trusts*, 8th ed., para 2.6.5 (Can one avoid the "relevant income" anti-avoidance provisions?).

49 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.

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 the individual "can" benefit in year 1 because of the contingency that the individual may marry a beneficiary in year 2. See *IRC v Tennant* 24 TC 215. The author's preferred analysis is perhaps less artificial.

13.23.3 *Beneficiary dead when income arises*

Now suppose the opposite situation:

Year 1: a beneficiary receives a benefit from a trust (which is not taxable for lack of relevant income).

Year 2: the beneficiary dies.

Year 3: relevant income accrues.

Here it is plain that there is no tax charge on the beneficiary. Income cannot be deemed to have accrued to him once he is dead.

The same applies in relation to income which accrues in the tax year of death, but after the death. One cannot say that income accruing after the death of a person "can" be applied for his benefit.

13.24 Individual excluded from benefit

Income arising after a former beneficiary is excluded from benefit cannot (on any view) be "relevant income" in relation to that beneficiary. It is not necessary that the beneficiary should be excluded from benefit altogether: just that he is excluded from benefit from the income.

13.25 Relevant income must relate to the transfer from which the benefit arises (two transfers of assets)

It is not enough for s.740 that (1) a person receives a benefit and (2) there is relevant income in relation to that beneficiary. Both must relate to the same transfer of assets. In the words of the statute:

> (1) This section has effect where—

> (a) by virtue or in consequence of a transfer of assets, either alone or in conjunction with associated operations, income becomes payable to a person resident or domiciled outside the United Kingdom; and
> (b) an individual ordinarily resident in the United Kingdom who is not liable to tax under section 739 by reference to *the* transfer receives a benefit provided out of assets which are available for the purpose by virtue or in consequence of *the* transfer or of any associated operations.
>
> (3) ... the relevant income of a year of assessment, in relation to an individual, is any income which arises in that year to a person resident or domiciled outside the United Kingdom and which by virtue or in consequence of *the* transfer or associated operations referred to in subsection (1) above can directly or indirectly be used for providing a benefit for the individual or for enabling a benefit to be provided for him.
>
> (emphasis added)

This has important consequences. Suppose:

(1) A settlor by a single disposition transfers assets to a settlement within s.740.

(2) Part of the trust fund is invested in assets which yield relevant income.

(3) Another part of the trust fund consists of a house occupied rent free by a beneficiary.

The beneficiary pays tax on the benefit by reference to the relevant income. By contrast, suppose:

(1) A settlor by *two* separate transfers creates *two* settlements within s.740:

   (a) a trust which holds income-producing assets and accumulates "relevant income"; and

   (b) a trust which holds the family home.

(2) A beneficiary enjoys the benefit of free occupation in the home.

The beneficiary is not subject to tax under s.740 as there is no "relevant income" in relation to this benefit. Thus the use of two settlements may avoid a tax charge under s.740 which would have arisen if there were one.

Indeed, it is not necessary to use two settlements. The same applies if there are two separate transfers of assets to one settlement.

13.26 Tax and tax credits of actual income of person abroad

This topic is not difficult to understand – at least it does not seem difficult once one has understood it. But it is impossible to summarise briefly. One must bear in mind that there are three applicable concepts:

(1) The actual income of the person abroad.

(2) "Relevant income" for s.740.

(3) The income which is deemed to accrue to the UK resident individual who receives a benefit by virtue of s.740 ("s.740 deemed income").

These must not be confused! The *actual income* of the person abroad is taxed (if at all) under general principles.

Relevant income is not taxed as such: it is merely something to be computed as a part of the process of ascertaining the amount of s.740 deemed income.

Section 740 deemed income is taxed at the lower/basic/higher rates. In practice an individual within s.740 is likely to be taxed on his s.740 deemed income at the higher rate of 40%.

This section considers the complications which arise if the actual income of the person abroad is subject to UK tax or foreign tax. How does this affect the s.740 deemed income? It is necessary to consider separately the position where the person abroad is:

(1) A discretionary trust.

(2) Any trust, on the purchase of own shares.

(3) A company owned by the individual.

(4) A company owned by a non-resident trust.

13.26.1 *Tax and tax credits of non-resident discretionary trust within s.740*

A non-resident discretionary trust will normally pay tax on its actual UK source income at the rate applicable to trusts. The amount of tax paid reduces the "relevant income" so that if the gross income is £100 and tax is 40%, the relevant income is reduced to £60. However, s.740 makes no further allowance for a beneficiary. So if a beneficiary receives a benefit of £60, taxable under s.740, he pays tax at the rate of 40% on the £60. The effective rate of tax on the actual income of the person abroad is therefore 64%. Section 744 ICTA 1988 probably does not help. It would be much better if the beneficiary received an income receipt from the trust.[50] Then s.740 would not apply[51] and instead the beneficiary will effectively obtain some credit for the UK tax paid by the offshore trust under the regime of sections 686, 687 ICTA 1988.[52]

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.740 deemed income where the possibility of any double taxation relief is lost.

An IP trust is better still for Schedule F income and foreign dividend income.

These are harsh rules, but the unfairness of s.740 is generally avoidable in practice and any other rule would certainly be extremely complicated to draft and to apply.

13.26.2 *Purchase of own shares*

The receipt on a purchase of own shares by a UK company is income: see 13.10 (Capital receipt deemed to be income).

Any trust, discretionary or IP, is subject to additional rate tax under s.686A ICTA 1988 on a purchase of own shares. This raises the same tax problems as a discretionary trust within s.686. One solution is to alter the terms of the trust before the purchase, so the proceeds of sale belong to the

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50 As to how to achieve this, see 6.13 (Payment from trust: income or capital?).

51 See 13.7 (Benefit chargeable to IT defence).

52 Unfortunately the credit is less than full credit in the case of Schedule F income. The regime is too complex to set out here.

life tenant. Another solution may be to make the trust UK resident for income tax purposes.

13.26.3 *Tax and tax credits of non-resident company within s.740*

A non-resident company will normally pay tax on its actual UK source income at the basic rate. The amount of tax paid reduces the "relevant income" so that if the gross UK source income is £100 and tax is 22%, the relevant income is reduced to £78. Once again, s.740 makes no further allowances. So if an individual receives a benefit of £78, on which he is taxed under s.740, he pays tax at the rate of 40% on the £78. The effective rate of tax on the actual income of the person abroad is therefore nearly 55%.

A similar point arises in relation to Schedule F 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.740 would not apply. The individual would still not receive any credit for the tax paid by the offshore company but his dividend income would at least be taxed at the slightly lower Schedule F upper rate of 32.5%.

13.26.4 *Tax planning by immigration of non-resident company*

Further tax planning is to make the company UK resident (or to acquire a UK resident company). Then the actual income of the company is paid out by way of dividend (assuming this is possible as a matter of company law) and taxed at the Schedule F upper rate with the benefit of the UK tax credit. Watch s.490(4) ICTA 1988. The effective rate of tax on the dividend is reduced to 25%.

This has been the position since the current absurd Schedule F rules took effect in 1999. The result can hardly have been foreseen by the Government when the rules were enacted. The rules have not, however, been changed since. One would like to think that this was a pragmatic policy decision by the Government. For under this planning the Government do obtain *some* tax, whereas if the absurd 64% CGT rate were applicable, then offshore income and gains are unlikely to be remitted at all and everybody is the loser.

13.27 Section 740 foreign domicile defence

Section 740(5) provides an exemption for foreign domiciled beneficiaries, which I call "the section 740 foreign domicile defence" (or where the context is clear, "the foreign domicile defence"). It must be split into parts to attempt to make any sense of it:

> [a] An individual who is domiciled outside the United Kingdom shall not, *in respect of any benefit not received in the United Kingdom*, be chargeable to tax under this section
> [b] by reference to relevant income which is such that if he had received it he would not, by reason of his being so domiciled, have been chargeable to income tax in respect of it; and
> [c] subsections (6) to (9) of section 65 shall apply for the purposes of this subsection as they would apply for the purposes of subsection (5) of that section if the benefit were income arising from possessions outside the United Kingdom.

The foreign domicile defence applies if the benefit is not received in the UK.
The defence is only that such benefits are not charged *by reference to relevant income which meets the necessary requirements*. I shall call that income "excluded relevant income". If there is other relevant income then the benefit received outside the UK can still be charged by reference to that income. Thus the defence is not a complete defence to a charge on benefits received outside the UK.

13.28 Where is a benefit received?

The section requires one to identify where a benefit is received (or at least, whether it is received in the UK). But to identify the place of receipt of a benefit is as hard (or harder) as to identify the situs of property, the source of income, or a remittance of income, problems to which the courts have never found wholly satisfactory answers.

Where the benefit is the outright transfer of an asset, it is suggested that the benefit is received in the place where the asset is situate under the private international law *situs* rules. If the benefit is money paid to a beneficiary's account it is received in the place where the account is kept. If the benefit is the transfer of a debt (or shares) it is received where the debt or shares are situated.

13.28.1 *Receipt of asset outside UK and subsequent remittance*

Suppose:

(1) an individual receives a benefit in the form of the transfer of money (or a chattel) outside the UK, and

(2) later remits that money (or chattel) to the UK.

(The deemed remittance rules discussed below do not apply.) It is considered that the foreign domiciliary's defence ceases to apply and the benefit becomes taxable under s.740. Michael Flesch QC has argued that all that matters is the place of receipt at the time the benefit is conferred and a subsequent remittance is irrelevant:

> This is because the only benefit Mr. X received was received by him, from the company, *outside* the UK. When, three months later, Mr. X brought the money to the UK he was merely transferring money he already owned from one bank account to another. And that is not, in my view, the receipt of a benefit within section 740(5).
> Putting it another way, just as one cannot step into the same river twice, so too one cannot receive the same benefit more than once.[53]

This view is hard to sustain for the following reasons:

(1) One cannot receive the same benefit twice (in the sense that the second receipt is not a new benefit), but one can receive one benefit in different places (and the second receipt is the receipt of the old benefit in the UK). The issue is, perhaps, what is the benefit. Flesch regards the benefit as the *transfer* of the asset, not the asset itself. The transfer can only happen once. However, it is equally possible to say that the benefit is not the *transfer*, it is the *asset* transferred.

(2) The wording in s.740(5) is comparable to (and based on) the wording in the Schedule D Case V remittance basis: s.65(5) ICTA 1988 ("sums received in the UK in the year of assessment"). It is clear that

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53 *GITC Review* Vol 1 Issue 2, p.16, accessible *www.taxbar.com*. Heraclitus' *dictum* about the river is also highly debatable.

those words cover a receipt outside the UK and subsequent remittance.

(3) The Flesch view would make the charge easy to avoid by arranging a receipt outside the UK followed by a remittance to the UK. It requires a degree of literalism to which the Courts do not subscribe.

(4) My view is more consistent with the application of the deemed remittance rules to the s.740 foreign domicile defence; see below.

Suppose:

(1) an individual receives a non-UK situate asset;

(2) the individual sells the asset and remits the proceeds.

The benefit is received in the UK and the s.740 foreign domicile defence ceases to apply.

13.28.2 *Receipt of asset outside UK used to repay debt or used as security*

What happens if a benefit is received outside the UK and used to repay a UK-linked debt?[54] This question takes us to s.740(5)[c]. This incorporates by reference s.65(6) to (9) (the deemed remittance rules)[55] on the counterfactual assumption that the benefit was income arising from possessions outside the UK, i.e. income taxable under Schedule D Case V. Once amended as s.740(5)[c] requires, section 65(6) provides (so far as relevant):

> For the purposes of [section 740] any [benefit] which is applied outside the United Kingdom by a person ordinarily resident in the United Kingdom in or towards satisfaction of [a UK-linked debt] shall be treated as received by him in the United Kingdom ...

A benefit in the form of money received outside the UK and used to repay

54 I.e. a debt for money lent (or lent outside the UK and later received in the UK); see 7.40.1 (UK-linked debt).

55 See 7.40 (Deemed remittances).

a UK-linked debt is "treated as received in the UK". So it will no longer qualify for the protection of the s.740 foreign domicile defence.

13.28.3 *Interest free loan*

Where is the benefit of an interest free loan received? The possible solutions are:

(1) where the money lent is originally received (ignoring what happens later);

(2) where the money lent is held for the time being;

(3) where the debt is situate.

The main objection to solutions (1) and (2) is that the benefit is not money lent, it is the interest foregone.[56] Strictly that benefit is not received anywhere, but just as every intangible asset has a situs, so every intangible benefit can have a place of receipt attributed to it. It is suggested that the best solution is that the benefit is received where the debt is situate.[57]

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.

13.28.4 *Rent free use of chattel or land*

The position is different if the benefit is rent free 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

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56 A further objection to solution (1) is that it only makes sense on the basis of the Flesch view (rejected above) that one cannot remit a benefit. A further objection to solution (2) is the problem of where the benefit of the interest-free loan is received after the money is spent. One could say that the benefit is (presumably for ever after) received where the money is spent, but this is very artificial, and only raises further imponderable questions to identify the place where the money is spent.

57 Another possible solution is to ask where the situs of the source of the interest would be for IT purposes if interest were payable. But since interest is not payable this would be a difficult hypothetical question to answer.

chattel is for the time being.

13.28.5 *Release of loan*

Suppose:

(1) money is lent to a beneficiary at a commercial rate (not a benefit);

(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) 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 release of a debt which is not a debt for money lent.

13.29 Excluded relevant income

"Excluded relevant income" is my term for :

> relevant income which is such that if he [the foreign domiciled UK resident individual] had received it he would not, by reason of his being so domiciled, have been chargeable to income tax in respect of it.

This applies the same counterfactual hypothesis as s.739.[58]

The following is not excluded relevant income:

(1) UK source income, or

(2) Irish source income;

(3) foreign source income which has been received in the UK (while the

58 See 12.16 (s.739 foreign domicile defence).

source of the income still exists).

As noted, to the extent that there is income of that kind, the s.740 foreign domiciliary defence will not apply.

13.29.1 *Source ceasing*

Suppose:

(1) a trust has foreign source income (which is excluded relevant income);

(2) the income is remitted.

The income ceases to be excluded relevant income. If the source ceases in a year before remittance, however, the income clearly remains excluded relevant income.

13.29.2 *Section 739 and 740 foreign domicile defences compared*

Sections 739 and 740 both offer a form of foreign domicile defence. The s.740 defence is less generous. So a transferor (liable under s.739 but not s.740) may be in a better position than other beneficiaries (liable under s.740)!

13.30 Summary of responses to s.740

13.30.1 *Basic planning*

(1) Avoid "relevant income" by

  (a) distributing income:
    (i) as it arises; or
    (ii) in a year before a beneficiary receives a benefit; or

  (b) using interest in possession settlements in preference to discretionary; or

  (c) not using trusts and companies where inappropriate.

(2) Tax Motive Defence.

(3) Foreign Domicile Defence.

(4) Where the settlor is UK resident and has an interest, the defence that section 739 applies so there is no "relevant income" within s.740.

(5) Arrange that foreign domiciled beneficiaries receive benefits of an *income* nature (outside s.740 and not taxed on the remittance basis).

13.30.2 *Sale of equitable interest scheme*

The following arrangement may be worth considering:

(1) An appointment confers a valuable equitable interest on a foreign domiciled beneficiary, B.

(2) B sells the equitable interest for a capital sum.

Neither the conferring nor the sale of the interest is a benefit within s.740: see 13.4 ("Benefit"). CGT may be avoided if the sale involves the disposal of a non-UK situate asset: see 35.24 (Situs of equitable interest under a trust). Take care on implementation!

13.31 Transfers between settlements

Section 90 TCGA 1992 provides a code dealing with transfers between settlements for the purposes of section 87 TCGA 1992. This is needed because "trust gains" are computed by reference to "settlements". Each settlement has a notional amount of "trust gains".

Section 740 by contrast has no such need. Relevant income is *not* computed by reference to settlements. It is computed by reference to a transfer and associated operations.

Example

(1) A settlement within s.740 has a pool of relevant income.

(2) The trustees transfer one half of the trust fund to a new settlement on

similar terms.

None of the relevant income in relation to beneficiaries ceases to be relevant income. It can still be used for the benefit of all the beneficiaries. For s.740 purposes, nothing has changed. The transfer to the new settlement can simply be disregarded.

CHAPTER FOURTEEN

TRANSFER OF ASSETS ABROAD: DOUBLE TAXATION ISSUES

14.1 Undistributed UK taxable income of offshore company

Suppose an offshore company ("OC") receives and retains UK taxable income,[1] say, rental income. If s.739 did not apply, there would be one charge to tax: income tax borne by OC. However, if s.739 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.

(2) The transferor ("T") pays income tax on the same income under section 739.

What is there to prevent double taxation?

14.1.1 *Section 743(1) credit*

Section 743(1) provides some relief for T:

> Income tax at the basic rate, the lower rate or the Schedule F ordinary rate shall not be charged by virtue of section 739 in respect of any income to the extent that it has borne tax at that rate by deduction or

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1 OC's income may be UK taxable because:
(1) the income has a UK source; or
(2) OC is a UK resident foreign incorporated company (rare in practice).
For the purposes of this section, this makes little difference. (Of course it makes a difference for OC's capital gains.) For simplicity it is assumed in the discussion that OC is non-resident and OC's income has a UK source.

otherwise ...

I refer to this as section 743(1) credit. This was considered in *R v Dimsey & Allen* 74 TC 263 at para.53:

> This provision would have dealt with the case where the transferee's income included income sourced in the United Kingdom 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.[2]

14.1.2 *The Dimsey concession*

The limitation of s.743(1) credit was explained in *Dimsey & Allen* at para.56:

> Section 743(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 739(2), the transferor has paid tax on his deemed income.

In the course of argument in *Dimsey & Allen* the Revenue announced a concession to solve this problem:

> **The Inland Revenue's Practice on section 739**
> If in any case tax is paid by the transferee, the Inland Revenue will give credit for that tax against any charge to tax on the transferor under section 739 ICTA 1988 on the same income; and conversely, if in any case tax is paid on any income by the transferor under section 739, the Inland Revenue will not tax the transferee on that income. So that in every case, the Treasury received in all the full amount of tax chargeable on the transferor as if he were the only person liable.

I refer to this as the *Dimsey* concession. The consequence is that either:

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2 At paragraph 55 Lord Scott suggested (without deciding) that this provision would also give relief in circumstances where OC was a UK resident foreign incorporated company even though such a company would be subject to corporation tax (rather than income tax). Since the Revenue would give this relief in practice under the *Dimsey* concession, the point will not need to be decided.

(1) T pays all the tax on the income (and OC pays none); or

(2) (a) OC pays tax (usually basic or Schedule F lower) rate tax; and

(b) T has the credit for OC's tax (so he usually pays higher rate tax only).

This concession does not say whether (1) or (2) is to be the case. As far as the Revenue 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.[3] One can imagine a situation where T and OC each ask the Revenue to assess the other! There is no mechanism for any tax paid by T to be recovered from OC or vice versa. The Revenue have a broad discretion, subject to judicial review if they act unreasonably. How in practice should the Revenue collect tax? It is suggested that the Revenue's starting point should be that tax is to be borne by OC where tax is reasonably collectible from OC, i.e. if:

(1) the income is Schedule F income subject to the tax credit (in this case, of course, no one has any choice about the matter);

(2) tax is collectible under the non-resident landlord regulations, i.e. if OC complies with its duties under those regulations; or

(3) OC is prepared to complete UK tax returns and pay the tax on its income.

It is fair that OC, which receives the income, should pay the tax on it. Then only higher rate tax is normally collected from T. Only in cases where OC refuses to pay should all the tax be collected from T.

It is arguable that section 744 also provides a defence to double taxation: see 14.5 (Section 744 relief). If this is correct, the *Dimsey* concession is the law. There is little practical difference between this and the *Dimsey*

3 For instance, if OC owes him a small debt.

concession.

14.1.3 *Section 739(2) defence to double taxation?*

Section 739(2) deems the income of OC to be that of T "for all the purposes of the Income Tax Acts". It should follow that OC is not taxed on its income; hypothesising (as one must) that the income is that of T, it is not possible that the sum could be in the hands of OC. The *Dimsey* concession would be unnecessary and its associated difficulties would not arise. This argument was rejected in *Dimsey & Allen*.

14.2 Distribution to T of income of company within section 739

So far we have been considering undistributed income of OC. I now turn to consider the position where the income is distributed to T by way of dividend. Suppose:

(1) An offshore company ("OC") within section 739 receives income ("OC's income").

(2) T owns all the shares in OC.[4]

(3) The income of OC is distributed by way of dividend to T ("the dividend income").

Possible charges to tax here are:

(1) IT on OC's income paid by T (or by OC and T but with credit to avoid double taxation: see above) under section 739.

(2) IT on the dividend (paid by T) under Schedule D Case V.

Is there any relief from economic double taxation?

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4 The position is not materially different if the shares in OC are held in a trust under which T is life tenant.

14.3 Section 743(4) relief

Section 743(4) provides:

> Where
> [a] an individual has been charged to income tax on any income deemed to be his by virtue of section 739 and
> [b] *that income* is subsequently received by him,
> it shall be deemed not to form part of his income again for the purposes of the Income Tax Acts.
>
> (Paragraphing and emphasis added)

I refer to this as s.743(4) relief. There are three conditions for this relief to apply:

(1) The individual is charged to income tax on OC's income under section 739.

(2) The individual receives the income.

(3) The dividend income which the individual receives is "that income", i.e. the same income as OC's income.

Condition (1) would normally be satisfied; see 14.1 (Undistributed income of OC). Condition (2) is obviously satisfied; condition (3) is satisfied: see 14.6.2 (When is income "the same" for s.743(4)?). Thus, even though OC's income is distributed to T:

(1) there is only one tier of income tax, the charge under s.739.

(2) T has the benefit of tax credits or DT Relief relating to OC's income.

At first sight this seems anomalous. If s.739 did not apply (e.g. because the individual owning OC was not the transferor or because the motive defence applied) then the position is quite different:

(1) there will be two charges to tax if OC's income is UK source:

(a) income tax on OC's income paid by OC under ordinary principles; and

(b) income tax on the dividend paid by T under Schedule D Case V.

(2) T does not have the benefit of tax credits and DT Relief relating to OC's income.

On reflection, there is no anomaly. The object of s.739 is to put the transferor in the same position as if he had not made the transfer: see *Chetwode v IRC* 51 TC 647.

14.3.1 *Identifying income qualifying for s.743(4) relief*

It may happen that the income of OC for company law purposes is greater than the income of OC for tax purposes (e.g. because of capital allowances). Section 743(4) relief applies only so far as the income of the company has been subject to tax under s.739. For example, if 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 section 739.

(2) IT on the dividend on the amount of 90 (i.e. 100–10) under Schedule D Case V.

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 s.743(4) 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.739 income. The position is analogous to the *Duke of Roxburghe* case; see 7.35 (Remittance from mixture of taxed and untaxed income).

14.3.2 *Planning implications: advantages of distribution and re-settlement*

It follows that where a s.739 charge arises[5] it is worthwhile distributing income to T and letting T re-settle the income if he wishes. If this is not done during T's life, the opportunity is lost later; see below.

14.4 Distribution (*not* to T) of income of company within section 739

Suppose:

(1) An offshore company ("OC") within section 739 receives income ("OC's income").

(2) T is not a shareholder in OC but has "power to enjoy" the income;[6]

(3) P (a UK resident third party) owns all the shares;[7]

(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.739.

(2) P is subject to tax on the dividend.

Section 743(4) relief does not help P because that relief only applies where OC's income is subsequently received by the transferor, T. The *Dimsey* Concession does not cover this situation.

14.5 Section 744 relief

Section 744(1) provides:

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5 I.e., T is UK domiciled or T is foreign domiciled but income has a UK source.

6 He may have power to enjoy by reason, perhaps, of a debenture or through being a beneficiary of the trust which holds OC.

7 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.660A ICTA 1988 does not apply.

> No amount of income shall be taken into account more than once in charging tax[8] under the provisions of sections 739 and 740; and where there is a choice as to the persons in relation to whom any amount of income can be so taken into account—
>
> (a) it shall be so taken into account in relation to such of them, and if more than one in such proportions respectively, as appears to the Board to be just and reasonable; and
>
> (b) the jurisdiction of the Special Commissioners on any appeal against an assessment charging tax under those provisions shall include jurisdiction to review any relevant decision taken by the Board under this subsection.

I refer to this as s.744 relief. This provision prevents double taxation:

(1) By double applications of s.739; e.g. where there are two transferors.

(2) By double applications of s.740; e.g. where two different individuals receive benefits.

(3) By applications of s.739 and s.740.[9]

(4) It is suggested that it should also be read to prevent double taxation under general principles and under ss.739 and 740.

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8 Section 744(2) defines the "amount of income taken into account in charging tax" as:

> "(a) in the case of tax which under section 739 is charged on income, to the amount of that income;
>
> (b) in the case of tax charged under that section by virtue of section 743(5), to an amount of the income out of which the benefit is provided equal to the amount or value of the benefit charged;
>
> (c) in the case of tax charged under section 740, to the amount of relevant income taken into account under subsection (2) of that section in charging the benefit."

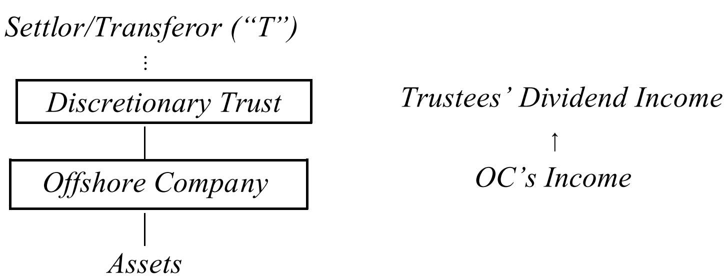
9 Although the words in s.744 *could* be construed to apply to situation (3) only, that would be absurd. (Indeed, it is unusual that income could be taxed under s.739 and s.740. An example might be if income accrues which is not within s.739 because it is not remitted to the UK, then there is a charge under s.740, and then there is a remittance.) Another example might possibly be if s.739(2) does not apply (because the transferor has no "power to enjoy") but subsequently there is a capital payment within s.739(3).

Although Lord Greene in *Howard de Waldon* contemplated that there would be economic double taxation in these circumstances, that was before the enactment in 1981 of (what is now) section 744.

In practice this situation is rare as T either has no "power to enjoy" and so is outside s.739, or else he is life tenant/shareholder and receives the dividends personally and section 743(3) relief applies.

14.6 Section 739 trust/company and company/subsidiary structure

So far we have been considering the (relatively) simple situation where OC is held by an individual (or an IP trust). We now turn to consider the position where OC is held by a non-resident discretionary trust. That is, trustees of a discretionary trust within s.739 and s.660A hold a non-resident company within s.739:



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.739 at stage (1);

(2) the trustees' dividend income charged under s.739 or s.660A at stage (2).

What is there to prevent double taxation?

14.6.1 *Section 743(4) relief*

It will be recalled that section 743(3) applies if:[10]

(1) OC's income is within s.739;

(2) the trustees' dividend income is received by T;

(3) the trustees' dividend income is "that income" (i.e. the same income as OC's income);

(4) the individual is charged to income tax on OC's income under section 739.

Condition (1) is satisfied. Condition (2) is satisfied because income is treated as received by T.

14.6.2 *When is income "the same" for purposes of s.743(4)?*

At first sight condition (3) is more doubtful.

OC's income and the trustees' dividend income 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": *Vestey v IRC* 54 TC 562 but this was reversed by the House of Lords.[11]

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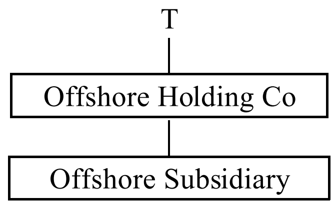
10 See 14.3 (Section 743(4) relief)..

11 For another case where the Court looked at the economic substance in order to determine whether or not two assets were "the same" (for the purposes of stamp duty subsale relief) see *Fitch Lovell Ltd v IRC* [1962] 1 WLR 1325. This is supported by an obiter dictum in *Howard de Walden v IRC* 25 TC at 131, decided in 1940. Lord Greene MR said:

> "One further point taken by Mr. Tucker may be mentioned. He 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 Mr. Tucker, involves double taxation since no relief is afforded by [what is now] s.743(3). 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

This is supported by *Aykroyd v IRC* 24 TC 515. The facts were relatively simple. T (UK domiciled) held an offshore holding company (within s.739) which held an offshore subsidiary (within s.739):[12]



(1) In 1936/7 the offshore subsidiary received income within s.739 ("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 company's income"). This income was also within s.739.

(3) The transferor ("T") was assessed on the offshore holding company's income in 1937/8. He was not assessed on the offshore subsidiary's income in 1936/7.

This was not a trust/company structure but a company/subsidiary structure, but in the context of s.743(4) relief the issue is the same.

T argued that he could be assessed at stage (1) and so he could not be assessed at stage (2). He relied on (what is now) s.743(4) relief. Macnaughten J accepted (rightly) that the relief could apply to the sequence of two dividends:

> companies being another. But quite apart from this, the argument based on hardship leaves us unmoved. The son will bear tax in the ordinary way upon his own income, the father will be taxed on the companies' income because he is the person against whom the deterrent action of the Section is directed."

This ignores the obvious purpose of s.743(4) which is directed at economic double taxation. This is also inconsistent with the view taken in *Aykroyd*. It is inconsistent with present Revenue practice. One might uncharitably describe this as wartime jurisprudence; "as we are at war", as Darling J said in another context, "the ordinary mode of construing legislation has been suspended"; cited "*R v Halliday* in Retrospect" [2003] LQR 455 (David Foxton).

12 More accurately, there were several holding and subsidiary companies but nothing turns on that.

> If the Appellant had in fact been charged in the year 1936–37, he could not have been charged again in the year 1937–38.

That is, the income of the offshore holding company was the same income as the income of the offshore subsidiary.

14.6.3 *When is an individual "charged to tax" under section 739?*

The next requirement of s.743(4) is that the individual must be "charged to income tax on income deemed to be his under section 739". In *Aykroyd* T failed because he had not been so "charged":

> It was suggested that, if the [offshore subsidiary's income] were liable to assessment for the year 1936–37, that provision [s.743(4)] prevented them being chargeable in the following year. But that argument depended on the substitution of the word "chargeable" for the word "charged". There is no ground that I can see for making any such substitution. ... as he had not been charged in the previous year, there was nothing to prevent him being charged in the year in question.

This is not obiter, but it is at first sight surprising and it certainly does not appear from the Judge's terse comment that the Court had the benefit of a full argument on the point.

Is it right? The word "charged" (like most words) must to some extent take its meaning from context. It may mean:

(1) declaration of liability by statute;

(2) assessment (including self-assessment);

(3) payment.[13]

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13 These correspond to the three stages in the imposition of a tax:

> "there is the declaration of liability, that is the part of the statute which determines what persons in respect of what property are liable. Next, there is the assessment. ... assessment particularises the exact sum which a person liable has to pay. Lastly, come the methods of recovery, if the person taxed does not voluntarily pay."
>
> *Whitney v IRC* 10 TC 87 at 109.

The most common and primary sense of the word "charged" is that it refers to the declaration of liability. Every year, for instance, the FA provides that income tax shall be charged for that year: see e.g. s.31 FA 2000. This is the statutory declaration of liability. It is not referring to the making of assessments or collection of tax.

However, this meaning poses impractical difficulties for the Revenue who may not know that a s.739 liability arises or may be unable to make an assessment. So the *Aykroyd* interpretation that "charged" means "paid" is probably correct.

This does not mean that the Revenue have an unfettered discretion:

(1) to assess T on the subsidiary company's income; or

(2) to assess T on the holding company's income.

Under self-assessment, T will normally self-assess his income and should in principle return the income of the offshore subsidiary as his income and s.743(4) relief applies. However, where T does not pay tax due on the offshore subsidiary's income the Revenue can collect tax on the offshore holding company's income and s.743(4) 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.739 applies. Is the transferor taxed under s.739 in respect of the subsidiary's income or the holding company's income? This may affect:

    (a) rates of tax, e.g. if the underlying company receives interest or rental income it makes a difference between:

        (i) 40% (higher rate due on interest); and

        (ii) 32.5% (Schedule F upper rate on a foreign dividend);

    (b) availability of s.743(1) credit for UK tax paid by the company and double tax relief.

(2) It may also affect the year in which the income is subject to tax.

14.6.4 *Section 744 relief to double taxation*

This provision is discussed in 14.5 (s.744 relief). It will apply in a s.739 trust/company or company/subsidiary structure but where s.743(4) covers the same ground it should not be needed.

14.6.5 *Trust/company structure: Revenue practice*

RI 201 provides:

> where income arises in an offshore company underlying a settlement and income is not paid up immediately to that settlement the provisions of section 739 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.739 will be invoked. This is clearly correct. It is suggested that a dividend of the same income by OC will not be taxed again (though RI 201 does not expressly address this issue).

(2) *If the income is paid up immediately*. RI 201 implies that:

   (a) s.739 will not be applied so OC's income (if non-UK source) will not be taxed; and

   (b) the income of the trustees will be taxed 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 the Revenue have a discretion? Does the answer depend on the type of income? One must bear in mind that some forms of income cannot be quantified until the end of an accounting period (e.g. trading and rental income).

This is a sorry muddle. In practice, the author suspects that the Revenue 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.

14.6.6 *Trust/company structure: further example*

In the trust/company structure illustrated at 14.6 (Section 739 trust/company structures) the company:

(1) receives £100 income;

(2) spends £20 of the £100 it received on expenses (not deductible for the purposes of s.739); 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 the Revenue 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.

14.7 Other occasions of double taxation

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. He was not taxed on the income accruing to the insurance company as the motive defence applied. Had the defence failed, there would have been double taxation:

(1) T would pay income tax on income arising to the life insurance company (to the extent that it arose in consequence of T's premium); and

(2) T would pay income tax on the gain arising from the policy under the chargeable events provisions.

The Special Commissioners noted correctly that s.743(4) provided no relief. The gain was not the same as the income. The potential for double taxation is one reason for applying the motive test generously.

The decision records that the Revenue offered relief against double taxation: see at p.83. It appears from this and other examples in this chapter that the Revenue are, generally, willing to offer such concessions at least if it is thought to give them a tactical advantage in litigation.

14.8 Section 740 charge followed by income distribution

I now turn to consider double taxation issues relating to s.740. Section 743(1) credit, the *Dimsey* concession and s.743(4) relief only apply to s.739, so they have no relevance here.

Suppose:

(1) trustees of a trust receive income and do not distribute it;

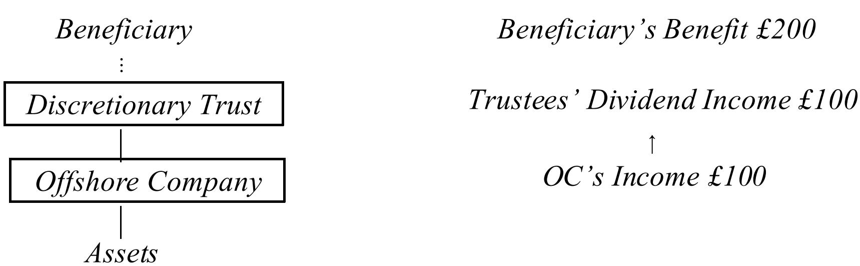
(2) a beneficiary receives a benefit taxable under s.740;

(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 the s.744 relief applies here.

14.9 Section 740 trust/company structure[14]

The problem is best illustrated by example:



Trustees of a discretionary trust within s.740 hold a non-resident company within s.740.

14 Contrast 14.6 (s.739 trust/company structure).

(1) £100 income is received by the company ("the company's income" at "stage (1)").

(2) The £100 is paid to the trustees as dividend income ("the trustees' dividend income" at "stage (2)").

Is the relevant income £100 or £200? That is, does the interposition of the company double the relevant income? If so, then if after stage 2 a beneficiary receives a benefit of £200 the s.740 charge is in principle on £200.

It is tentatively suggested that the answer is, no, for two reasons:

(1) If the company's income is distributed it ceases to be relevant income.[15]

(2) The s.744(1) defence applies; see 14.5 (Section 744 relief).

14.10 Double Taxation Relief: Treaties

On this topic see "Double Taxation Treaties: the Antidote to Anti-avoidance Provisions", Robert Venables QC, OTPR Vol 6 p.151.

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15 This argument will not avail if the facts are a variant of the above example:
(1) £100 income is received by the company; a beneficiary receives a benefit of £200.
(2) The £100 is subsequently paid to the trustees as dividend income.

CHAPTER FIFTEEN

TRANSFER OF ASSETS ABROAD: MOTIVE DEFENCE

15.1 The statute

Section 741 ICTA 1988 provides that ss.739 and 740 (the transfer of asset provisions) shall not apply if either:

> (a) the purpose of avoiding liability to taxation was not the purpose or one of the purposes for which the transfer or associated operations or any of them were effected; or
> (b) the transfer and any associated operations were bona fide commercial transactions and were not designed for the purpose of avoiding liability to taxation.

This is sometimes called "the motive defence".[1] There are two tests, and the taxpayer need only satisfy one of them. They are here called test (a) and test (b).

15.2 Enactment history

The original wording was much simpler. It provided exemption if:

> the transfer and any associated operations were effected mainly for some purpose other than the purpose of avoiding liability to taxation.[2]

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1 The word "motive" is not used in s.741, but this label is convenient, not seriously misleading, and originates from the Board of Inland Revenue's Notes on clause 18 Finance Bill 1936.

2 s.18 FA 1936. Section 28 FA 1938 substituted the present text.

The Solicitor-General explained why the change was made:

> A taxpayer[3] transferred a large amount – he was not one of the small people for whom my hon. and learned Friend was pleading – of foreign securities to a trust company abroad on certain trusts under which the income was to be accumulated until the death of the taxpayer. There was a discretion to the trustees to pay certain portions of the income to the taxpayer or to his son. The deed gives to the taxpayer and his son power, with the consent of the trustees, to revoke the trust, or, alternatively, they can withdraw all or any part of the trust property for their own benefit. The trust income has been accumulated, and none of it has been distributed. The vigilant Revenue authorities pursued this taxpayer, and he contended, successfully, as it transpired, on appeal, that the foreign trust was born because of his fears as to the financial position of this country and the dangers of the situation on the Continent ... in 1936. He stated that he wanted to find a stable country where he could make safe provision for his family. The Special Commissioners decided that the main purpose of the transaction was occasioned by A's pessimistic view of the European situation at the time; that, arising out of that, his main intention was to make provision for his family in a safer country; and that, if there was any intention of avoidance of taxation, it was incidental to the main purpose. They therefore decided that there was no liability under Section 18 FA 1936. That instance has only to be cited to the Committee for the Committee to realise that on this particular matter the hon. Member for Chesterfield (Mr. Benson) was a true prophet in 1936, when he said that the word "mainly" would be too wide.[4]

A case on similar facts might still succeed today, but the test is stiffer. The taxpayer would need to show:

(a) tax avoidance was not even one of the purposes of the transfer (test a); or

3 Presumably a UK resident and domiciled transferor. The Revenue did not contend at that time that (what is now) section 739 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 the Revenue found the case troubling.

4 Hansard 27 June 1938, col 1610. It is impressive that an income tax dispute relating to 1936/7 was resolved by a Special Commissioners' decision early in 1938.

(b) the transfer was "*bona fide* commercial" (test b).

15.3 *Bona fide* commercial

Bona fide commercial is a requirement for test (b) but not test (a). Several cases acknowledge the difficulty of the word "commercial",[5] and the epithet "bona fide" does not make it any clearer.[6] It is submitted that there is no single factor to determine what is "commercial" but a number of factors may indicate one way or the other.

15.3.1 *Non-business transactions*

In *Carvill v IRC* the Special Commissioner ventured this explanation:

> There was not much difference between the parties about what constituted a bona fide commercial transaction. Miss Gloster contended that this was any genuine transaction which implements or facilitates a business end; Mr. Vallance contended that the transaction must be in furtherance of commerce, ie a trade or business. I shall follow these two meanings.[7]

This is a fair 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

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5 *IRC v Plummer* 54 TC 1 at 48: "What exactly is comprehended in the phrase ... 'a bona fide commercial transaction', I do not know." (Viscount Dilhorne) Cf *IRC v Goodwin* 50 TC 583 at 598.

6 The Latin tag is ambiguous. "Bona fide" can mean "not a sham" but then the words obviously add nothing. It could perhaps mean "honest" so as to exclude fraudulent non-criminal transactions such as a transaction defrauding creditors, or criminal (but otherwise commercial) transactions such as money laundering, drug dealing or sanctions busting; but that is not likely to be the purpose of the words. It is suggested that the words are what linguists call "a mere intensifier", an appellation that the OED gives to some round Anglo-Saxon words which also begin with "b" and "f". "Bona fide" commercial means "truly" commercial. Its significance is to alert the reader that the drafter thought that there was a particular risk of false or weak claims that a transaction was "commercial". The tax law re-write is replacing "*bona fide*" with "genuine" which will have the same effect. I refer hereafter to "commercial" transactions and leave "bona fide" to be understood.

7 [2000] STC (SCD) 143 at 166.

be classified as commercial because they are not in furtherance of a business. One is the transfer of securities to a trust to avoid the hazards of war, discussed in 15.2 (Enactment history). Another example is a transfer to avoid claims by non-business creditors, e.g. a claim on divorce or forced heirship. These transfers may involve an element of bounty (and may be classified as non-commercial for that reason) but in any event they should be classified as non-commercial transactions because they are not in furtherance of a business purpose.

15.3.2 *Making and managing investments*

In the Revenue view:

> The expression "bona fide commercial" in Section 741(b) is taken to apply [1] only to the furtherance of trade or business, and [2] not to the making or managing of investments.[8]

The proposition that the expression "commercial" applies to the furtherance of trade or business is not controversial. The proposition that "commercial" does *not* apply to making or managing investments is doubtful:

(1) The statement does not say what the position is if the making or management of investments constitutes a business. A transfer may be both in the furtherance of a business *and* in the course of making or managing investments.[9] Should this (difficult) concept of business mark the border of what is commercial?

(2) More fundamentally, and contrary to the Revenue statement, making

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8 (RI 201, paragraphing added). This was perhaps the view of the drafter of s.703(1) ICTA 1988 which refers to transactions:

> "*either* for bona fide commercial reasons *or* in the ordinary course of making or managing investments."

(Emphasis added). But the last 9 words might have been added for the avoidance of doubt, or for some exceptional case, and it is not clear whether the drafter thought that making or managing investments would not usually be commercial.

9 Making or managing investments often constitutes a business. Thus s.105(3) IHTA 1984 refers to the business of making or holding investments; s.130 ICTA 1988 refers to the business of making investments.

or managing investments is generally regarded as "commercial". What can be more "commercial" than the management to maximise the return from investments? This criticism is recognised in *Lewis v IRC* [1999] STC (SCD) 349 at 362:

> It is trite law that in exercising their duties trustees must use as much diligence as a prudent man of business would exercise in dealing with his own private affairs ... 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.

15.3.3 *Transfer with element of bounty*

A transaction with an element of benevolence or bounty is not commercial.[10] The concept of bounty (unlike "commercial") is relatively clear.[11] For instance, a gift to a trust for the benefit of a settlor's family is

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10 *Bulmer v IRC* [1967] Ch 145, cited *IRC v Goodwin* 50 TC 583 at p.607. The Revenue adopt this approach in Venture Capital Schemes Manual para 12140:

> "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 would 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 would clearly not be a commercial subscription. Similarly, if the company is owned by a person whom the investor wishes to benefit, and the investor pays a large premium for the shares with the object of increasing the value of the other person's shares, that too would not be a commercial subscription."

Ambrose Bierce makes the same point: "A commercial pursuit is one in which the thing pursued is the dollar." *The Devil's Dictionary*, (definition of "Merchant").

11 The question does arise from whose viewpoint one assesses "bounty" or commerciality. The answer is that it should be looked at from the viewpoint of the transferor, but it would be a rare case where there is an arrangement under which one party is and the other party is not acting bounteously or commercially. In *IRC v Willoughby* the Special Commissioners found that Professor Willoughby's investment in bonds for his pension was commercial. In this case the Revenue 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

not commercial. The same applies if the class of beneficiaries includes the settlor and the trust is revocable. By contrast, a transfer of assets to a company wholly owned by oneself may be a "commercial transaction" even if the transfer is for less than full (or nil) consideration, and a transfer to an employee trust may be commercial.[12]

15.4 "Avoidance", "mitigation", "tax reduction", "evasion": introduction[13]

I begin with a fourfold categorisation:

(1) *Tax evasion*: Conduct which constitutes a criminal offence (fraud on the Revenue or similar offences). This normally involves dishonest submission of an incorrect tax return. Dishonesty is essential to the offence.

(2) *Honest misdeclaration*: The submission of an erroneous tax return without dishonesty. Those involved may be culpable (guilty of neglect or wilful default) but not dishonest.

(3) *Tax avoidance*: Arrangements that reduce tax liability in a manner contrary to the intention of Parliament (I come later to consider this concept in more detail).

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."

70 TC at 86. The point was not discussed on appeal.

12 This is supported by *Wannell v Rothwell* 68 TC 719 at 733, a case on s.384 ICTA 1988 which uses the word "commercial"; and *IRC v Levy* 56 TC 68. *Levy* is a case on s.660A ICTA 1988 which does not use the word "commercial" but the Courts at one time proposed to read in a gloss to the effect that the concept of "settlement" for the purposes of s.660A excluded commercial transactions. (In *IRC v Plummer* 54 TC 1 Lord Wilberforce rejected this gloss, though some subsequent cases have nevertheless regarded it with favour. We need not be concerned with that here: what matters is the sense which the Courts gave to the expression commercial when they used it.)

13 For further reading, see Nabil Orow, *General Anti-Avoidance Rules* (Jordans, 2000). This has an extensive bibliography.

(4) *Tax mitigation*: Conduct which reduces tax liabilities without "tax avoidance" (not contrary to the intention of Parliament).

The distinctions between these concepts (especially avoidance/evasion and avoidance/mitigation distinctions) are now commonplace. They may appear obvious. They are taught to every student. No policy debate would be possible without them. However, all four concepts and their associated terminology have only emerged after a gradual process of development. It is essential to bear this in mind on reading sources on this subject.[14]

15.4.1 *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)[15]. In 1900 the distinction was noted as two meanings of the word "evade".[16] The technical use of the words avoidance/evasion in the modern sense originated in the USA where it was well established by the

14 e.g., the 1920 Royal Commission on the Income Tax discussed evasion, honest mis-declaration and avoidance in one chapter headed "The Prevention of Evasion". In this discussion the words "avoidance" and "evasion" were used quite indiscriminately. See Cmd. 615 para 625. It is an interesting question whether the absence of terminology hampered a discussion of the issues or whether a lack of discussion or interest led to the absence of suitable terminology. I suggest the latter: in the 1920s, criminal prosecution for tax evasion was rare, and only in blatant cases. Thus the avoidance/evasion distinction was not relevant. Likewise, tax avoidance (in the modern sense) was then still in its infancy so the avoidance/mitigation distinction also had little relevance.

15 *Fisher v Brierly* (1860) 1 de G F&J 643 at 663. It is a pity this terminology did not catch on because it is much more transparent than avoidance/evasion.

16 *Bullivant v AG* [1901] AC 196 at p. 207:

> "The word 'evade' is ambiguous. ... there are two ways of construing the word 'evade': one is, that a person may go to a solicitor and ask him how to keep out of an Act of Parliament – how to do something which does not bring him within the scope of it. That is evading in one sense, but there is nothing illegal in it. The other is, when he goes to his solicitor and says, 'Tell me how to escape from the consequences of the Act of Parliament, although I am brought within it'. That is an act of quite a different character."

1920s.[17] 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".[18] A discussion of evasion in the modern 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 the law reports and elsewhere, at least up to the 1970s.[19] Only now that

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17 It is found in the scholarly *Minimising Taxes* Sears, 1922, Vernon Law Book Co and can be traced to Oliver Wendell Holmes in *Bullen v Wisconsin* (1916) 240 U.S. 625 at p 630. It regarded as basic in *Tax Avoidance*, Dennis Hartman, Legal Publishing Soc, Washington (1930) which cites two textbook definitions in similar terms. The practice of tax avoidance was more advanced in the USA; the first published work on the subject in England was Jasper Moore, *The Saving of Income Tax Surtax and Death Duties*, Butterworths, 1935 (the publication of which lead to the enactment of s.739).

18 The 1955 Royal Commission Cmd. 9474 para 1016:
"It is usual to draw a distinction between tax avoidance and tax evasion. The latter denotes all those activities which are responsible for a person not paying the tax that the existing law charges upon his income. *Ex hypothesi* he is in the wrong, though his wrongdoing may range from the making of a deliberately fraudulent return to a mere failure to make his return or to pay his tax at the proper time. By tax avoidance, on the other hand, is understood some act by which a person so arranges his affairs that he is liable to pay less tax than he would have paid but for the arrangement. Thus the situation which he brings about is one in which he is legally in the right, except so far as some special rule may be introduced that puts him in the wrong."
Note that "evasion" is used here (unlike present usage) to describe dishonest criminal evasion and honest mis-declaration. Lord Templeman used this (by now old-fashioned) terminology in *IRC v Challenge Corporation* [1986] STC 548. "Tax evasion occurs when the commissioner is not informed of all the facts relevant to an assessment of tax. Innocent evasion may lead to a re-assessment. Fraudulent evasion may lead to a criminal prosecution as well as re-assessment."

19 More recent examples include: *Coutts & Co v IRC* [1963] 2 WLR at 1418; *Jamieson v CIR* (1963) 41 TC at p 70; *Cory v IRC* [1965] AC at 1107; *Greenberg v IRC* (1971) 47 TC 240 at 271: "Parliament attempted to prevent this and other methods of tax evasion by provisions in the Finance Act 1960." This usage seems to have stopped in the 1970's; at this time UK economists were "giving increasing attention to the subject of tax avoidance and evasion" (*Tax Avoision*, p 1, IEA 1979) and their work perhaps 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 terminology has received official approval in the UK[20] can this usage be condemned as erroneous.[21]

15.4.2 *Avoidance/mitigation distinction*

The clear[22] articulation of the *concept* of an avoidance/mitigation distinction goes back only to the 1970s[23] and the concept originated from economists, not lawyers. In 1973 C.T. Sandford wrote:

> A government may have one of three attitudes to a particular 'avoidance' measure – using the wide definition of avoidance. It may welcome it; the government may have deliberately offered a tax concession to promote some objective, e.g. tax concessions on mortgage interest, combined with the abolition of Schedule A income tax, in order to encourage owner-occupation; or investment and initial allowances to stimulate new investment in development areas. Second, without having sought positively to encourage a particular 'avoiding' action the government may find it entirely acceptable as when an income tax payer reduces his tax liability by taking a wife or having children; or when a person on retirement transfers savings from a building society to some other form of investment in order to reclaim income tax. Third, the

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The term "avoision" used in the IEA publication referred to was coined as a convenient term to mean avoidance/evasion. The book noted the lack of *economic* distinction between the two concepts; the economic similarity was the justification for the new coinage. (The book also noted the blurring of a moral distinction between the two concepts either because avoidance was not seen by some as moral or because evasion was not seen by some as immoral; the book did not suggest a lack of a legal distinction which was unquestioned then and still should be now.)

20 *Craven v White* (1988) 62 TC 1 at 197; OED 2nd edition (1989) entry under "Taxation."

21 For a recent example of erroneous usage, see *R v Charlton* [1996] STC 1418 at 1421.

22 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.

23 In 1946, Wrottesley J was unaware of it in a s.741 context: "There cannot, I think, be two opinions as to what 'avoiding' means. Where what is to be avoided is a liability, it must mean to evade, or to keep out of the way of, whether it be as in Richard III, 'The censures of the carping world', or anything else unpleasant that might befall a man, such as a tax": *Congreve v IRC* 30 TC 163. This is describing avoidance in the loose or etymological sense (including mitigation).

> 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'.*[24]

The use of the terminology avoidance/mitigation to *express* this distinction is an innovation of Lord Templeman in 1986.[25] The expression "tax avoidance" has very often been used in the loose sense, meaning or including mitigation[26]. The reason may be either that the author does not have any avoidance/mitigation distinction in his mind or (if he does) that he is not using the modern terminology to express it. Even now, the term "tax avoidance" is sometimes still used in a loose or etymological sense to include mitigation but nowadays this usage is often jocular, which suggests that the technical meaning is seeping into the public

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24 *Hidden Costs of Taxation*, IFS, 1973, page 113 (emphasis added). Sandford proposed a second requirement of "avoidance" which he related to the taxpayer rather than to the legislature:

> "It is reasonable to confine 'avoidance' to action which results in the would-be avoiders substantially achieving the objective to which the tax had become an obstacle. Let us give some examples. If a man ceases to buy cigarettes because of tobacco tax he has not achieved his pre-tax objective, i.e. to smoke. Buying sweets instead of cigarettes therefore, is not avoidance. Again, if a taxpayer decides to use most of his wealth for a consumption spree because estate duty makes it not worth while saving for heirs, he is not 'avoiding' for he has abandoned his objective of passing property to heirs. On the other hand, if he reacts to estate duty by making *inter vivos* gifts (assuming he survives for seven years), this is avoidance; it has achieved, though by a more circuitous route, the objective of passing to heirs an intact property."

This is problematic, because there is no obvious way to identify the "objective to which the tax has become an obstacle", and it has not been adopted into the law.

25 *Challenge v IRC* [1986] STC 548. In accordance with the declaratory theory of law, Lord Templeman did not say that he was describing a concept relatively new to tax jurisprudence and framing terminology altogether new to describe it. This avoidance/mitigation terminology (although now part of the law of New Zealand and the UK) does not appear to have caught on in America.

26 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)

consciousness.[27] Likewise "mitigation" was and sometimes still is used in the sense of "avoidance".[28]

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",[29] "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.

15.5 Meaning of "avoidance" in section 741

The House of Lords in *IRC Willoughby* decided that "avoidance" in s.741 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. Tax avoidance was to be distinguished from tax mitigation. ... My Lords, I am content for my part to adopt these propositions.[30]

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

27 The author once saw an advertisement for PEPs: "Be a tax avoider!" PEPs were a tax free investment now replaced by ISAs. For another example, see *Board of Inland Revenue v Hoe*, A.P. Herbert's *More Uncommon Law,* Methuen, 1982, p.199:

> "Evidently those who do not smoke or drink are ... avoiding taxation."

28 e.g. C.T. Sandford wrote in 1973 that tax avoidance (in the strict sense) "is often referred to by expressions such as tax planning or tax mitigation": *Hidden Costs of Taxation*, IFS, 1973, p.104. *Craven v White* 62 TC at 203 (a requirement of *Furniss v Dawson* is that a transaction "had no other purpose than tax mitigation".

29 See s.748(3) ICTA 1988 (Controlled Foreign Companies). The Revenue's Guidance Note on the CFC legislation provides at INTM208010:

> "Despite numerous valiant attempts there has never been a consensus about what is meant by 'tax avoidance' ...
> The CFC motive test attempts to solve the first problem by avoiding any mention of the term 'tax avoidance', settling instead for the rather more neutral concept of a 'reduction in tax' ...".

See *www.inlandrevenue.gov.uk/ctsacfc/.*

30 [1997] STC 995 at p.1003.

distinction sensible, perhaps necessary. The Revenue accepted that the purchase of an ordinary offshore bond should be taxed under the chargeable event provisions and not ss.739 or 740. The best way[31] to reach that result is to give a narrow meaning to tax avoidance in s.741 and so to widen the motive defence.

15.5.1 *Purpose of tax evasion*

Suppose an individual transfers assets abroad with the dishonest purpose of *evading* UK taxation. Can one apply the avoidance/evasion distinction and say that the individual did not intend to *avoid* taxation, so that – while he may be liable to criminal sanctions – the motive defence applies and excludes the transfer of assets rules? The answer is plainly no. The argument is anachronistic, since in 1936 and for 40 years afterwards, the word "evasion" was used in English jurisprudence to describe avoidance. More fundamentally, the context shows that the expression "tax avoidance" includes (criminal) tax evasion. Any other result would be absurd. This was assumed without argument in *R v Dimsey & Allen* 74 TC 263.

15.6 Meaning of "taxation" in section 741

It has been held that *taxation* in s.741 means any form of UK taxation, and not only income tax: *Sassoon* v *IRC* 25 TC 154. This is the Revenue view: Inspector's Manual 4620:

> In this context 'taxation' includes Inheritance Tax and Capital Gains Tax as well as Income Tax.

Sassoon, though criticised,[32] is a decision of the Court of Appeal and must

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31 An alternative, obviously less satisfactory, would be to refuse to recognise the tax purpose of the acquisition, by saying that it is merely incidental, or by applying a *Brebner* or choice principle: see 15.20 (A choice principle?).

32 For the following reasons:

(1) The rule that an intention to avoid (say) stamp duty should have *income* tax consequences gives rise to obvious anomalies. The usual principle is that each tax must be considered separately. This is the approach usually adopted by anti-avoidance provisions: e.g. s.703 ICTA 1988, or s.137 TCGA 1992. But see s.75(5)(a) FA 1986 for an exception.

be taken to represent the present law.

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 an intention to avoid 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).

15.7 A two-stage test

It is submitted that the identification of a tax avoidance purpose (for the purposes of s.741) requires a two-stage approach:

(1) One must look into the mind of the transferor to ascertain whether his (subjective) purpose was (to use the neutral term) to reduce tax. If he had no purpose to reduce tax then the motive defence applies.

Before *Willoughby* this was the end of the matter because an

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(2) Since *Sassoon* was decided, the word "tax" has been given a limited definition: now s.832(3) ICTA 1988:
"Except so far as the context otherwise requires, in the Tax Acts, and in any enactment passed after 12 March 1970 which by any express provision is to be construed as one with the Tax Acts, the Corporation Tax Acts or the Income Tax Acts, 'tax', where neither income tax nor corporation tax is specified, means either of those taxes."
There are two reasons why this statutory change does not affect the position:
(i) 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"?)
(ii) 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) The preamble to s.739 refers only to the avoidance of income tax; but see now s.739(1A).

(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 s.741 currently raises: see ? (Practical examples).

While of course "context is king" *Sassoon* is supported by consideration of s.22 F(No 2)A 1931 where "taxation" plainly means any tax.

avoidance/mitigation distinction had not been recognised in this context.

(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 (or at least as objectively as possible).

It would wrong to ask whether the transferor subjectively thought his purpose was "tax avoidance" (as opposed to mitigation) because that is an issue of law, a decision for the Court and not for him. Indeed, it would generally be pointless, since (unless the individual is a tax lawyer) he will not know the correct meaning of the term in the present context.

The motive defence therefore involves a mixture of objective and subjective elements, as often happens. (Contrast for instance the question of whether or not there is a trade.)

Stage (1) – the mind of the transferor – is a question of fact, decided by the Special Commissioners on evidence and the appellate courts have had little to say about it. Anything which was said on the subject of tax avoidance in s.741 cases before *Willoughby* needs to be reviewed because it will not have considered stage (2).

15.7.1 *The Revenue view*

RI 201 states:

> [1] If a transaction involves tax avoidance, that is considered by the Revenue to be at least one of its purposes
> [2] even if the transferor did not form the subjective intention of avoiding tax.[33]

Point [1] seems self-evidently wrong: it would replace the statutory words (roughly, is the transaction effected for the purpose of tax avoidance) with

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33 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."

different words (does the transaction "involve" tax avoidance?). The paraphrase is not even helpful: how does one determine whether a transaction "involves" tax avoidance?

Point [2] is a direction to ignore the transferor's subjective intention of avoiding tax. If this means that whether the taxpayer thought his purpose was tax avoidance (as opposed to mitigation) is irrelevant, that must be right. If it means that in all cases what the taxpayer had in his mind is irrelevant, 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.[34] Of course context may show the word is used in an unusual sense, but that is not the case here. Second, this is the way that s.741 has always been applied and understood.[35] One might think that an advantage of the Revenue view is that it becomes unnecessary to investigate the mind of the transferor. Instead one seeks an "objective purpose" of the transfer. But "objective purpose" is also difficult to determine. It means, I think, the purpose which an ordinary reasonable person would have if he had made the same transfer in the circumstances of the transferor. It is difficult to identify purpose in this way because different people may do the same act with different purposes. And which circumstances are relevant? For instance, take the example of the transferor concerned as to the situation in Europe in 1936; see 15.2 (Enactment history). His subjective purpose was not tax avoidance. Was his objective purpose tax avoidance? I do not know how to begin to answer the question.

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34 "I shall begin by considering the word 'purpose', for both sides have relied on this word in different senses. Broadly, the appellants contend that it is to be given a subjective meaning and the Crown an objective one.

> I have no doubt that it is subjective. A purpose must exist in the mind. It cannot exist anywhere else."

Chandler v DPP [1964] AC 763 at 804. *Dicta* apparently to the contrary in *Newton v Commissioner of Taxation* [1958] AC 450 at p 465–6 are rightly criticised and distinguished in John Avery Jones [1983] BTR 22–24. Twenty years later, Avery Jones had the opportunity to make the same point judicially in *Carvill v IRC* [2000] STC (SCD) 143.

35 The drafter of s.32(3) FA 1951 plainly agreed with this. This provided (in outline) that where "the main benefit which might have been expected to accrue" from a transaction was tax avoidance, then tax avoidance "was *deemed* to have been the purpose of the transaction". This imposed an objective standard onto s.32(1) and only makes sense on the assumption that section 32(1) (which was modelled on what is now s.741) was otherwise determined subjectively.

The ink had hardly dried on the Revenue statement when the Special Commissioners rejected it; *Beneficiary v IRC*,[36] *Carvill v IRC*.[37] At present the Revenue contend these decisions were wrongly decided and the point may reach the courts.

15.8 Transfer made for tax and non-tax purposes

15.8.1 *Test (a)*

Test (a) depends on the condition:

> that the purpose of avoiding liability to taxation was not the purpose or one of the purposes for which the transfer or associated operations or any of them were effected.

If one of these purposes is tax avoidance, the transfer fails test (a). It does not matter what the other purposes are.[38]

15.8.2 *Test (b)*

Test (b) depends on two conditions; both must be satisfied:

> that the transfer and any associated operations were:
> [1] commercial transactions and
> [2] were not designed for the purpose of avoiding liability to taxation.

What happens if a commercial transaction has two or more purposes? The Revenue say in RI 201:

36 "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.

37 [2000] STC (SCD) 143 at paras. 9–13. The dictum of Lord Nolan in *IRC v Willoughby* mentioned above which appears to favour an objective approach is, as *Carvill* demonstrates, inconsistent with a long line of authority and has to be ignored (as in *Carvill*) or explained away (as in *Beneficiary*).

38 This is stated in *Ex p. Philippi* 44 TC 75 at p.110, but it is plain from the terms of s.741(a).

> The Revenue's view is that one of the essential conditions of s 741(*b*) 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[39] too generous to the Revenue. The Special Commissioner stated the law in *Carvill v IRC* [2000] STC (SCD) 143 at 166:

> One must ask in para (b) whether the transfer was designed for the purpose of avoiding tax or not. This seems to me to require that the 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.

This is easier to satisfy than under test (a). The point of test (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 tests.

15.9 Foresight and purpose

15.9.1 *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 the common 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

39 Depending what nuance one gives to the malleable word "significant".

purpose of causing some other result.

This distinguishes between "intention" and "purpose".[40] It recognises that a person may not have the purpose of causing a tax saving result if he has the purpose of causing another result even though he knows the tax saving would occur if he succeeds in his purpose of causing the other result.

"Purpose" is not always understood this way:

> The word [purpose] can be used to designate either
> [1] the main object which a man wants or hopes to achieve by the contemplated act, or ...
> [2] those objects which he knows will probably be achieved by the act, whether he wants them or not.
> I am satisfied that in the criminal law in general, and in this statute in particular, its ordinary sense is the latter one.
>
> (*Chandler v DPP* [1964] AC 763 at 804)

Here the word "purpose" is understood in the same sense as "intention" (as defined above, i.e. foresight counts as purpose) and (I think) "object" is used in the narrower sense.[41]

15.9.2 *"Purpose" in s.741*

In RI 201 the Revenue say:

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40 Bentham's terminology was direct and oblique intention, *The Principles of Morals & Legislation*, Chapter VIII (Of intentionality). See M. Cathleen Kaveny "Inferring Intention from Foresight" 120 LQR 81.

41 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, whether in judgments, academic writings or 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, and regardless that in some cases the legal usage is a term of art differing from the popular usage."

DPP v Lynch [1975] AC 653 at 688. See John Avery Jones "The mental element in anti-avoidance legislation" [1983] BTR 22.

> 'Purpose' is taken to be the end it is sought to achieve by the transaction.[42]

This adopts (I think) the narrower concept of purpose and it is suggested that this is the law. Purpose in s.741 is what a person wants or hopes to achieve (not merely foresight). The issue arises in test (a) cases.[43]

15.10 Purpose of advisors and agents

In the case where:

(1) a company makes a transfer, and

(2) there is no quasi transferor,[44]

usual company law principles must be applied to attribute to the company the purpose of the individuals acting on its behalf.

In a case where a transferor is acting by agent or attorney, the author suggests that the purpose of the agent or attorney should, on normal agency principles, be attributed to the transferor.

If a person relies wholly on advisors, and executes documents without more than a vague idea of approving proposals put to him and not properly understood, it is suggested that one may fairly say that he has adopted the purpose of his advisors or (which comes to the same thing) that the purpose of his advisors is to be attributed to him.[45]

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42 This is based on *Newton v Commissioner of Taxation of the Commonwealth of Australia* [1958] AC 450 at 465. Note by the way how the 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".

43 The issue should not arise in a test (b) case (commercial transactions) because 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 *Chandler* sense of purpose) it would not be the main purpose.

44 In such a case of course there would be no *individual* "transferor" who is within s.739: see 12.4.2 (Transfers by companies). The purpose of the company which makes the transfer is still relevant for the application of the motive defence to s.740.

45 This point was not taken in *Philippi* 44 TC 75 where the Court of Appeal said at p 114:

> "Young Mr. Philippi gave evidence before the Commissioners. He said that he never had any idea of tax in his mind when he made that transfer. It was

15.11 Avoidance/mitigation distinction

This section sets out the most important judicial and other statements on the avoidance/mitigation distinction.

15.11.1 *Intention of Parliament*

Lord Nolan said:

> Tax avoidance within the meaning of section 741 is a course of action designed to conflict with or defeat the evident intention of Parliament.
>
> [*IRC v Willoughby* 70 TC 57 at p.116]

This is now the authoritative general statement on the subject. There have been some attempts to be more specific.

15.11.2 *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 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]

> true that it was saving him a great deal in United Kingdom 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 him as a witness of truth. They thought perhaps he was a young man who knew quite a lot about soldiering but perhaps little about anything else. Anyway, they accepted his evidence that what he had done he did on his father's advice."

Assuming that this implausible story is true (though "young Mr Philippi" was aged 23 at the time of the transfer) the Court should have held that he had adopted the (tax avoidance) purpose of his father. The point was not argued and hence not considered; it remains open to argue in another case.

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 has intended to apply. Professor Willoughby's offshore bonds seem reasonably clear[46] 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[47] 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. [48]

15.11.3 *Economic consequences*

Lord Nolan said:

> The hallmark of tax avoidance is that the taxpayer reduces his liability to tax without incurring the *economic consequences* that Parliament *intended* to be suffered by any taxpayer qualifying for such reduction in his tax liability. The hallmark of tax mitigation, on the other hand, is that the taxpayer takes advantage of a fiscally attractive option afforded to him by the tax legislation, and genuinely suffers the *economic consequences* that Parliament *intended* to be suffered by those taking advantage of the option.[49]

This repeats the test of the intention of Parliament with the added refinement of identifying the intended "economic consequences". This is based on two Templeman judgments:

> The material distinction in the present case is between tax mitigation

46 Though it might be argued that Parliament had intended the chargeable events regime for normal bonds but not for personal portfolio bonds.

47 Lord Hoffmann has here used "avoid" in the loose etymological sense (to include mitigation). Section 99 provides that an arrangement was void as against the Commissioner for income tax if its purpose or effect was "tax avoidance".

48 *O'Neil v Commissioner of Inland Revenue* [2001] STC 742.

49 70 TC at 116 (emphasis added).

> 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.[50]

The non-recourse loan in *Ensign Tankers* is a clear example of a transaction without economic consequences and in *Challenge* Lord Templeman gave another example which will be particularly relevant to the practical examples considered below:

> When a taxpayer makes a settlement, he deprives himself of the capital which is a source of income and thereby reduces his income. If the settlement is irrevocable and satisfies certain other conditions the reduction in income reduces the assessable income of the taxpayer. The tax advantage results from the reduction of income.[51]

These are transactions with obvious economic consequences.

It is curious that Lord Nolan emphasised this test, because Professor Willoughby's investment in his bond had no substantial "economic consequences" as compared to a direct personal portfolio investment.[52]

Incidentally, one wonders what economists would think of the term "economic consequences". One suspects it is what John Kay derides as

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50 *IRC v Challenge* [1986] STC 548 cited in *Ensign Tankers v Stokes* [1992] STC at 240. (Lord Millett (whose decision in the High Court was reversed in *Ensign Tankers*) took the opportunity in *Collector of Stamp Revenue v Arrowtown Assets Ltd* (Court of Final Appeal of the Hong Kong Special Administrative Region, 4 December 2003) to cast doubt on the correctness of *Ensign Tankers*, but that does not affect the point here.)

51 *IRC v Challenge* [1986] STC at 554–5.

52 Though Lord Nolan did seek, somewhat unconvincingly, to identify economic consequences: "The reality in truth is that the bond holder has a contractual right to the benefits promised by the policy, no more and no less. It is therefore quite wrong to describe the bond holder as having, in the words of the Appellants' printed case 'in substance all the advantages of direct personal ownership without the tax disadvantages'. The significance of this misdescription would become all too apparent if—perish the thought—Royal Life were to become insolvent and unable to meet its obligations to the bond holders."

"DIY economics".[53]

15.11.4 *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 USA's Tax Shelter Regulations (2003) is an interesting and well thought out attempt to identify indicia of tax avoidance for the purposes of disclosure obligations. The categories of "reportable transactions" include:

(1) transactions with a confidentiality agreement relating to tax;

(2) transactions with fees linked to tax savings;

(3) transactions giving rise to losses or book-tax differences.

The OECD also identified secrecy[54] as a common characteristic of

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53 See *The Truth About Markets*, John Kay (Allen Lane, 2003). "Economic consequences" is, I suggest, a form v. substance distinction under a more appealing name. This is a classification and not a criticism. There is nothing necessarily wrong with a form v. substance distinction if it is recognised for what it is.

54 There are different types of secrecy:
(1) Secrecy against other tax advisers (the scheme vendor wishing to keep the profits of a scheme to himself).
(2) Secrecy against the Revenue (as the OECD envisage) in order to postpone the time when the Revenue are informed for as long as lawfully possible. There is normally a significant delay between the date of a transaction and the date of any return.
(3) Secrecy against the Revenue in order to avoid or frustrate any investigation. Of course dishonest concealment of material facts marks a point where avoidance becomes evasion.
Concealment in category (3) is not primarily characteristic of tax avoidance schemes. It is a problem which may affect all aspects of tax collection (whether or not involving avoidance). The Keith Committee recognised this: Committee on 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. The disclosure provisions in the Finance Bill 2004 show that Parliament has now recognised this.

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.[55]

None of these features are normally associated with the practical transactions discussed below. But if, exceptionally, that was the case then it would be a factor suggesting that the transaction should be characterised as tax avoidance.

An important indicia is familiarity and use. Once a tax avoidance arrangement becomes common, it is almost always stopped by new legislation within a few years. If something commonly done is contrary to the intention of Parliament, it is only to be expected that Parliament will stop it. So that which is commonly done and not stopped is not likely to be contrary to the intentions 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 may be said to confuse the acts of the Revenue with the intention of Parliament. It also seems strange that the same act might be stigmatised as tax avoidance if challenged by the Revenue shortly after it is first done; but if such acts become the general practice over a long period of time then the intention of Parliament is decided differently. Nevertheless, it is submitted that the better view is to have close regard to this factor. Judges have a strong intuitive sense that that which everyone does, and has long done, should not be stigmatised with the pejorative term of "avoidance". This, I suggest, is the true reason why the courts refused to regard bed-and-breakfast transactions or back-to-back loans as tax avoidance.[56] An example in this category is a transfer to an offshore company to avoid IHT, a standard practice since the inception of CTT.

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55 OECD Report by Committee of Fiscal Affairs (1980) cited in OECD International Tax Avoidance and Evasion (1987), page 17.

56 *Ensign Tankers (Leasing) Ltd v Stokes* 64 TC 617 at 739. These tax planning techniques have been accepted by the Revenue for decades: Revenue International Tax Handbook, para 1201.

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.[57]

Category (1) is obviously mitigation and category (3) is obviously avoidance. It is suggested that category (2) should not be regarded as avoidance. A clear example is a transfer to a company to reduce the rate of stamp duty land tax from 4% to 0.5%. The Government considered imposing 4% stamp duty on shares in property-owning companies to prevent this[58], but decided not to proceed with the idea. 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).

15.12 Failed indicia of tax avoidance

15.12.1 *Spirit of the statute*

Other approaches in distinguishing tax avoidance and tax mitigation are to seek to identify "the spirit of the statute" or "misusing" a provision. I take this to mean exactly the same as the "evident intention of Parliament" properly understood. If that is right, the expression adds nothing but rhetoric and confusion. If it means anything vaguer or more intuitive than that, then the concept deserves the ridicule expressed in *Norglen v Reeds Rains Prudential*.[59] Either way, the expression is best avoided in our context.

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57 *Tax Avoision* (1979, IEA) p 81.

58 Modernising Stamp Duty (Inland Revenue, A Consultative Document, 2002) para 2.34.

59 "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.

15.12.2 *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 artificiality[60] 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.[61] It is of no use in determining whether any of the practical examples considered below are tax avoidance. Try it and see.

The same objection applies to that particular obstacle to clear thinking, the term 'device'.[62]

15.13 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 the Revenue). For a revealing example of this usage see the National Audit Office Report (Countering VAT Avoidance, 1992):

> Avoidance involves complex issues and the position is constantly changing. A policy change in the UK, or a ruling from the European

60 e.g. an appointment of non-resident trustees.

61 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."

Cmd. 9474 para 1024.

62 *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."

> 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.[63]

(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 Revenue 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.

The avoidance/mitigation distinction is not self-explanatory, it is not a given. It is a construct defined and determined by reference to values and attitudes of the tax culture in which we live. The difference between the approaches (1) and (2) is partly: *whose* values and tax culture does one apply, and partly: *to what materials* does one refer to ascertain these values? I will give an example. In 1973, C.T. Sandford wrote:

> At present gifts made more than seven years prior to death pay no tax (with the possible exception of capital gains tax). ... Is there evidence that such gifts are contrary to the intention of Parliament? Both circumstantial evidence and logic point to this conclusion. Thus if Parliament were indifferent to the making of gifts prior to death, would there have been successive increases in the gifts *inter vivos* period, which, since 1894, has risen in four successive stages from one to the present seven years?

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63 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.

Sandford considers and dismisses some policy arguments in favour of an estate duty and concludes:

> A reasonable interpretation would be that the gifts *inter vivos* provision was intended to prevent as many gifts as possible from circumventing estate duty.[64]

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", but 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 impose a new tax law, 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. One point to note is that a comment from the Government (or any advocate 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 advocate).

15.14 How to ascertain "the evident intention of Parliament"?

This is the problem at the heart of the concept of "tax avoidance". If this term means an arrangement contrary to the intention of Parliament, one must identify that intention. C.T. Sandford addresses 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.[65]

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64 *Hidden Costs of Taxation*, IFS, 1973, page 113.

65 *Hidden Costs of Taxation*, IFS, 1973, page 114 (emphasis in original).

Sandford is 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, e.g. 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.

15.14.1 *Two levels of intention*

Now, it may be objected that a concept of "tax avoidance" based on what is contrary to "the intention of Parliament" is not coherent. The object of construction of any statute is always said to be to find "the intention of Parliament".[66] In any successful tax avoidance scheme, even as blatant a scheme as *Fitzwilliam*,[67] the House of Lords 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 avoiders does not circumvent its intentions but abides by them.[68]

The answer is that the expression "intention of Parliament" is being used in two senses. It is perfectly consistent to say that the *Fitzwilliam* scheme:

(1) escapes IHT (there being no provision to impose an IHT charge); and yet

(2) constitutes the avoidance of IHT.

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66 See *Cross on Statutory Interpretation*, 3rd ed., 1995, chapter 2.

67 [1993] STC 502.

68 A.A. Shenfield, *The Political Economy of Tax Avoidance*, Institute of Economic Affairs, Occasional Paper 24, 1968, p.20–1.

One is seeking the intention of Parliament at a higher, more generalised level. A statute may fail to impose a tax charge, leaving a gap that even a court cannot fill even by purposive construction, but nevertheless one can conclude that there would have been a tax charge had the point been considered. An example is the notorious case of *Ayrshire Employers Mutual Insurance Association v IRC* 27 TC 331 where the House of Lords held that Parliament had "missed fire".[69] A.A. Shenfield recognised this (perhaps grudgingly):

> What the complainant against avoidance means by the intentions of a law is not what may be deduced from what it says, but what parliament intended it to say, or what parliament ought in the complainant's opinion to have intended it to say, or what in his opinion it would have been equitable for it to say. Now I do not say that this can never have substance. We all know that, quite apart from outright errors of draftsmanship, there is a distinction between the letter and the spirit of a law. But the spirit of a law is elusive. It is tempting to believe that one has grasped the spirit of a law when in truth one is moved by prejudice or preconception. We ought to be extremely careful ...[70]

15.15 Reduction, deferral and unsuccessful avoidance

15.15.1 *Reduction*

Section 741 refers to "avoidance" alone but several later provisions refer to "avoidance *or reduction*" of tax.[71] 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

69 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 The Rt. Hon. Sir Kenneth Diplock, The Holdsworth Club, 1965. However, in *Cooper v Billingham* 74 TC 139 the Court of Appeal was prepared to say that the same result could happen today (albeit rarely).

70 *Ibid*, note 68.

71 The earliest of these was s.35 FA 1941 (Excess Profits Tax); the formula survives in modern provisions: s.775 ICTA 1988 and as part of the more lengthy formula in s.703 ICTA 1988.

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.[72] But nowadays a court would not be so literal and there is no doubt that (for the purposes of s.741) the reduction of tax from £10 to £6 amounts to the avoidance of £4.

15.15.2 *Deferral*

It is suggested that arrangements to defer tax may be regarded as "avoidance", and indeed the classic avoidance case *Furniss v Dawson* might be characterised as involving mere "deferral" of tax. (Of course, the fact that tax is merely deferred, and will or may later be paid, may be a factor which supports the conclusion that the arrangement is to be characterised as mitigation and not avoidance.)

15.15.3 *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.[73]

15.16 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:[74]
  (a) Foreign settlor: UK and foreign beneficiaries;
  (b) Foreign settlor: only UK beneficiaries;
  (c) UK settlor: UK beneficiaries;

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72 Contrast the common statutory expression "mitigate or remit" a penalty.

73 OECD Report by Committee of Fiscal Affairs (1980) cited in OECD's International Tax Avoidance and Evasion (1987), page 17.

74 It is assumed that the spouse of the settlor is also excluded.

(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 ruling that taxation includes any tax.[75]

However, a tax charge does not arise in isolation, but is charged in different ways on the settlor, beneficiaries or trustees[76] or beneficiaries. It is best to consider these three classes of taxpayer separately, though the issues partly overlap. So in the case of a trust transfer one must ask whether the purpose is avoidance of IT/CGT/IHT liabilities of (1) the settlor; (2) the trustees; (3) the beneficiaries. Thus what seemed like only 3 sub-issues raises 9 sub-issues. Further, post-*Willoughby* one must consider whether there is an 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?).

15.17 Trust transfers where settlor excluded

Transfers to a trust from which the settlor is excluded have two common

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75 See 15.6 (Meaning of "taxation" in s.741.)

76 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.

features which are relevant for the motive defence:

15.17.1 *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 obtains 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.[77] However, the Revenue 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.

15.17.2 *Non-tax reason for creating trust*

There will usually be non-tax reasons for the settlor to make a trust, rather than making absolute gifts. The advantages are asset protection in the broadest sense: protecting the trust fund from profligate beneficiaries, divorcing spouses, and sometimes forced heirship or foreign exchange control. These are good reasons but not commercial ones. So a trust transfer must pass test (a), not test (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 naturally be (and in practice generally is) a discretionary trust.

15.18 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.

15.18.1 *Avoidance of trustees' tax*

In deciding whether the trust transfer yields a tax advantage for the

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77 See Lord Templeman's dictum in 15.11.3 (Economic consequences). The exceptional case of s. 86 TCGA 1992 is discussed below.

trustees, one obviously cannot compare the actual position (appointment of foreign trustees) with the position if the transfer had not taken place. One must compare it with something else the settlor might have done (which in this context must be the appointment of UK trustees). That seems a reasonable comparable; the settlor has a choice: to transfer to trustees in the UK or elsewhere and he must do one or the other. In the absence of UK tax, there will often be no reason to prefer the one to the other.

The choice of UK trustees (rather than foreign trustees) will not in principle yield any greater CGT.[78] There is no question of CGT avoidance.

Income tax is slightly more complicated. The choice of exclusively UK trustees of a discretionary trust will yield the Revenue some income tax on foreign source income not due from non-resident or mixed resident trustees.[79] However, if one trustee (even a minority trustee) is resident outside the UK, the trust is not (in short) subject to 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 110 FA 1989 assists in the appointment of non-resident trustees, suggesting that this cannot be contrary to the intention of Parliament. To hold otherwise would be to suggest that the settlor has a duty to maximise UK income tax liability. Any IT saving here must be mitigation.

15.19 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 the UK beneficiaries is that they will pay tax under Schedule D Case V in respect of income distributions from the trust, but no tax on accumulated income and (in the absence of s.740) no income tax on capital distributions. This is certainly an income tax advantage if the transfer to a discretionary trust is compared with a transfer to the

78 As long as the UK trustees are professionals: see 4.8 (UK professional trustees treated as non-resident).

79 See 4.2 (Trustee residence for income tax). The position before the FA 1989 was thought by the Revenue to be the same, and was held in *IRC v Dawson* 62 TC 301 to be only slightly (and for present purposes not materially) different.

beneficiaries or to a transfer to an interest in possession trust.

Is the purpose of the transferor to obtain this advantage? Normally his purpose will be to obtain non-tax advantages, and even foresight of the tax advantage will not constitute purpose.[80]

15.20 A choice principle?

Common sense suggests that there is a difference between:

(1) a tax saving which arises because the transfer *is made* (i.e. it would not arise if the transfer had not been made)[81]; and

(2) a tax saving which arises because the transfer is made *in one particular way* (i.e. it would not arise if the transfer were made in some other way).[82]

This takes us to the "celebrated"[83] passage in *IRC v Brebner*:

> [1] My Lords, I would only conclude my judgment 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

80 See 15.9 (Foresight and purpose).

81 Such as the saving of the settlor's own tax liabilities arising from the transfer; see 15.17.1 (No avoidance of settlor's tax liabilities).

82 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).

83 *Willoughby v IRC* [1995] STC at p.167. 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 such a distinction is irrelevant in s.703 cases. This is stated in *Marwood Homes v IRC* [1999] STC (SCD) 44 para. 20 but it is clear from the definition of "Tax advantage" in s.709 ICTA 1988. This term includes a relief from or repayment of tax, as well as the avoidance or reduction of a charge to tax. The concept includes both tax avoidance and mitigation.

> 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.[84]

The point being made here is not (or not just) that foresight of a tax advantage is not a tax avoidance purpose[85]. Lord Upjohn goes further in point [2]: he suggests that where there is a "commercial transaction" knowledge and *choice* of the tax advantageous course over an alternative does not "necessarily" constitute the main purpose or even one of the main purposes of the transaction.

At what point does choice of a tax advantageous course become a tax avoidance purpose in its own right in addition to the commercial purpose? Lord Upjohn does not give an answer to this: to say at [3] that it is a question of fact for the Commissioners, if true, is not exactly helpful.

It is suggested that the test should be: does the tax advantage form an incidental or subsidiary aspect of achieving the commercial transaction (as opposed to being an end in its own right)? If so there is no tax avoidance purpose. This is an evaluative test which is perhaps easier to state than to apply, but it may sometimes be helpful. It overlaps with an avoidance/mitigation distinction, since an advantage which is judged to be incidental or ancillary to a commercial transaction is not likely to be contrary to the intention of Parliament: it is more likely to constitute mitigation than avoidance.

The dictum is sometimes regarded as supporting a "choice doctrine". "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."[86] But this formulation goes too far: if a UK settlor creates a trust for his family - a family transaction, he has to choose between UK and foreign trustees; but the choice of foreign trustees by the UK settlor is avoidance.

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84 *IRC v Brebner* 43 TC at 718; emphasis original but paragraph numbers added. The wording of s. 703 is not quite the same as test (b): s.703 refers to "main object" and s.741 refers to "purpose" but for present purposes I suggest there is little significant distinction between them. This was presumably the view adopted in *Willoughby* in the Court of Appeal where the case was considered in a s.741 test (b) context.

85 The point made at 15.9 (Foresight and purpose).

86 Philip Baker QC "Tax avoidance, tax mitigation and tax evasion", accessible *www.taxbar.com*.

One can accept a choice principle if it is combined with the concept of the intention of Parliament, i.e. if the settlor makes choices within the intention of Parliament, there is no tax avoidance; this is equivalent or very similar to the concept discussed above of "special tax regime".

I suggest the point made in *Brebner* is really this: where a transaction is done for a non-tax reason, one should be slower to conclude that a purpose is tax avoidance than in the case of a purely tax motivated transaction. This reflects the reasonable assumption that a purely tax motivated transaction is more likely to be contrary to the intention of Parliament. I refer to this as the *Brebner* principle. The *Brebner* principle applies not only to commercial transactions, but also to any transaction carried out for primarily non-tax reasons including "ordinary family dealing", which would include most trust transfers, at least those where the settlor is excluded.[87]

15.21 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[88] 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.740 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 relevant income, which may greatly exceed their "share" of the trust fund computed on any other basis.

If there is avoidance of UK tax there is likely to be avoidance of tax in every other jurisdiction where beneficiaries are resident;[89] it is impossible for the settlor to make a discretionary trust (allowing tax free accumulation) anywhere without tax avoidance elsewhere – which, if not

87 *Mangin v IRC* [1971] AC at 751 and 756, restating the *Brebner* principle in the context of an extremely free reading of a New Zealand provision.

88 It might be different if the trustees (perhaps guided by a strongly worded letter of wishes) slavishly follow the wishes of a beneficiary.

89 Assuming they are in a jurisdiction with a tax system comparable to the UK.

absurd, is somewhat startling.

15.22 Avoidance of beneficiaries' CGT liabilities

The CGT position is complicated by recent tax reforms. Before 1998, capital payments from the trust would be free of tax to the beneficiaries. This was expressly set out in s.87 TCGA 1992. 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. This could be taken to suggest that post-1998 transfers constitute CGT avoidance by the beneficiaries. But the points made in relation to IT avoidance/mitigation apply here too, and s.69(2) TCGA is even stronger than s.110 FA 1989. So the better view is that any CGT saving is mitigation.

15.23 Foreign settlor; only UK beneficiaries

The next case to consider is a transfer to a trust whose beneficiaries are all UK resident and domiciled. A trust transfer primarily motivated by non-tax advantages (asset protection) should not normally be regarded as having the purpose of tax reduction.

In an unusual case, however, that might be one of the settlor's purposes. Indeed, it could be his primary purpose. It can happen be that the settlor creates a trust primarily for a UK beneficiary, and the only reason he does this is tax considerations. Asset protection does not concern every settlor. He would make an absolute gift to a UK beneficiary but for UK tax reasons only he makes a transfer to a trust for his benefit. The transfer is solely UK tax driven.[90]

In these (factually unusual) circumstances the question arises whether the tax saving purpose is avoidance or mitigation. Section 69(2) TCGA 1992 and s.110 FA 1989 show the intention of Parliament to be that the choice of foreign trustees by a non-resident and non-domiciled settlor should not

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90 This might be made evidentially clear by contemporary correspondence, or if, perhaps, the settlor's gift to a UK child is settled and his gift to other children outside the UK is absolute; but such details only go to identify the settlor's purpose, and are not otherwise significant for tax.

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.

15.24 UK settlor and UK beneficiaries

Contrast now a settlor who is UK resident and domiciled, making provision for UK beneficiaries. Assume the settlor is not to be a beneficiary. Again, he will often prefer a trust to outright gifts, for non tax reasons, and the choice is UK or offshore. If he chooses the latter, his purpose (or one of his purposes) is likely to be to reduce CGT or Income Tax and this purpose will be tax avoidance rather than mitigation. This is not an invitation to partake in a statutory regime; we all know that this income tax saving is what s.740 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 is clearly drawn in the 1974 Green Paper on Wealth Tax:

> **Overseas trusts**
> 22. Trusts where the trustees are not resident in the United Kingdom 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 United Kingdom 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 United Kingdom 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 United Kingdom 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 United Kingdom, the trustees will be liable to the same extent as if the trust had been resident.[91]

While the author 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.

15.25 UK settlor; foreign beneficiaries

Now consider a UK settlor making a trust (from which he is excluded) for foreign beneficiaries.

What about liabilities of the beneficiaries? Since they are not UK resident, they are largely outside the scope of IT and CGT, so there is no avoidance.

In deciding whether the trust transfer yields a tax advantage for the trustees, one can again compare the actual position (appointment of foreign trustees) with the appointment of UK trustees. UK trustees would pay IT if the trust were discretionary but not (for all practical purposes) if it were interest in possession. Any IT saving must be mitigation. CGT is different: UK trustees will pay the tax, and foreign trustees will not. However, trustees are in economic reality paying tax on behalf of the beneficiaries. Where the beneficiaries are not within the scope of the tax then any tax saving by the trustees must be mitigation. This is consistent with the rule that the anti-avoidance provisions of s.87 TCGA 1992 and s.740 ICTA 1988 will not in principle apply on payments to beneficiaries

91 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.

outside the scope of CGT and IT.

15.26 UK settlor: UK & foreign beneficiaries

Where there is a mixture of UK and non-UK beneficiaries I suggest the starting point is that one would expect the settlor to make his trust here, so a transfer to foreign trustees would be regarded as avoidance. (In such a case there is something to be said in income tax terms for the creation of two separate trusts for two separate classes of beneficiaries, the residents and the non-residents, so one at least qualifies for the motive defence. But CGT considerations point the other way.)

15.27 Transfer to trust: settlor a beneficiary

15.27.1 *Foreign domiciled UK resident settlor-beneficiary*

The next case concerns a foreign domiciled UK resident settlor who transfers assets to a non-resident trust under which he is the principal beneficiary.

Income tax is not avoided since trust income continues to be taxed on a remittance basis under s.660A ICTA 1988. There may be an IT reduction after the death or exclusion of the settlor but it will not (normally) be the purpose (or even one of the purposes) of the settlor to obtain that (normally very long term) advantage, quite apart from the question of whether the advantage is avoidance or mitigation.

There is in principle a significant CGT advantage[92] and to obtain that advantage is often one of the purposes of the trust. If so, is it CGT "avoidance"? It must have been a decision of Parliament *not* to apply s.86 TCGA 1992 to a foreign domiciled settlor. It is suggested that there is no CGT "avoidance". This is a "statutory invitation" in plain terms.

15.27.2 *Non-resident non-domiciled settlor-beneficiary*

It is not likely that UK tax saving constitutes even one of the purposes of making a trust where the settlor is the principal beneficiary and neither domiciled nor resident. The question of avoidance/mitigation does not

92 See 18.11 (CGT planning).

then arise.

15.28 When is the appointment of non-UK resident trustees of an existing UK resident trust made for the purpose of avoiding IT or CGT?

Similar principles apply. One case is where the settlor and beneficiaries are wholly UK based, the settlor has created a UK trust, and foreign trustees are later appointed. The inference that the appointment has the purpose of saving UK income tax or CGT is very strong and this purpose is avoidance not mitigation.

At the other end of the scale is the case where the settlor and the principal beneficiaries have gone to live abroad permanently and local trustees are appointed. One reason for the export of the trust is that the settlor may (or may continue to be) a trustee. If so, the appointment may have no tax saving purpose at all. But if (as is likely) it has a tax saving purpose, that is mitigation and not avoidance.

What if all the beneficiaries are abroad but the settlor remains in the UK? The same tax savings could in principle be had by winding up the trust with outright appointment to beneficiaries, and that transfer is not likely to constitute avoidance. So the appointment of foreign trustees should not be avoidance.

What if the settlor goes abroad and the beneficiaries remain in the UK? It is tentatively suggested that a tax saving purpose (if it exists) is likely to be avoidance.

A more borderline case is where the settlor and beneficiaries go to live abroad for a medium term period (say more than five years[93]). 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.

93 There is no particular significance in selecting five years as illustrative of a medium term period, but it is consistent with the rule that an individual leaving for any shorter period now remains within the scope of CGT: s.10A TCGA 1992.

15.29 When is a trust transfer made for the purpose of avoiding IHT?[94]

15.29.1 *Change of situs without alteration of ownership*

The transfer of money by a foreign domiciled person from a UK bank to a foreign bank in order to make the money excluded property, is an act of tax mitigation, not avoidance. See *Beneficiary v IRC* [1999] STC (SCD) 134 at 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.

15.29.2 *Transfer to trustees*

The residence of trustees is almost wholly irrelevant for IHT.

A gift by a settlor to a trust from which he is excluded is mitigation of his own IHT[95] 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 1984 provides that property in a trust made by a person not domiciled in the UK is, if not situate in the UK, excluded property. Any inheritance tax 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 inheritance tax liabilities.[96]

A gift by a settlor to a trust from which he is not excluded, in circumstances where the settlor is anticipating becoming UK domiciled, is borderline. Section 48 IHTA 1984 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

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94 For transfers before 27 March 1974 it would be necessary to consider Estate Duty.

95 See 15.17.1 (No avoidance of settlor's tax liabilities).

96 The avoidance/mitigation issue did not arise in *Beneficiary v IRC* [1999] STC (SCD) 134, because the Special Commissioners held that reducing IHT was not a purpose in the mind of the transferor.

that such a gift should be regarded as IHT mitigation not avoidance. This is consistent with the rule (generally accepted though questioned by some) that the gifts with reservation provision does not apply here.[97]

15.30 Transfer of UK assets from non-resident trustees to non-resident trust subsidiary

By "trust subsidiary" I mean a company wholly owned by trustees, which holds beneficially what might in substance be regarded as trust assets.

15.30.1 *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 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 possible problems of trustees investing in civil law countries.

(2) In the case of land (or other onerous property), avoiding personal liabilities of trustees arising from direct ownership.

(3) In the case of interest in possession trusts, to allow effective accumulation of income (avoiding 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.

Where it is the policy of trustees that all its trust funds should be held in separate wholly owned trust subsidiaries[98], the conclusion that purpose (1) is a commercial purpose seems factually likely. (Purpose (2) is rarer but

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97 See 25.12 (GWR to discretionary trust).

98 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 (Andrew Edwards, 1998) para. 12.5.2. Trusts managed in Switzerland always use underlying companies for Swiss law reasons.

certainly commercial when it occurs. Purpose (3) is not commercial.) If the analysis of commercial above is accepted, purpose (1) should be regarded as 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 test (b) and not test (a).

15.30.2 *Is the transfer for tax avoidance?*

Transfer of UK assets[99] 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 section 660A ICTA 1988 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[100] be regarded as mitigation. There is of course no economic difference between owning a UK asset directly (non-excluded property) and holding it via a company (effectively converting it into excluded property). But the principle that companies are not transparent for tax purposes is very deep in the tax system. Planning of this kind has been possible since the repeal of the Mortmain Acts (which were enacted to prevent tax avoidance by vesting land in companies) and cannot be regarded as contrary to the intention of Parliament.

The transfer to a company also has a possible CGT disadvantage,[101] and a possible income tax disadvantage,[102] so any tax reduction may be regarded as part of a "package deal", with advantages and disadvantages. This does not savour of tax "avoidance".

99 Similar considerations apply to a transfer of non-UK assets with a view to realisation and re-investment in UK assets.

100 An exceptional case would be if the property was put in the company shortly before a ten year anniversary and taken out shortly thereafter.

101 Doubling up of trust gains, with serious implications under s.87 TCGA 1992.

102 Loss of tax credits and double taxation relief; sometimes, possible charge under income tax benefit in kind rules.

(2) Escaping additional rate income tax (on UK source income of discretionary trust).

The striking thing about this tax is that there is generally[103] no effective method for the Revenue to collect it and in practice no one expects it to be paid in cases where all the beneficiaries are outside the UK.[104] Perhaps this supports a conclusion of mitigation.

(3) Escaping higher rate income tax (on income of interest in possession trust).

I suggest that a distinction should be drawn between UK resident life tenants (tax advantage is avoidance) and non-residents (tax advantage is mitigation). In many circumstances, however, non-residents do not pay income tax at the higher rate: s.128 FA 1995.

15.30.3 *Transfer to trust to which s.660A applies*

If the purpose is to avoid a charge under s. 660A ICTA 1988, this is plainly avoidance and not mitigation.

15.30.4 *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.

15.31 Non-resident foreign domiciled individual transfers UK property to offshore company

A foreign domiciled UK resident individual who transfers his UK assets to a company incorporated abroad and not UK resident may also enjoy comparable tax advantages:

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103 Except in the case of UK land.

104 It is considered that non-payment is not in principle dishonest, and so not a fraud on the Revenue, though this conclusion depends to some extent on the facts of the case.

(1) Obtaining IHT excluded property status.

(2) Avoiding higher rate income tax.

Such transfers also give significant advantages which have nothing to do with tax. In particular, in the case of UK land, avoiding personal liabilities arising from direct ownership. In such cases, the motive defence may well apply. But if a purpose of the transfer is to reduce IHT or IT, this is mitigation not avoidance; the arguments are the same as above.

15.32 Transfer by UK resident foreign domiciled individual to offshore company

Suppose the facts are as in the above paragraph but the transferor is UK resident. If a purpose was to reduce IHT, the transfer is IHT mitigation. A transfer to reduce income tax is IT avoidance.

15.33 Transfer by UK resident foreign domiciled individual to UK resident foreign incorporated company

If a purpose of the transfer is to reduce IHT, there is a tenable argument that the transfer is not avoidance. If the purpose is to avoid CGT (by utilising s.162 TCGA 1992 relief) then the position is more doubtful. However, in this case there is no IT avoidance and the CGT position is made much worse. It is considered that the transfer is a "package" with tax pros and cons, and overall should not be regarded as avoidance. In any case, the Revenue are likely to regard the claim indulgently.

15.34 Transfer from one trust to another trust

There are so many reasons why funds may be transferred between trusts that it is impossible to generalise as to whether such transfers are made for tax avoidance.

One reason such transfers are made is where a single trust holds several sub-funds for different branches of a family. The transfer avoids the unfairness which arises under a single trust, that gains accruing to one share are taxable on a beneficiary of another share who receives a capital payment. It is considered that a transfer for this reason does not have the motive of CGT "avoidance".

15.35 Time to ascertain purpose and change of purpose of transferor

What matters is the purpose of the transferor at the time of the transfer.[105] It is quite common that a transfer is made by a foreign settlor for foreign beneficiaries, unimpeachably for non-UK tax reasons, and then 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 paragraph 15.37 (Associated operations and the motive defence).

(3) There may be a change of purpose without any new transfer or associated operation. In that case the motive defence remains available and transfer of assets provisions do not bite at all.

15.36 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 intention of the transferor at the time of the transfer. Otherwise the operation of s.741 will be highly anomalous and

105 The point was made in *Herdman v IRC* 45 TC 394; but it is plain from the terms of s.741.

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).

15.36.1 *Transfer by non-resident before 1996*

Parliament decided in 1936 not to apply the transfer of asset provisions to transfers made by non-ordinarily[106] resident transferors, and that was (after some vacillation) held to be the law.[107] In principle, a transfer of assets by a non-resident after 1936 could not be said to be contrary to the intention of Parliament, and so it could not constitute income tax avoidance.[108] 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.[109] 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[110] and, of course, a transfer made for CGT or IHT avoidance would also be caught.

15.36.2 *Transfer before 1981; transferor having no power to enjoy*

Similar considerations apply to a transfer before 1981 to which s.739 did not apply (because the transferor had no power to enjoy the income of the

106 For convenience, non-resident is hereafter used to mean non-ordinarily resident.

107 See 12.7.2 (Transferor not ordinary resident).

108 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.

109 s.81 FA 1997. There is an exemption only for income arising before 1996.

110 Examples of special cases are:
(1) a transfer just before 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.

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.[111] So such a transfer should not constitute income tax avoidance. In 1981 Parliament brought in s.740 which applied to pre-1981 transfers.[112] The better view is that a transfer outside s.739 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.740 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.

15.37 Associated operations and the motive defence

Applying the motive test is relatively straightforward when there is a single transfer. It is more complicated if there are a transfer and a number of associated operations to consider. In the following discussion:

(1) An "innocent" transfer or associated operation is one which satisfies the motive test (in short, which is not made for tax avoidance purposes).

(2) A "tainted" transfer or associated operation is one which does not satisfy the motive test (in short, which is made for tax avoidance purposes).

Test (a) provides:

> that the purpose of avoiding liability to taxation was not the purpose or one of the purposes for which the transfer *or associated operations or any of them* were effected.

Test (b) provides:

> that the transfer *and any associated operations* were bona fide commercial transactions and were not designed for the purpose of

111 See 12.3 (Which individual).
112 s.45 FA 1981; there is an exception for income arising before 1981.

avoiding liability to taxation.

(Emphasis added)

The transfer and any relevant associated operations must each separately satisfy the motive test. One does not group the transfer and the associated operations together, and look for a single main purpose of the group. There are as many tests to pass as there are transfers and relevant associated operations.

15.38 Which associated operations are relevant for the motive defence?

The motive test refers to "*any* associated operations". However, it cannot mean any associated operations whatsoever. If in 1096 a Crusader transfers land to trustees to avoid feudal duties, and in 2000 the land is again transferred to trustees, the two operations are associated. See 11.9 (Associated operations). It cannot be that the Crusader's (arguable)[113] tax avoidance motive would prevent the transfer in 2000 from qualifying for relief!

In context, the reference is to the associated operations referred to in s.739 or s.740. That is, the associated operations relevant to the operation of those sections. That is, the transfer and operations by virtue of which income accrues to the non-resident. There may and generally will be other associated operations, but those are irrelevant and must be ignored.

The House of Lords so held in *Herdman v IRC* 45 TC 394 where:

(1) Assets were sold to an Irish company in consideration of shares and a loan. This was an innocent transfer (the motive was to avoid Irish tax).

(2) The company accumulated income and used it to repay the loan. This was an associated operation, and the motive was to avoid UK tax.

The motive defence applied. No income arose to the non-resident by

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113 Feudal duties would be "taxation"; see 15.6 (Meaning of "taxation"). I forbear to consider the question whether the transfer should be regarded as avoidance or mitigation of feudal duties (and would that depend on attitudes to taxation in the Middle Ages or contemporary attitudes or a combination of the two?).

virtue of the associated operation. The Special Commissioners held in an unreported decision that this is still the law[114] and the Revenue now accept this. RI 201 provides:

> The law was amended in 1969 following a decision of the Courts (in *IRC v Herdman* 45 TC 394) that only the transfer and any associated operations giving a power to enjoy at the outset were relevant for determining whether the terms of s 741 were satisfied. The amendment to the legislation sought to bring all associated operations into consideration when s 741 was invoked. Because of doubts expressed as to the effectiveness of this amendment, it has been the Revenue's practice in considering whether a defence under s 741 is available to consider only the transfer and any associated operations which directly establish a power to enjoy the income of the overseas person under any particular sub-head in s 742(2).

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114 The Revenue argued that the law was altered by FA 1969, s.33. This was supported by a statement by Harold Lever in Hansard, 17 July 1969, column 955–6. At the time Harold Lever was Financial Secretary to the Treasury.

> "The *Herdman* decision in the House of Lords was to the effect that section [739] did not apply in cases where a change of circumstances enabled arrangements which were originally innocent of the purpose of avoiding tax to be used later on for the purpose of tax avoidance. If anyone had the good fortune to find himself connected with a settlement abroad originally of the most innocent intent he was free, without the impact of section [739], to exploit it without limit because section [739] would not bite on it, according to the *Herdman* decision.
>
> It therefore became necessary to put back the teeth in section [739] which had been knocked out by the *Herdman* case. If we are to have a section [739], 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 [739] 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."

See also the obiter dictum of Morritt LJ in *IRC v Willoughby* 70 TC at p.97:

> "In the FA 1969, legislation was enacted, s.33, to nullify the decision of the House of Lords on the point."

However, the law is plain and there is no ambiguity which might justify recourse to Hansard on *Pepper v Hart* principles.

Suppose:

(1) A transfers assets to a non-resident company in return for shares in that company ("the first transfer"). Suppose the first transfer is innocent, there being no tax avoidance motive. Income accruing to the company is not caught by ss.739 or 740 as the motive defence applies.

(2) A transfers the shares in that non-resident company to an offshore trust ("the second transfer").

The second transfer is an operation associated with the first. See 11.9 (Associated operations: definition).

Suppose the second transfer has a tax avoidance motive. Can the Revenue argue that the first transfer fails to qualify for the motive defence? The argument would be that one cannot say that:

> the transfer and *any* associated operations

are innocent of tax avoidance. For there is an associated operation and it is not innocent. But that associated operation is not relevant for the purposes of s.739. Income accrues to the non-resident company in consequence of the first transfer. It does not accrue in consequence of the first transfer in conjunction with associated operations.

Take the same transactions, but assume that the first transfer had a tax avoidance motive, and the second transfer was innocent. The motive defence plainly does not apply. It is not enough to find an innocent associated operation. So income of the company is within s.739 or s.740. Dividends from the company to the trustees are caught by s.739 or s.740 since the income arises by virtue of the tainted transfer to the company and an associated operation (the dividends).

15.39 Life policies

On the application of the motive defence to gains from these policies, see 19.7 (Motive defence to s.740).

15.40 Dealing with the Revenue

Section 741 provides:

> Sections 739 and 740 shall not apply if the individual shows in writing or otherwise to the satisfaction of the Board that [the motive defence applies].

This imposes the burden of proof on the taxpayer. That makes no practical difference as the burden of proof generally rests on the taxpayer, and in any event, disputes are rarely decided by the burden of proof.[115]

Contemporary correspondence and background documentation may be relevant to the factual issue of whether the transferor had the purpose of reducing tax. It will not shed much light on the issue of whether the purpose should be classified as avoidance or mitigation. Some factors such as confidentiality or tax related agreements may shed light on this, or at least, on whether the parties regarded the matter as tax avoidance.[116] In *IRC v Willoughby* 70 TC 57 for instance, the Special Commissioner reviewed sales literature relating to the offshore bonds. In practice, expect the Revenue to ask for contemporary documentation and 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 the intended beneficiaries.

(3) Details of assets transferred.

(4) Contemporary correspondence between trustees, accountants and settlor. (Legal advice may be privileged.)

Sometimes 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.

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115 See 2.6 (Proof of intention).

116 See 15.11.4 (Indicia of avoidance).

Section 741 does not, it is submitted, require a formal claim. If there had been an innocent transfer, a taxpayer was formerly entitled (indeed required) to complete his tax return on the basis that the motive defence applied; he was not required to prove the motive defence applied to the satisfaction of the Board before completing his tax return on that basis. However, it is now necessary for an individual to indicate on the self-assessment return that he has taken advantage of the motive defence.

The Revenue say in RI 201:

> Taxpayers are required to disclose clearly in their self-assessment return if there is any income or benefit assessable under s 739 or 740, and whether reliance is being placed on s 741 to exclude income or benefit from assessment. Where such a disclosure has been made and exemption under s 741 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.

In practice, on receiving a tax return claiming a s.741 defence, the Inspector will open a s.9A TMA 1970 enquiry, and refer the matter to the Revenue's s.739 group.

15.40.1 *Appeals*

Section 741 provides:

> The jurisdiction of the Special Commissioners on any appeal shall include jurisdiction to review any relevant decision taken by the Board in exercise of their functions under this section.

The jurisdiction of the Special Commissioners is appellate and not supervisory; see *Lothbury Investment Co. Ltd v IRC* 53 TC 223 (where this conclusion was reached on comparable legislation now obsolete). This was common ground in *Beneficiary v IRC* [1999] STC (SCD) 134.

A decision of the Special Commissioners is, on ordinary principles, binding on the parties (subject to an appeal) only in relation to the assessments under appeal. It does not bind the parties in other respects, and in *Carvill v IRC* [2000] STC (SCD) 143 a Special Commissioner allowed a section 741 appeal in circumstances where an earlier appeal relating to earlier years had been decided against the taxpayers. The taxpayers then sought to recover from the Revenue the tax which they had 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 section 739 or 740 for a number of years without due consideration being given to the section 741 defence, and then it occurs to a taxpayer that a section 741 defence is possible. It is considered that the principle in *Carvill (No. 2)* only applied where a motive defence had been litigated and decided by the Special Commissioners, and in the absence of litigation on the point it should be possible to put in an error or mistake claim under usual principles.

15.41 Can an individual disclaim the motive defence?

An important question (which would have amazed those who framed the transfer of asset provisions) is whether it is possible for an individual to disclaim the motive defence. There are at least two circumstances where the application of section 739 or 740 may reduce a tax charge:

(1) A UK domiciled and resident beneficiary who receives a capital payment from an offshore trust would usually prefer to be taxed under s.740 than under s.87 TCGA 1992, which may apply if s.740 does not.

(2) A UK resident transferor who receives a distribution from a non-resident company may be more lightly taxed under s.739: he is taxed on the company's income but has the benefit of tax and tax credits paid by the company, and the distribution is tax free.

It is arguable that the words "the individual shows" etc., indicate that the benefit of s.741 can be disclaimed. The individual may choose not to show that there was no tax avoidance purpose. Otherwise we would have the absurd result that a transfer for tax avoidance may be less harshly taxed than one which was not.

However, this view would cause considerable difficulties. Suppose a non-resident trust has relevant income of £1m and trust gains of £1m, and capital payments of £1m are made in year 1 to beneficiary A and in year

2 to beneficiary B. A and B are both resident and domiciled in the UK. Suppose the trust is in principle within the motive defence because the transfer to it was not for tax avoidance purposes. A would probably wish to disclaim the motive defence, if he could, so the capital payment to him was subject to income tax, and he avoided the CGT surcharge. However, it would be in the interest of B to argue that the motive defence did apply, so that the payment to A "washed" the capital gain and the payment to B was tax free. It is evident that the offshore trust rules simply do not work if the motive defence can be disclaimed by one beneficiary and claimed by another. Nor do they work fairly if it can be disclaimed by one beneficiary in a manner which binds all the others. So the better view is thought to be that the motive defence (if applicable on the facts) is compulsory and binds all the beneficiaries.

15.42 Assessment of avoidance/mitigation distinction

See my forthcoming article in [2004] BTR Issue 4 for an assessment of subjectivity, morality and judicial criticism of the avoidance/evasion distinction.

CHAPTER SIXTEEN

RATES OF INCOME TAX

16.1 Introduction

To keep the discussion within reasonable bounds, I concentrate on two common types of income: interest and dividends.

It may be helpful first of all to list the eight possible rates of income tax on individuals.[1] They are:

Rate of tax		**Applicable to**
Starting rate:	10%	Income up to £2,020
Lower rate:	20%	"Savings income" (interest up to basic rate limit (£31,400)
Basic rate:	22%	Other income up to basic rate limit
Higher rate:	40%	Income above basic rate limit
Sch. F ordinary rate:	10%	Dividends up to basic rate limit
Sch. F upper rate:	32.5%	Dividends above basic rate limit
Effective rate on UK dividends within the basic rate limit:	0%	Dividends up to basic rate limit
Effective rate on UK dividends above the basic rate limit:	25%	Dividends above basic rate limit

1 Rates of tax on trustees are not considered here.

16.2 Starting/basic/higher rates

Section 1(2) ICTA 1988 introduces the starting/basic/higher rates:

> Where any Act enacts that income tax shall be charged for any year, income tax shall be charged for that year—
>
> (aa) in respect of so much of an individual's total income as does not exceed [£2,020], at such rate as Parliament may determine to be the starting rate for that year [10%] ;
>
> (a) in respect of any income which does not fall within paragraph (aa) above or paragraph (b) below [income between £2,020 and £31,400], at such rate as Parliament may determine to be the basic rate for that year [22%];
>
> (b) in respect of so much of an individual's total income as exceeds [the basic rate limit, £31,400], at such higher rate as Parliament may determine [40%];
>
> but this subsection has effect subject to any provision of the Income Tax Acts providing for income tax to be charged at a different rate in certain cases.

These rates apply unless disapplied by any other provisions. The important provisions for our purposes are ss.1A and 1B ICTA 1988.

16.3 Terminology

I need to coin some definitions to deal with the clumsy drafting.

16.3.1 "*The basic rate limit*"

The limit at which income passes from s.1(2)(a) to s.1(2)(b), currently £31,400, I call (slightly inaccurately) "the basic rate limit".

16.3.2 *"Interest income"*

Section 1A(2)(a) refers to:

> any income chargeable under Case III of Schedule D other than—
>
> (i) relevant annuities and other annual payments that are not interest ...

I refer to this (slightly inaccurately) as "UK interest income".
Section 1A(3)(a) refers to:

> any income chargeable under Case IV or V of Schedule D which—
> (a) is equivalent to a description of income falling within [s.1A(2)(a)] but arises from securities or other possessions out of the United Kingdom;

I refer to this (slightly inaccurately) as "foreign interest income".

16.3.3 *"Schedule F income" and "foreign dividend income"*

Section 1A(2)(b) refers to:

> (a) any income chargeable under Schedule F

I can refer to this as "Schedule F income".
Section 1A(3)(b) refers to:

> any income chargeable under Case IV or V of Schedule D which...
> (b) consists in any such dividend or other distribution of a company not resident in the United Kingdom as would be chargeable under Schedule F if the company were resident in the United Kingdom.

I refer to this (slightly inaccurately) as "foreign dividend income".

16.3.4 *"Income to which s.1A applies"*

Section 1A(2),(3) provides the definition.[2] So far as matters for our

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2 This provides:

"(2) Subject to subsection (4) below, this section applies to the following income—
- (a) any income chargeable under Case III of Schedule D other than—
  - (i) relevant annuities and other annual payments that are not interest; and
  - (ii) amounts so chargeable by virtue of section 119 ...;
- (aa) any amount chargeable to tax under Case VI of Schedule D by virtue of section 714, 716 or 723;
- (b) any income chargeable under Schedule F; and
- (c) subject to subsection (4) below, any equivalent foreign income.

purposes, s.1A applies to:

(1) UK interest and foreign interest income.

(2) Schedule F and foreign dividend income.

This is subject to s.1A(4) which I consider below.

16.4 Rates of tax on interest

Section 1A ICTA 1988 is headed "**Application of lower rate to income from savings and distributions**" but the heading of the section is wrong: Section 1A applies the lower rate to interest but the Schedule F ordinary rate to dividends.[3] Section 1A begins:

> (1) Subject to sections 469(2), 686 and 720(5), so much of any person's total income for any year of assessment as—
> (a) comprises income to which this section applies, and
> (b) in the case of an individual, is not—
> (i) savings income falling within section 1(2)(aa) [i.e. starting rate income], or
> (ii) income falling within section 1(2)(b) [i.e. higher rate income],
>
> shall, by virtue of this section, be charged for that year at the rate applicable in accordance with subsection (1A) below, instead of at the rate otherwise applicable to it in accordance with section 1(2)(aa) and (a).

The scheme of s.1A is to replace the starting and basic rates with different

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(3) The income which is equivalent foreign income for the purposes of this section is any income chargeable under Case IV or V of Schedule D which—
(a) is equivalent to a description of income falling within subsection (2)(a) above but arises from securities or other possessions out of the United Kingdom; or
(b) consists in any such dividend or other distribution of a company not resident in the United Kingdom as would be chargeable under Schedule F if the company were resident in the United Kingdom."

3 The heading was accurate when s.1A was enacted in 1996 but ceased to be accurate when the section was amended in the 1997 reforms.

(more favourable) rates. Section 1A does not affect the higher rate: see s.1A(1)(b)(ii). The drafter wanted "savings income" to continue to qualify for the (even more generous) starting rate. He achieved this effectively (though clumsily) by excluding from s.1A "savings income falling within s.1(2)(aa)".[4] Section 1A(1A) sets out these favourable rates:

> (1A) The rate applicable in accordance with this subsection is—
> (a) in the case of [Schedule F income], the Schedule F ordinary rate [10%];
> (b) in the case of [foreign dividend income], the Schedule F ordinary rate [10%]; and
> (c) in the case of any other income, the lower rate [20%].

The reader who follows this fantastic labyrinth will conclude that the rates of tax on:

(1) UK interest; and

(2) foreign interest income when the arising basis applies

are the starting/lower/higher rates, 10%/20%/40%.

16.5 Rate where remittance basis applies

Section 1A(4) provides:

> This section does not apply to—
> (a) any income chargeable to tax under Case IV or V of Schedule D which is such that section 65(5)(a) or (b) provides for the tax to be computed on the full amount of sums received in the United Kingdom;

---

4 "Savings income" (in short) is UK interest and foreign interest. The definition is in subsection 1AA:

> "In subsection (1)(b)(i) above "savings income" means income to which this section applies other than—
> (a) income chargeable under Schedule F, or
> (b) equivalent foreign income falling within subsection (3)(b) below and chargeable under Case V of Schedule D."

The label "savings income" is not an accurate one.

This disapplies s.1A and returns to s.1. So foreign interest income taxed on the remittance basis is taxed on the starting/**basic**/higher rates, 10%/**22%**/40%. How much is at stake? At most the difference between the lower rate and the basic rate, 2%, for income between the starting rate and higher rate limits: 2% of (£31,400–£2,020) = £588.

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 some of his income only, it would be necessary, in the absence of s.1A(4), to investigate whether the remitted income represents interest or some other source of income. By disapplying s.1A, and returning to s.1, it is not necessary to ask this question.

16.6 Rates of tax on dividend income

The effect of s.1A ICTA 1988 set out above is that:

(1) Schedule F income and

(2) foreign dividend income taxed on an arising basis

are taxed at the Schedule F ordinary rate (10%) up to the basic rate limit. Section 1A does not affect the higher rate. But s.1B ICTA 1988 provides:

> **Rates of tax applicable to Schedule F income**
> (1) In the case of so much of an individual's income which consists of—
> (a) [Schedule F income] (if any), and
> (b) equivalent foreign income falling within section 1A(3)(b) and chargeable under Case V of Schedule D [foreign dividend income] (if any),
> as is income falling within section 1(2)(b) [higher rate income], income tax shall, by virtue of this subsection, be charged at the Schedule F upper rate, instead of at the rate otherwise applicable to it in accordance with section 1(2)(b).

The reader who follows the twists and turns of ss.1A and 1B will conclude that Schedule F income is taxed at the Schedule F ordinary rate/the Schedule F upper rate 10%/32.5%. After allowing the tax credit and grossing up, the effective rates on net UK dividends are 0%/25%. Foreign dividend income is also taxed at 10%/32.5% when the arising basis applies but without the tax credit or grossing up.

16.6.1 *Rate on foreign dividends when remittance basis applies*

What about foreign dividend income taxed under the remittance basis? Section 1A does not apply: see 16.5 (Rate where remittance basis applies). So this income is taxed at the starting rate/basic rate, 10%/22% up to the basic rate limit.

What about income above the basic rate limit? There are two views. The conventional view is that s.1B does not apply to it, so the income is taxed at 40%. Section 1B applies to "equivalent foreign income falling within s.1A(3)(b)". The dividends do not fall within s.1A(3)(b) because of s. 1A(4).[5] On this view the dividend income taxed on the remittance basis is taxed at the starting/basic/higher rates, 10%/22%/40%.

The contrary view has been suggested. Maurice Parry-Wingfield has read the sections very closely:

> Section 1B(1)(b) refers to income "falling within" – not, for instance, "falling to be dealt within" – section 1A(3)(b). This subsection merely identifies a particular sort of income, namely foreign dividends generally; it is s.1A(4) that determines how they are dealt with (or rather, not dealt with).[6]

On this view, foreign dividend income taxed on the remittance basis is taxed on the starting/basic/**Schedule F upper rates**, 20%/22%/**32.5%**.

This literal reading is right, if one focuses on the individual subsections, but the provisions must be construed in the context of the whole. The better view is considered to be that foreign dividend income taxed on the remittance basis does not "fall within" s.1A(3)(b) for the purposes of s.1B(1)(b). This is consistent with the position relating to foreign interest income: see above. (On the other hand, it is inconsistent with the rates applying to s.660A: see below. But that seems the lesser point in the battle of the anomalies.) Parry-Wingfield concedes:

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5 See 16.5 (Rate where remittance basis applies).

6 *Taxation*, 1 March 2001, page 513.

> I have no doubt that the draftsman meant the 40% rate to apply, but I believe he failed.

The admission is fatal to the argument. The (not so) modern approach to construction is summarised by Lord Diplock:

> 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.[7]

Thus a taxpayer with income above the basic rate limit, who is not domiciled in the United Kingdom, but remits his foreign source dividend income, will be taxed at the starting/basic/higher rates ,10%/22%/40%, and will pay more tax than an individual who is UK domiciled. See, however, 7.9 (Circumstances where it is desirable not to claim Schedule D remittance basis treatment).

16.7 Rates of tax on settlor within section 660A

Section 660C ICTA 1988 provides:

> (1) Tax chargeable by virtue of this Chapter shall be charged—
> (a) in the case of income falling within subsection (1A) below, as if it were income to which section 1A applies by virtue of subsection (2)(b) of that section; and
> (b) in the case of any other income, under Case VI of Schedule D.
> (1A) Income falls within this subsection if it is—
> (a) income chargeable under Schedule F;
> (b) income to which section 1A applies by virtue of its being equivalent foreign income falling within subsection (3)(b) of that section and chargeable under Case V of Schedule D [i.e. foreign dividend income]; ...

Thus, we have two rules: one rule for Schedule F and foreign dividend income; and another rule for other income.

7 "The Courts as Legislators", Address to the Holdsworth Club, 1965.

16.7.1 *Schedule F income within s.660A*

Schedule F income falls within s.660C(1A). So tax is charged:

> as if it were income to which section 1A applies by virtue of s.1A(2)(b).

Income up to the basic rate limit is chargeable at the Schedule F ordinary rate and qualifies for the tax credit. What about Schedule F income above the higher rate limit? Since the Schedule F income is chargeable under Schedule F, s.1B applies and the income is taxed at the Schedule F upper rate.

The same applies to foreign dividend income when taxed on an arising basis.

16.7.2 *Rate on foreign dividends when s.660A remittance basis applies*

What about foreign dividend income which qualifies for the s.660A foreign domicile defence,[8] but is later remitted and becomes taxable under the 660G Proviso? This is *still* taxable at the Schedule F ordinary/upper rates. Section 1A(4) which imposes the starting/basic/higher rates on remitted foreign dividend income does not apply to income within the s.660A remittance basis: it only applies to income within s.65. Contrast the position for foreign dividend income taxed under ordinary principles.[9] While this is an anomaly, it is not possible to construe the legislation any other way.

16.7.3 *Interest income*

Section 660C(1A) provides a special rule for Schedule F income and foreign dividend income. It says nothing about interest. So interest within s.660A is chargeable under Schedule D, Case VI. It is outside my definition of "interest income" for the purposes of s.1A ICTA 1988.[10] Accordingly, it is taxed at the starting/basic/higher rates of 10%/22%/40% and not at the starting/**lower**/higher rate of 10%/**20%**/40%. The difference is only 2%.

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8 See 10.8 (s.660A foreign domicile defence).

9 See 16.6 (Dividend income).

10 See 16.3.2 (Interest income).

16.8 Rates of tax on transferor within s.739

Sections 743(1)(1a) ICTA 1988 are (so far as relevant here) the same as s.660C, so the position is the same as set out for s.660A above.

16.9 Commentary

Before 1997 the rates of income tax were relatively simple. Now a short monograph could be written on the topic. No accurate description could be readily comprehensible; and no comprehensible description could be accurate. The complexity appals even tax practitioners enured to it.[11] The causes are political: Malcolm Gunn identifies them:

(1) the Chancellor's desire to raise taxes without increasing the basic or higher rates of income tax. Hence the 1997 raid on pension funds and charities has brought on the Schedule F lower and upper rates, and the 2004 increase in the rate applicable to trusts from 34% to 40%;

(2) the Chancellor's desire to score political headlines. On the day after the March 1999 Budget we saw: 'the lowest starting rate of tax since 1962'. Those headlines have long since been forgotten, and they were in any event deceptive of the big picture at the time, but we live with the consequence of them.

The tax law rewrite will no doubt simplify the drafting, which is a triumph of obfuscation. Only political reform can provide a much needed simplification of these rules.

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11 "Every time I try to work through sections 1, 1A and 1B, Taxes Act 1988 to see if I have correctly remembered what rates of tax apply to different types of income, I despair."

CHAPTER SEVENTEEN

CAPITAL GAINS TAX ON INDIVIDUALS

17.1 Non-resident individual

Section 2 TCGA 1992 provides:

> ... a person shall be chargeable to capital gains tax in respect of chargeable gains accruing to him in a year of assessment
> [1] during any part of which he is resident in the United Kingdom, or
> [2] during which he is ordinarily resident in the United Kingdom.

In principle, therefore, an individual who is neither resident nor ordinarily resident in the UK during a tax year is not within the scope of CGT. The expression "neither resident nor ordinarily resident" is a clumsy one. In this chapter I shall for simplicity abbreviate it to "non-resident" and leave "and not ordinarily resident" to be understood.

The non-resident individual is generally outside the CGT net regardless of his domicile and regardless of the location of the asset disposed of. This may be contrasted with income tax and inheritance tax, where tax is charged on UK source income and UK situated property regardless of the residence of the individual.

There are two exceptions to the general rule:

(1) Temporary non-residents.

(2) A non-resident trader with a UK branch or agency.

It follows that an individual (regardless of his domicile) can generally avoid CGT if he disposes of an asset in the tax year before he acquires the status of UK resident or ordinary resident – or if he postpones the disposal until the tax year after he has lost that status. The simplest form of CGT planning for an individual whose stay in the UK is a short term one is not to dispose of assets giving rise to chargeable gains while UK resident.

On years of arrival and departure see 5.13 (CGT on individuals: year of arrival and departure).

17.2 Requirements to qualify for CGT remittance basis

Section 12(1) TCGA 1992 provides:

> In the case of individuals resident or ordinarily resident but not domiciled in the United Kingdom,
> [1] capital gains tax shall not be charged in respect of gains accruing to them from the disposal of assets situated outside the United Kingdom...
> [2] except that the tax shall be charged on the amounts (if any) received in the United Kingdom in respect of those chargeable gains, any such amounts being treated as gains accruing when they are received in the United Kingdom.
>
> (Paragraphing added)

In short, where a foreign domiciled individual is UK resident (and so within the scope of CGT), and disposes of assets situated outside the UK, tax is charged (if at all) only on gains remitted to this country.

The CGT remittance basis applies only to foreign domiciled individuals. The use of the word "individual" means that trustees, personal representatives and companies do not qualify for the remittance basis. The Schedule D remittance basis is slightly wider and can apply to trustees and some UK domiciled individuals.

No claim is required, unlike the Schedule D remittance basis, see 7.8 (Claims). This is certainly deliberate. Foreign domicile treatment will be advantageous to the taxpayer in almost all circumstances but not in relation to losses; see 17.18 (Capital losses). If a claim was required, an individual could elect for UK domicile treatment in a year he realised his losses, and foreign domicile treatment in a year he realised his gains.

There is no guidance on the position of a UK resident individual who changes his domicile during a tax year. It is suggested that gains accruing during the non-domiciled part of the year qualify for the remittance basis.

The CGT remittance basis applies to foreign situated assets. The situs of assets is discussed at 35.1 (Situs of assets). (By contrast, the Schedule D remittance basis applies to income from a foreign source; this is a slightly different concept.)

The CGT remittance basis applies to assets situate in Ireland. (By contrast, the Schedule D and earnings income remittance bases do not apply to Irish source income.)

17.3 Operation of CGT remittance basis

The term "received in the United Kingdom" is derived from the Schedule D remittance basis, see 7.10 (The remittance basis). Its meaning is extended in two ways by s.12(2):

> [a] ... there shall be treated as received in the United Kingdom in respect of any gain all amounts paid, used or enjoyed in or in any manner or form transmitted or brought to the United Kingdom, and
>
> [b] subsections (6) to (9) of section 65 of the Taxes Act (under which income applied outside the United Kingdom in payment of debts is, in certain cases, treated as received in the United Kingdom) shall apply as they would apply for the purposes of subsection (5) of that section if the gain were income arising from possessions out of the United Kingdom.
>
> (Paragraphing added)

Limb [a] extends the concept of receipt in the same manner as the employment income remittance basis; see 8.12 ff (Meaning of "remitted to the UK"). This probably brings into charge chattels representing gains which are enjoyed *in specie* in the UK; see 8.14 (Assets purchased out of employment income and brought to UK).

Limb [b] applies to CGT the deemed remittance rules; see 7.40ff (Foreign income used to repay loans: deemed remittances).

A standard way of avoiding the Schedule D remittance basis is to remit after the termination of the relevant source of income. This technique is not applicable to CGT which has no equivalent to the source doctrine.

17.4 Interrelationship of remittance basis with (1) taper relief and (2) other CGT reliefs

TCGA 1992 Schedule A1 para.16(4) applies:

> In relation to any gain that is treated by virtue of—
> (a) subsection (1) of section 12
> ...
> as accruing after the time of the disposal from which it accrues ...

This applies to a gain taxed under the CGT remittance basis, under which gains are treated as accruing when received in the UK. This gives a fictitious date of accrual (and, by implication, a fictitious date of disposal). The fiction is undone for taper relief. Paragraph 16(4) provides:

> ... references in this Schedule
> [a] to the disposal on which the gain accrues,
> [b] to the asset disposed of on that disposal and
> [c] to the time of that disposal
> shall be construed disregarding that subsection.
>
> (Paragraphing added)

So taper relief is calculated by reference to the actual date of disposal.

Example

(1) A foreign domiciliary acquires a foreign situated asset in year 0.

(2) He sells the asset a year later, in year 1.

(3) He remits the proceeds a year later, in year 2.

CGT taper relief is calculated on the basis that he held the asset for one year. But for other reliefs, the date the gain accrued (and by implication the date of disposal) is deemed to be the date of remittance. This will be relevant to, for instance, claims for CGT roll-over relief or enterprise investment scheme reinvestment relief.

17.5 Remittance of part of gain

Suppose a foreign domiciliary purchases a foreign asset for £1m; he sells it for £3m and realises a gain of £2m. If he remits the entire £3m proceeds he will clearly pay tax on the entire £2m gain. But what is the position if he remits only £1m and retains the balance abroad? There would seem to be three possibilities:

(1) The amount remitted is "in respect of" a chargeable gain and CGT is charged on £1m.

(2) The amount remitted is not "in respect of" the gain and is not chargeable to tax.

(3) A proportionate part of the amount remitted is in respect of the gain and CGT is charged on two-thirds of £1m.

The Revenue take view (3):

> Where a capital remittance is made to the United Kingdom from a fund or account into which the proceeds of sale of assets situated outside the United Kingdom have been paid, the remittance will include a due proportion of any capital gains 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.
>
> (Inspector's Manual, paragraph 1567, published 9/95)

While the contrary is arguable, it is considered that the prospects of success in the (likely) event of litigation are slim.

17.6 Gains accruing when non-resident, remitted when United Kingdom resident

CG Manual 25310 provides:

> An individual who becomes resident or ordinarily resident in the United Kingdom but remains domiciled abroad may have realised

> gains on assets located outside the United Kingdom before[1] he or she became resident in the United Kingdom. Those gains may be remitted to the United Kingdom after that individual has become resident. In applying the remittance basis the remittance of such gains should be ignored.

This is sensible and right.

17.7 Gains accruing when resident, remitted when non-resident

The Revenue accept that there is no charge on gains accruing when a taxpayer is UK resident and remitted when non-resident. CG Manual 25312-3 provides:

> **25312 Remittance basis/UK domicile**
> In other words the conditions for remittance basis to apply to gains arising from foreign assets are that
> · the individual realising the gains is within the charge to Capital Gains Tax at both the date of disposal and the date of remittance (ie is resident and/or ordinarily resident at those dates)
> and
> · the individual was not domiciled at the date the gain was realised.
> **25313 Remittance basis/UK domicile**
> The individual's domicile status (although not his or her residence status) at the date of the remittance is irrelevant.

But see 17.15 (Temporary non-residents) below on the possible application of s.10A TCGA 1992 in this situation.

17.8 Gains remitted after acquisition of United Kingdom domicile

CG Manual 25311 provides:

> An individual who is resident or ordinarily resident but who has not been domiciled in the United Kingdom may change his or her domicile status and become domiciled from some date. If that individual:

1 The meaning is, in clear tax years before becoming non-resident. For the year of arrival, see 5.13 (CGT on individuals: year of arrival and departure).

- realised gains on foreign assets in the period when he or she was resident or ordinarily resident but not domiciled, and
- remits those gains after becoming domiciled,

he or she should be assessed on the gains remitted in accordance with TCGA 1992, s.12. The fact that he or she has become domiciled does not prevent assessment of the gains on the remittance basis.

The contrary view is arguable: s.12 TCGA 1992 only applies "in the case of an individual resident or ordinarily resident but not domiciled in the United Kingdom" so it arguably does not apply following acquisition of a UK domicile. This view is, indeed, the more natural reading of s.12. The CGT position (if this view is correct) is only consistent with the position under the Schedule D, Case V remittance basis: see 7.12 (Remittance after acquisition of UK domicile). The difficulty with this is that it seems anomalous that UK tax should be saved by acquisition of a UK domicile. The fact that the anomaly apparently exists for IT is not a powerful reason for extending it to CGT. It is considered that a Court would be likely to strain the construction of the section in order to uphold the Revenue view and prevent an unmerited tax saving. The Revenue approach is said to be supported by a decision of the General Commissioners. On balance, the author considers the prospects of success on an appeal on this point to be slim.

17.9 Gains on gifts and other deemed gains

17.9.1 *The CGT background*

In economic reality a gift cannot give rise to an economic gain and will normally give rise to a loss. However, for CGT purposes a disposal is treated as made for market value if (in the clumsy phrase of the statute) it is a disposal:

> otherwise than by way of a bargain made at arm's length.

On a disposal between connected persons, the transaction is treated as "otherwise than by way of a bargain made at arm's length"; see s.18(2) TCGA 1992.

17.9.2 *Gift by foreign domiciliary*

The CG Manual at 25331-2 states:

> Where an individual assessable on the remittance basis has gifted foreign assets to another person and has not received any disposal proceeds he or she may still be deemed to have realised a gain on the disposal. As that gain is not represented by any money or money's worth in the hands of the individual making the gift, it is not possible for the individual to remit the gain. The gain arising on the making of the gift can therefore never become assessable.
>
> Similarly it is never possible to assess other deemed gains arising to such individuals from foreign assets when the gains are not represented by any asset that can be remitted to the United Kingdom.

This is correct, but in view of the importance of the point for tax planning it is reassuring to see it stated unequivocally in the Manual.

17.9.3 *Sale by foreign domiciliary to connected person*

Suppose now:

(1) F (not UK domiciled) transfers an asset (not UK situate) to B for (say) £100;

(2) F and B are connected persons; so the sale is treated as being for market value, and a gain (which may be more or less than £100) is treated as arising.

It is suggested that the £100 is to be regarded as a sum received "in respect of" the gain. If the sum is received in the UK there will be a charge to tax. If the £100 equals the market value of the asset then the computation is straightforward. Interesting questions arise on a sale at an undervalue. Supposing the asset is worth £200 and has a base cost of £50, giving rise to a deemed gain of £150. If the £100 is remitted it is suggested that one half of the deemed gain should be brought into charge, but other views are possible.

17.10 Liquidation of offshore company

If:

(1) a foreign domiciliary owns non-UK situate shares in a company which is put into liquidation, and

(2) the individual receives sums from the liquidator of the shares,

there will be a disposal: s.122 TCGA 1992. It is considered that under the remittance basis any gain is taxable if the liquidator transfers to the shareholder money in the UK or assets enjoyed in specie here. It should normally be possible to avoid this.

17.11 CGT planning by avoiding a chargeable remittance of gains

If a foreign domiciliary has realised a foreign gain, he must attempt to avoid remitting the proceeds. It may be convenient to retain three funds in three accounts:

1. Schedule D Case IV or V income.

2. Proceeds of disposals including a substantial amount of capital gains.

3. Proceeds of disposals which did not give rise to any (or any substantial) capital gains.

Then if funds are remitted to the UK they can be taken from account 3, and no (or no substantial) tax charge arises; then from account 2, where the gain is taxable but the tax charge is not on the entire proceeds remitted. Funds in accounts 1 and 2 (income and realised gains) can be given to others (while abroad) and a remittance by them would not be taxable provided the gift is genuine, unconditional and completed abroad: see 7.26 (Gift to third party completed abroad).

In computing CGT liabilities on remittances the legislation requires unworkable computations in all but the simplest cases. The Revenue take a realistic approach, see CG Manual 25420:

> 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.

Examples are given in the Manual at 25421 ff.

17.12 CGT planning by turning UK situate into non-UK situate property before disposal

17.12.1 *Moveable assets in United Kingdom*

Moveable assets could perhaps be moved offshore prior to a disposal.

17.12.2 *Shares situate in United Kingdom*

Shares in a UK company are generally UK situate property.

One solution may be to procure the company to issue bearer shares and deposit them abroad. This should be an effective means of creating foreign situate property. See 35.6 (Bearer shares and securities). There is, in principle, a charge to Stamp Duty. The Revenue are at the present time attacking these arrangements with a zeal that is inappropriate, having regard to the technical arguments.

It may be possible as an alternative to arrange that the company has a foreign share register: see 35.2 (Registered shares and securities). However, s.353 Companies Act 1985 requires a company's register of members to be kept at its registered office. To this there is an exception in s.362 Companies Act 1985 for certain overseas branch registers. However, a duplicate of the overseas branch register must be kept at the registered office: see Companies Act 1985 Schedule 14 Part II paragraph 4.

Before the FA 2000 common CGT planning where a UK resident foreign domiciliary ("F") held shares in a UK situate company which he wished to sell free of CGT was:

(1) F gave his shares to a company incorporated in Jersey but resident in the UK ("the Jersey Co").

(2) F elected to hold over the CGT (this is no longer possible).

(3) F sold the shares in the Jersey Co to the purchaser free of CGT.

Note where this was done, the Transfer of Asset conditions are satisfied by the gift.

17.12.3 *Securities in United Kingdom*

Where a foreign domiciliary owns securities in a UK company, it may be possible to make the securities non-UK situate by arranging for them to be registered on a register which is kept out of the UK. Section 190 Companies Act 1985 provides that a company registered in England and Wales must not keep a register of holders of debentures in Scotland, and vice versa. However, it appears to be possible for a company to keep its register of debenture holders outside the UK (unlike the position in relation to shares). Care is needed on implementation.

17.12.4 *Unincorporated UK business carried on by foreign domiciliary*

This could be transferred to a foreign incorporated company under s.162 TCGA 1992 and shares later sold (or settled first). Watch stamp duty. Even if the company were subsequently to become non-resident on emigration of shareholder/directors, no tax would arise except on growth in value since transfer to the company.

17.12.5 *Other property*

In other cases, more artificial tax avoidance schemes may need to be considered (such as may also be used by UK domiciled individuals). These are outside the scope of this book.

17.13 CGT planning before disposal of foreign situate asset

A possibility would be to give the asset to a connected person. The connected person may be a trust created by the foreign domiciliary or a member of his family, or a company owned or controlled by him. A non-resident trust will usually be the most convenient option. No CGT charge arises: see 17.9 (Gains on gifts and other deemed gains). The trust acquires the asset at market value. It will not realise a gain when the asset is sold in due course, by reason of its high acquisition value. And in any case the trust may be effectively outside the scope of CGT. This is, obviously, subject to a *Furniss* objection if the sale is preordained at the time of the gift.

17.14 CGT planning before acquisition of asset or trade

17.14.1 *A general policy*

Individual
⋮
Trust
|
Assets

A good general policy would be that assets on which a chargeable gain may arise should be acquired by a non-resident trust. The anti-avoidance provisions relating to offshore trusts do not apply to foreign domiciled beneficiaries and any gain made by the trustees can be remitted to the non-domiciled settlor in the UK without charge: see 18.2 (The charges to tax on offshore trusts). Take care that the trust is non-resident.

17.14.2 *Structure for UK trading company*

It is not ideal for a foreign domiciled individual to carry on trade through a UK incorporated company which he owns absolutely, as that would give rise to CGT. If the foreign domiciliary does not want to go to the trouble and expense of using an offshore trust, what is the alternative? One possibility is to use a foreign incorporated UK resident company. The shares in the company will not be UK situate for CGT; see 35.4 (Registered shares and securities: situs for CGT). The drawback is that s.739 ICTA 1988 may apply: see 11.4.1 (Foreign incorporated company).

A workable 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.739.[2]

17.15 Temporary non-residents

Prior to the FA 1998, a simple method of avoiding CGT was as follows:

(1) An individual left the UK for the minimum period required to become non-resident.

(2) He disposed of assets during the period of non-residence.

(3) In the following year he would return to the UK.

In practice this technique was used mainly by UK domiciled individuals. Section 10A TCGA 1992 is intended to prevent this, but applies to UK domiciled and non-domiciled individuals alike. The conditions for the application of the section are set out in s.10A(1):

> This section applies in the case of any individual ("the taxpayer") if—
>
> (a) he satisfies the residence requirements [in short, is UK resident] 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

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2 I am grateful to David Rothenberg for this idea.

> [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.
>
> (Sub-paragraphing added)

The consequence of the section applying is set out in subsection (2):

> 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 ...
> were gains or, as the case may be, losses accruing to the taxpayer in the year of return.

(It is mentioned for completeness that there is a complex exception for assets acquired by the taxpayer while abroad.)

This section does apply to a foreign domiciled individual. It may be fairly rare for the foreign domiciled individual to come to the UK for the minimum of four years, leave, and return within five years; nevertheless this will happen from time to time. If, in such cases, the individual disposes of UK situate assets while non-resident, he will be charged to tax on his return.

The more difficult question is how s.10A applies to foreign assets. That is, how does s.10A interact with s.12 TCGA 1992 (remittance basis for foreign situated assets)? Section 12 (1) provides:

> In the case of individuals resident or ordinarily resident but not domiciled in the United Kingdom, capital gains tax shall not be charged in respect of gains accruing to them from the disposal of assets situated outside the United Kingdom (that is, chargeable gains accruing in the year 1965-66 or a later year of assessment) except that the tax shall be charged on the amounts (if any) received in the United

3 Limb [ii], appears to be otiose, given paragraph (d); but it does not matter.

> Kingdom in respect of those chargeable gains, any such amounts being treated as gains accruing when they are received in the United Kingdom.

There are two apparent conflicts between s.10A and s.12. First, s.10A provides that the taxpayer shall be charged to CGT; s.12 provides that CGT shall not be charged in respect of certain gains. Here, plainly, the words of s.10A do not override the narrow exemption in s.12. Second, s.10A provides that the gains accrue in the year of return, and s.12, that the gains accrue in the year of remittance. Again, it appears that s.12 takes precedence.

In all the following examples, "F" is a person non-UK domiciled but within the scope of s.10A: he has resided in the UK for a period ("the original UK resident period") sufficient to satisfy the requirement of s.10A(1)(d); he leaves the UK for one year ("the non-resident period") and then returns ("the year of return").

Example 1

F disposes of foreign assets during the non-resident period, and does not remit the gains to the UK.

It is conceived that one first applies s.10A (which says that the taxpayer shall be charged to CGT as if the gains were gains accruing to the taxpayer in the year of return) and then one applies s.12 (which says that CGT shall not be charged) – so no CGT is payable. Any other result is absurd.

Example 2

F disposes of foreign assets during the non-resident period but remits the proceeds to the UK after the year of return.

Applying s.12 again, the gain is taxed in the year of remittance.

Example 3

F disposes of foreign assets during the non-resident period, and remits the proceeds to the UK in the non-resident period.

It is submitted that the better view is that there is no tax charge in these circumstances. The gains are treated as accruing when received in the UK (applying s.12, overriding s.10A).

Example 4

F disposes of foreign assets during the original UK resident period and remits the proceeds during the non-resident period.

It is again submitted that the better view is that there is no tax charge in these circumstances. The gains are treated as accruing when received in the UK (applying s.12, overriding s.10A).

17.16 Double tax treaties as a defence to CGT charge

A person who is resident in another state may find he is within the scope of UK CGT because:

(1) he is also resident in the UK, or

(2) he becomes resident in the UK in the same tax year, or

(3) he is within the scope of s.10A TCGA 1992.

The OECD Model Convention provides that gains accruing to an alienator who is resident (for the purposes of the Treaty) in the other country shall not be subject to tax in the UK. This is often used as a defence to the s.10A charge by persons domiciled in the UK. It will less often be necessary for a person who is not domiciled in the UK to rely on this, but it may be relevant. The relevant treaty must be examined in each case. The Model OECD Treaty[4] provides:

> **Article 4**
> 1 For the purposes of this Convention, the term "resident of a Contracting State" means any person who, under the laws of that State, is liable to tax therein by reason of his domicile, residence, place of management or any other criterion of a similar nature, and also includes that State and any political subdivision or local authority thereof. This term, however, does not include any person who is liable to tax in that State in respect only of income from sources in that State or capital situated therein.

4 2000 version. The earlier versions are not significantly different.

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; 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);
(b) if the State in which he has his centre of vital interests cannot be determined, or 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;
(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.

The commentary provides:

11 The Article gives preference to the Contracting State in which the individual has a permanent home available to him. This criterion will frequently be sufficient to solve the conflict, eg where the individual has a permanent home in one Contracting State and has only made a stay of some length in the other Contracting State.

12 Subparagraph (a) means, therefore, that in the application of the Convention (that is, where there is a conflict between the laws of the two States) it is considered that the residence is that place where the individual owns or possesses a home; this home must be permanent, that is to say, the individual must have arranged and retained it for his permanent use as opposed to staying at a particular place under such conditions that it is evident that the stay is intended to be of short duration.

13 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). 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).

Analysis

Conceptually and for convenience of exposition it would be helpful to consider separately the concepts of:

(1) "home"

(2) "permanent"

(3) "available"

But this neat analysis is not practical: to some extent the three terms all interact, for a property which is not "available" or "permanent" is less likely to be a "home".

Meaning of "home"

Paragraph 13 of the commentary is certainly correct as far as it goes.
The ordinary meaning of the word "home" is discussed in *Re Y* [1985] Fam. 136 at 140, where Sheldon J said:

> The further question remains, therefore, of what is to be regarded as a "home" for these purposes. It is a question to which little or no assistance in finding an answer is provided by sections 107(1) and 87(3) of the Children Act 1975. Nor, in my view, unless it is to be given, for any particular purpose, some arbitrary statutory meaning, is the concept capable of precise definition. Nor, too, in my opinion, should such a definition be attempted beyond indicating the principal features that a "home" may be expected to embody. Subject to that, in my judgment, it must be a question of fact in any particular case whether or not the applicant has a "home" here within the meaning of the Children Act 1975.

Sheldon J is right that it is not possible to provide a definition. This is what Dicey and Morris mean when they say in relation to the use of the word "home" in s.4 Domicile and Matrimonial Proceedings Act 1973, that one cannot lay down detailed rules. One can, however, identify the features that a "home" may be expected to embody, that is, the characteristics that a "home" may be expected to have. Sheldon J then proceeds to identify these features:

> '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 is not a factor which sheds much light on whether that place is a "home". One can spend a great deal of time, or all one's time, in a place which is not one's home. For instance, no one regards a boarding school as "home" (except an orphan who has no better home elsewhere). Conversely, one can spend relatively little time in a place which is one's home. This very point arose in the case of *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 tenant and 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. Nourse J expressed the point this way:

> 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, No. 168 CM 200 (1987), on the law of domicile, at paragraph 4.20. The Law Commission observes that:

> 'Home' conveys ... the combined ideas of physical presence and *emotional link.*
>
> (My italics)

Sheldon J probably had the same point in mind when he referred to the "comforts of home". The folk-saying is true that "home is where the heart is". In the dictionary definition which Sheldon J approved, home is a place which one *regards* as one's proper abode. The views of the individual himself are therefore highly relevant. It would be, to put it at its lowest, surprising if a place which an individual actually regarded as his home was not in fact his home. The views of the parties as to which property was the main residence were held to be relevant in *Frost v Feltham* (see 55 TC at p 16); the same applies *a fortiori* in determining whether a property is a "home".

The fact that one does not have a room set aside for oneself in a "home" does not shed much light on whether it is a "home". The more important question is whether space is available when one wishes to use it. In Robert Frost's well-known 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.

Meaning of "permanent"

The concept of permanent is more difficult than the concept of home. The OECD commentary is untrammeled by the restraint of precision.

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. The commentary continues:

> 14 If the individual has a permanent home in both Contracting States, paragraph 2 gives preference to the State with which the personal and

economic relations of the individual are closer, this being understood as the centre of vital interests. In the cases where the residence cannot be determined by reference to this rule, paragraph 2 provides as subsidiary criteria, first, habitual abode, and then nationality. If the individual is a national of both States or of neither of them, the question shall be solved by mutual agreement between the States concerned according to the procedure laid down in Article 25.

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.

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.

This is only relevant where the tie-breaker is not decided by the question of a permanent home.

For a discussion of treaty residence, see OTR, Vol 8, p.189 (Robert Venables QC).

17.17 United Kingdom branch or agency

Section 10 TCGA 1992 provides that the non-resident individual or trustee is subject to tax if he is carrying on a trade, profession or vocation in the UK through a branch or agency. Tax is charged on disposals of UK assets which are, or have been, used in a trade. Tax will also be charged on a disposal of the trade itself.

Where an asset ceases to be a chargeable asset, e.g. if the business ceases, or if it becomes situated outside the UK, it is deemed to have been disposed of at market value, thereby crystallising any inherent capital gain: the gain is restricted to the increase in value since 14th March 1989.

However, these rules can easily be avoided by a well advised individual. The business, including chargeable assets, could be transferred to a company as a going concern in exchange for shares and relief claimed under s.162 TCGA 1992 so that the gain is rolled into these shares. This would enable the non-resident to sell the shares in the company free of tax. Section 10 would have no application in these circumstances. Such a plan is subject to the possible application of the *Ramsay* principle, especially if the company does not retain the business which is acquired for very long. With this in mind, the transfer to the company should be made before the vendor has found a purchaser for the asset, or at least before the purchaser has committed himself to the purchase.

17.18 Capital losses

"Allowable losses" are in principle deductible for CGT. CGT is charged on *the total amount of chargeable gains less allowable losses* of a tax year (and unused losses of an earlier year): see s.2 TCGA 1992. Section 16 TCGA 1992 explains the term "allowable loss", subject to immaterial exceptions:

> (1) ... the amount of a loss accruing on a disposal of an asset shall be computed in the same way as the amount of a gain accruing on a disposal is computed.
>
> (2) Except as otherwise expressly provided, all the provisions of this Act which distinguish gains which are chargeable gains from those which are not, or which make part of a gain a chargeable gain, and part not, shall apply also to distinguish losses which are allowable losses from those which are not, and to make part of a loss an allowable loss, and part not; and references in this Act to an allowable loss shall be construed accordingly.
>
> (2A) A loss accruing to a person in a year of assessment shall not be an allowable loss for the purposes of this Act unless, in relation to that year, he gives a notice to an officer of the Board quantifying the amount of that loss; and sections 42 and 43 of the Management Act shall apply in relation to such a notice as if it were a claim for relief.

Two important provisions restrict the term "allowable losses".

17.18.1 *Loss on disposal by non-resident*

Section 16(3) TCGA 1992 provides:

> A loss accruing to a person in a year of assessment during no part of which he is resident or ordinarily resident in the United Kingdom shall not be an allowable loss for the purposes of this Act unless, under section 10, he would be chargeable to tax in respect of a chargeable gain if there had been a gain instead of a loss on that occasion.

A loss accruing to a person who is neither resident nor ordinarily resident in the UK is not an allowable loss. This is the corollary of the more general principle that a gain accruing to such a person is not a chargeable gain (leaving aside the exception for the UK branch or agency/permanent establishment). The realisation of losses outside the scope of CGT is wasteful and to be avoided wherever possible. The individual leaving the UK may consider realising his losses before he acquires non-resident and non-ordinarily resident status. The individual returning to the UK may postpone the disposal of assets with inherent losses until he re-acquires UK resident status.

17.18.2 *Loss on disposal by foreign domiciliary*

Section 16(4) TCGA 1992 provides:

> In accordance with section 12(1), losses accruing on the disposal of assets situated outside the United Kingdom to an individual resident or ordinarily resident but not domiciled in the United Kingdom shall not be allowable losses.

This wording is confusing. It means that losses accruing to a foreign domiciliary on a disposal by the foreign domiciliary of foreign situated property are not allowable.[5]

The rule is capable of acting harshly. A foreign domiciliary will be worse off than a UK domiciliary if:

(1) he realises losses on foreign situate property; and

(2) he realises gains:
  (a) on UK situate property; or
  (b) on foreign situate property and remits the gains to the UK.

It is, however, difficult to think of any better rule.[6]

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5 The section could be taken to mean that losses are not allowable on a disposal (by any person) to a foreign domiciliary; but that cannot be correct.

6 Relief on all losses is too generous when gains are taxed on a remittance basis. Relief on losses remitted to the UK seems sensible at first sight, but in practice it would usually be easy to remit the losses to the UK, so that amounts to a relief for

It may sometimes be possible for a foreign domiciliary to avoid the problem by taking action before disposing of an asset on which a loss will accrue. Consider:

(1) arranging that assets are situated in the UK prior to disposal, by a reversal of the techniques discussed in 17.12 (CGT planning by turning UK situate into non-UK situate property before disposal);

(2) inter-spouse transfer if the other spouse is UK domiciled; see 30.13.3 (Asset yielding a loss).

In practice, a foreign domiciliary would normally be able to avoid CGT on his foreign situated assets and the restriction on allowable losses is a small price to pay for that privilege.

(almost) all losses, at least for a well advised taxpayer.

CHAPTER EIGHTEEN

CAPITAL GAINS TAX AND TRUSTS

18.1 Basic principles

Section 69(1) TCGA 1992 provides:

> In relation to settled property, the trustees of the settlement 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 trustees)...

A trust is in principle treated as a single unit. If the trustees are UK resident, they are subject to CGT. If non-resident, they are broadly outside the scope of CGT but various anti-avoidance provisions may tax the settlor or beneficiaries. On the concept of residence, see 4.3 (Trust residence for CGT).

18.2 The charges to tax on offshore trusts

Because a trust is an entity for CGT purposes it follows that UK trustees are subject to CGT even if their beneficiaries have no connection with the UK. More significantly, the converse will also apply; offshore trustees are not subject to tax even if their beneficiaries are resident in the UK. It is usually an easy matter to select or appoint offshore trustees who will not be liable for CGT. Beneficiaries are, in principle, to be ignored and are taxed neither on trust gains nor on payments out of the trust.

If this principle were to be applied without qualification, CGT would be very easy to avoid. The logical principle is therefore tempered with compromise. Little attempt is made to charge offshore trustees with CGT (unlike IT or IHT). However:

(1) If the settlor is UK domiciled and has an interest under the settlement (as widely and artificially defined) he will be liable to tax on capital gains accruing to the offshore trustees. See s.86 TCGA 1992. I refer to this as the *s.86 charge*.

(2) UK domiciled beneficiaries of an offshore trust may be subject to tax if they receive capital payments from the trustees. See s.87 TCGA 1992. I refer to this as the *s.87 charge*.

A full discussion of these rules requires, and has received, a long book to itself: Robert Venables QC, *Non-Resident Trusts*, 8th ed., 2000. Since the problems mainly affect UK domiciled individuals, and this book is long enough already, the discussion here is an outline only.

18.3 The s.86 charge

The statute provides:

> **Attribution of gains to settlors with interest in non-resident or dual resident settlements**
> (1) This section applies where the following conditions are fulfilled as regards a settlement in a particular year of assessment—
> (a) the settlement is a qualifying settlement in the year;
> (b) the trustees of the settlement fulfil the condition as to residence [in short, are non-UK resident];
> (c) a person who is a settlor in relation to the settlement ("the settlor") is domiciled in the United Kingdom at some time in the year and is either resident in the United Kingdom during any part of the year or ordinarily resident in the United Kingdom during the year;
> (d) at any time during the year the settlor has an interest in the settlement;
> (e) by virtue of disposals of any of the settled property originating from the settlor, there is an amount on which the trustees would be chargeable to tax for the year under section 2(2) if the assumption as to residence ... were made [in short, assuming UK resident trustees]
> ...
> (4) Where this section applies—
> (a) chargeable gains of an amount equal to that referred to in

> subsection (1)(e) above shall be treated as accruing to the settlor in the year, and
> (b) those gains shall be treated as forming the highest part of the amount on which he is chargeable to capital gains tax for the year.

18.4 Foreign domiciliary exemption for s.86

The s.86 charge applies if the settlor:

> is domiciled in the United Kingdom at some time in the year and is either resident in the United Kingdom during any part of the year or ordinarily resident in the United Kingdom during the year.

In short, the s.86 charge does not apply where the settlor is a foreign domiciliary. Note that no protection is afforded (unlike inheritance tax) by the settlor having a foreign domicile merely at the time that the settlement was made. The s.86 charge will apply if the settlor is UK domiciled and either resident or ordinarily resident in the year of assessment in which the gains accrue.

18.5 Two settlors for CGT s.86 charge

The s.86 charge only applies to disposals of settled property "originating from the settlor". This expression is defined in TCGA Schedule 5 paragraph 8, see 34.2.2 (CGT definitions of "settlor").

18.5.1 *Two direct settlors: A adds property to B's trust*

The position is straightforward if one individual ("A") creates a trust and another ("B") adds property to it. A and B are both settlors. If A is foreign domiciled and B is UK domiciled, then A is not subject to CGT under s.86 and B is subject to tax on gains from the funds he provided.

The same applies if B adds value indirectly to A's trust (e.g. by a gift to a company held by the trust). B is a "settlor" for s.86 purposes: see 34.8 (Provision of property for company held by trust). A "just apportionment" is practical, though it may not be easy.

The CG Manual contains the following unexceptionable guidance:

34894.
[June 2003]
If IR Trusts–Bootle or Financial Intermediaries and Claims Office (formerly Claims Branch) have given advice on apportionment for Income Tax purposes, this should be followed for CGT. Otherwise, if settlors together make the settlement, the gains in such a case should be apportioned according to the amounts each put in. If a settlor adds to a settlement, then the amount put in should be compared with the value of the settlement at that time. Districts should endeavour to reach a fair and easily worked solution.[1]

18.5.2 *Direct and indirect settlors*

The position is less clear where there is an arrangement under which:

(1) A makes a gift of property to B, and

(2) B gifts the property to a trust.

There are two settlors, an indirect settlor ("A") and a direct settlor ("B"). See 34.4 (Gift to B followed by gift to trust by B). Both have provided the *same* property. No issue arises if A and B are both foreign domiciled. What is the position if they are both UK domiciled? There is no clear provision how to apportion the gains between A and B, and since the gains cannot be subject to tax twice, it is strongly arguable that there is no tax charge at all. The Courts would have taken that view in the past: see *Lord Herbert v IRC* 25 TC 91. It is possible that a Court applying a "never mind the words" purposive approach would seek to identify a "real" settlor (presumably B) and infer that A is not to be regarded as the settlor.

If A is UK domiciled and B is not (or *vice versa*) there is no double charge, but the argument just about still runs that A (the UK settlor) cannot be taxed; though in these circumstances the argument is unmeritorious and one would not like to rely on it.

This issue usually arises in the context of failed tax planning of the kind discussed at 34.18 (Tax planning to create settlement with foreign domiciled settlor).

If A is not UK domiciled and B is UK domiciled, there is no double

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1 The Manual continues with an anodyne example not printed here.

charge. B can argue that he is not the "real" settlor. In practice this factual situation should not arise.

18.6 The s.87 charge

The statute provides:

> **Attribution of gains to beneficiaries**
> (1) This section applies to a settlement for any year of assessment during which the trustees are at no time resident or ordinarily resident in the United Kingdom.
> (2) There shall be computed in respect of every year of assessment for which this section applies the amount on which the trustees would have been chargeable to tax ... if they had been resident or ordinarily resident in the United Kingdom in the year; and that amount ... is ... referred to as the trust gains for the year.
> ...
> (4) Subject to the following provisions of this section, the trust gains for a year of assessment shall be treated as chargeable gains accruing in that year to beneficiaries of the settlement who receive capital payments from the trustees in that year or have received such payments in any earlier year.

18.7 Foreign domicile exemption for s.87

Section 87(7) provides the exemption:

> A beneficiary shall not be charged to tax on chargeable gains treated by virtue of subsection (4) above as accruing to him in any year unless he is domiciled in the United Kingdom at some time in that year.

A beneficiary who is not domiciled in the UK at any time during the tax year is altogether exempt from the s.87 charge regardless of his residence or ordinary residence and regardless of the domicile of the settlor. This exemption is much more generous than the remittance basis, for the beneficiary may receive the gains in the UK free of tax.

18.7.1 *Change of domicile of beneficiary*

The beneficiary qualifies for the relief if he is domiciled outside the UK throughout the year that the gain is deemed to have accrued to him. That is the later of:

(1) the year of the capital payment; and

(2) the year the trust gains accrue.

If, therefore:

(1) the capital payment is made in year 1 when the beneficiary is not UK domiciled; and

(2) the trust has no "trust gains" at that time; and

(3) trust gains accrue in a later year ("year 2") during which the beneficiary is UK domiciled,

then the foreign domicile relief does not apply.

The position would be different if trust gains equal to (or exceeding) the capital payment accrued in year 1. In that case, the trust gains of year 2 would not be attributable to the beneficiary, even if he has become UK domiciled by then. Section 87(5) provides:

> The attribution of chargeable gains to beneficiaries under subsection (4) above shall be made in proportion to, but shall not exceed, the amounts of the capital payments received by them.

18.8 Four basic strategies for the s.87 charge

The problem of s.87 only applies where there is a UK domiciled beneficiary, and is therefore strictly outside the scope of this book. In outline, however, the position is as follows:

18.8.1 *Indefinite deferral*

This is obvious and straightforward. Beneficiaries are only liable to the s.87 charge if they receive a capital payment, and only then if they are UK domiciled. But there may be no immediate need for a capital payment to be made. Instead, the capital of the trust fund may be retained abroad and any trust gains reinvested there. The beneficiaries of the settlement would enjoy immediate or (if the trust income is accumulated) long-term benefits of a trust fund unreduced by the burden of CGT. In this way the charge may be postponed until further tax planning becomes possible – or indefinitely, and the s.87 charge remains no more than a cloud on the horizon.

18.8.2 *The non-resident beneficiary*

Trust gains are treated as chargeable gains accruing to a beneficiary who receives capital payments. But a beneficiary who is neither resident nor ordinarily resident in the UK is not subject to capital gains. Such a beneficiary may therefore receive capital payments from the trust with impunity, just as he can realise capital gains of his own without incurring any tax charge. However, a temporary non-resident will be subject to CGT on his return: see 17.15 (Temporary non-residents).

18.8.3 *Mixed UK and foreign beneficiaries: simple capital payments*

Trust gains which have been attributed to a beneficiary in an earlier tax year cease to be available for the purpose of the s.87 charge in the following year. This principle applies whether or not the beneficiary was subject to the s.87 charge. Suppose that capital payments had been attributed to a non-resident or a foreign domiciled beneficiary and the capital payments equal the total trust gains. Those gains are sometimes said to have been *washed*. In subsequent tax years these are not taken into account and a capital payment may be made to a UK beneficiary without incurring any tax charge under s.87. The trustees should note that correct timing is of vital importance. The payment to the exempt beneficiary must be made in one tax year and the payment to a UK beneficiary must be postponed until the following tax year. Subsequent trust gains may be taxed on the UK beneficiary.

18.8.4 *Mixed UK and foreign beneficiaries: capital payment and resettlement*

If one or more of the beneficiaries of the settlement are at any time not domiciled in the UK, the trustees might consider advancing the trust capital to those beneficiaries absolutely. The beneficiaries might then independently resettle the property and gain additional inheritance tax advantages. The CGT position would be substantially improved for the other beneficiaries by washing out an amount of trust gains equal to the advancement. Great care is needed in implementing arrangements of this kind. See also Example 2 in 34.18 (Tax planning to create a settlement with foreign domiciled settlor).

18.9 CGT problems on termination of a non-resident settlement

Every settlement must eventually come to an end. Any outstanding trust gains at that time will be attributed to the beneficiaries who become entitled to the trust property: s.97(2) TCGA 1992. This rule will not, in practice, affect well drafted settlements, whose life may extend for a century or more. Moreover, if action is taken in good time it will generally be possible to extend the life of poorly drafted settlements by judicious exercise of trustees' powers. The trustees should firmly bear in mind the date when their settlement may come to an end so as to take action beforehand.

18.10 Non-resident companies held by trustees

There is no CGT advantage to be gained by transferring trust assets to a company the shares of which are held by trustees on the terms of their settlement. Gains accruing to such a company are normally attributed to the trustees and constitute trust gains: s.13 TCGA 1992. In addition, there may be a chargeable gain when the offshore trustees dispose of the company's shares. The use of the company may therefore double the potential CGT charges. However, this will normally be of concern only to UK domiciled settlors or beneficiaries.

18.11 Capital gains tax planning

In the short term the foreign domiciliary may be content to use the remittance basis to avoid any CGT liability. In the longer term, this is bound to become unsatisfactory and something more is required. The principle of the foreign domiciliary's long-term CGT planning is that the foreign domiciliary should hold his wealth through the medium of an offshore trust. The offshore trustees will not be subject to CGT in any event, and neither will foreign domiciled beneficiaries, even if all the gains are remitted to the UK.

18.12 Creating a settlement

The creation of an offshore trust presents no CGT problem if:

(1) the individual is non-resident; or

(2) the asset transferred is sterling; or

(3) the asset transferred is not UK situate; or

(4) the asset transferred does not give rise to a gain.

For UK assets pregnant with gain, see 17.12 (CGT planning by turning UK situate into non-UK situate property).

18.13 Capital gains tax planning for offshore trustees

Offshore trustees must firstly ensure that they do not themselves become liable for the tax: see 18.1 (Basic principles) above. The trustees' next aim should be the careful consideration and avoidance of the s.87 charge on the beneficiaries: see 18.8 (Four basic strategies for the s.87 charge).

18.14 United Kingdom resident trust

A UK resident trust is in principle subject to CGT even if the settlor is a foreign domiciliary. One might avoid this problem for the future by exporting the trust (appointing non-resident trustees) but there will be a "migration" charge under s.80 TCGA 1992. This applies even if the assets are not situated in the UK. The remittance basis does not apply as that only applies to "individuals"; trustees are not individuals: s.65(2) TCGA 1992.

One solution may be to transfer assets from the trust to foreign domiciled beneficiaries absolutely. Although this involves a disposal by the trustees, it will often 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 sell without a CGT charge.

18.15 United Kingdom resident trust (settlor a beneficiary)

An interesting question arises where the settlor is foreign domiciled, UK resident, and has an interest in the trust (as defined). Section 77(1) provides:

> (1) Where in a year of assessment—
>
> (a) chargeable gains accrue to the trustees of a settlement from the disposal of any or all of the settled property,
>
> (b) after making any deduction provided for by section 2(2) in respect of disposals of the settled property there remains an amount on which the trustees would be chargeable to tax for the year in respect of those gains if —
>
> (i) the gains were not eligible for taper relief, but section 2(2) applied as if they were (so that the order of deducting losses provided for by section 2A(6) applied), and
>
> (ii) section 3 were disregarded,
>
> 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[2] but
>
> [ii] instead chargeable gains of an amount equal to that referred to in paragraph (b) shall be treated as accruing to the settlor in that year.
>
> (Paragraphing added)

Suppose the trustees dispose of assets situated outside the UK. Does the remittance basis apply? The Revenue say it does not.[3] CG Manual 34911 provides:

> The remittance basis of assessment provided by Section 12 TCGA 1992, see CG25300+, does not apply to trust gains attributed to a settlor who is not domiciled in the UK. If settled property situated outside the UK is disposed of by trustees, the chargeable gain which

2 i.e. those gains.

3 This is also the view of Robert Venables QC: *Non-Resident Trusts*, 8th ed., 11.6.4 (Charge on settlor with interest in settlement – UK settlor provisions).

> in consequence is treated as accruing to the settlor does not accrue to that person *by reason of* the disposal of assets situated outside the UK. It accrues as a consequence of the operation of the statutory provisions. The requirements of Section 12(1) are therefore not satisfied.
>
> (Emphasis added)

Now, s.12 provides that CGT shall not be charged in respect of gains accruing to [the foreign domiciliary] *from* the disposal of assets situated outside the United Kingdom.

Note first of all that the section does not say that there must be disposal by the foreign domiciled individual.

The Revenue argument set out above is wrong (or at least wrongly expressed) because it asks the wrong question. The issue is not whether the gain accrues *by reason of* the disposal of foreign assets. The issue is whether there is a charge to CGT *in respect of* gains accruing to the foreign domiciliary *from* the disposal of foreign assets.

The Revenue could reformulate their argument and say that the gains accruing to the foreign domiciliary do not arise from the disposal of the trustees' assets but only as a consequence of s.77. But the fact that it needs a statutory provision to deem the gain to accrue to the settlor should not mean that the gain does not accrue *from* the disposal of the foreign assets.

A better Revenue argument is that s.77 does not deem the gains from the assets to accrue to the settlor, but *chargeable gains of an amount equal* to those gains.[4] However, the distinction between a chargeable gain and an amount equal to a chargeable gain is so slender as to be meaningless. The two gains can be identified. Even if they cannot be identified, the artificial gain deemed to accrue to the settlor may still be said to arise *from* the disposal of the foreign assets by the trustees, albeit indirectly.

Does the scheme of the legislation shed any light on the issue? The Revenue may say there is an anomaly in that (on the author's view) trustees with a UK resident foreign domiciled settlor may escape tax but tax will be charged if the settlor is not UK resident. But, in the first case, the settlor is subject to tax on a remittance basis, so the anomaly is not that

4 Similar questions arise in relation to DTT relief where the trust is resident in a jurisdiction with a double tax treaty. See *Taxation of Non-Resident Companies and their Shareholders*, by Stephen Brandon QC, Key Haven Publications.

serious.

Comparisons can be drawn with s.660A ICTA 1988, but that section operates in an entirely different way and does not shed much light on the current issue.

Note that if the settlor were to die in the same year of assessment, the gains would not be attributed to him (see s.77(6) TCGA 1992) and would be chargeable in full on the UK trustees.

CHAPTER NINETEEN

LIFE POLICIES AND CONTRACTS ("BONDS")

19.1 Introduction

This chapter considers gains from:

(1) a policy of life insurance,

(2) contract for life annuity, or

(3) capital redemption policy.

In practice one usually meets life insurance rather than life annuities or capital redemption policies. The asset is often described in the life insurance industry as a bond; statute has adopted that term in the expression "personal portfolio bond". Strictly the term "bond" is wider, meaning any obligation undertaken by deed. So these are together referred to in this chapter as "a policy or contract". This is the terminology generally used in the legislation.

They fall within the scope of Chapter II, Part XIII, ICTA 1988, known as the "chargeable event provisions". A full discussion of these provisions needs a book to itself.[1] A continual process of amendment has created a fine tangle even by the standards of UK tax legislation. The provisions are often very crude with many traps (e.g. on a partial surrender). There is also scope for tax planning. This is the only place I have seen in the

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1 This book has yet to be written, but for an introduction see Robert Venables QC, *Non-Resident Trusts* 8th ed., 2000, Chap. 12B (Offshore Insurance Policies).

Revenue Manuals where districts are warned "not to attempt any discussion or explanation as to the equity of the treatment for tax"; Assessment Procedures Manual, 3147a.

In outline, there are three stages to the application of these provisions. The first is to ascertain whether there is a "chargeable event". The second stage is to compute the gain arising[2] on the chargeable event. These aspects are not discussed here. The third stage is to ascertain the person chargeable, a process described in the statute as "the method of charging the gain to tax".

19.2 The charge on individuals and individual 'creators'

Section 547 ICTA 1988 provides:

> (1) Where... a gain is to be treated as arising in connection with any policy or contract—
> (a) if, immediately before the happening of the chargeable event in question, the rights conferred by the policy or contract were
> [i] vested in an individual as beneficial owner, or
> [ii] were held on non-charitable trusts created by an individual or
> [iii] as security for a debt owed by an individual,
> the amount of the gain shall be deemed to form part of that individual's total income for the year in which the event happened;
>
> (Paragraphing added)

Rule [i] – gain charged on individual if he is beneficial owner – is natural and sensible.

There are two strange features about rule [ii] where a policy or contract is held in a trust. Firstly, it does not refer to the "settlor", which is the normal tax terminology, but to trusts "created" by a person. In practice, the settlor will usually be the "creator".[3]

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2 The general usage of the CGT legislation is that gains "accrue"; in the chargeable events legislation the gains "arise". There is no difference in meaning.

3 The reason for the different term was, possibly, (1) to avoid the rule that a "settlor" must have provided an element of bounty or (2) a concern that a company may not be a "settlor"; see 34.17 (Settlement made by company), or (most likely) (3) as a rough and ready way to deal with the two-settlor situation. That is, if one person

Secondly, amazingly, the individual is charged on the gain accruing to a trust which he created quite 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 settlor's marginal rates. This is wholly contrary to principle, which elsewhere only charges the settlor in this way if he or those closely connected to him are beneficiaries. But there it is.

Rule [iii] – gain charged on individual if held as security for a debt owed by an individual – is another incredibly rough and ready solution to the problem of imposing the tax charge where the economic ownership lies. CGT has the opposite rule: s.26 TCGA 1992.

For cases where more than one person has an interest, see s.547A ICTA 1988 (multiple interests).

19.2.1 *UK resident foreign domiciled individual*

The drafting technique is that the gain is added to the individual's "total income". The gain is then taxed on an arising basis. The remittance basis does not apply even if the individual is not domiciled here and the gain arises from an offshore policy. This is a surprising inconsistency with the general scheme of taxation for foreign domiciliaries and presumably an oversight. But the language is clear and one cannot read in a remittance basis even on a purposive construction.

It follows that a policy or contract which will give rise to a gain within the chargeable event provisions is not a suitable form of investment for:

(1) a UK resident foreign domiciled individual;

(2) a trust with a UK resident foreign domiciled "creator",[4]

unless the individual expects to be non-resident in the year of the

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created a trust and another added property, only the first was the "creator"; and was subject to tax on the whole of the gain. That rule is now perhaps mitigated by s.547A ICTA 1988. (Contrast the usage of Civil Procedure Rules 64.4(2) distinguishing the person who created the trust from one who provided property for the purpose of the trust.)

4 But it may be suitable if held by a non-resident company held by the trust: see below.

chargeable event.

19.2.2 *Individual non-resident in year of chargeable event*

Section 547(1)(a),(b) charge the gain on an individual and on a company and provide no express exemption for a non-resident individual or company. However, ESC B53 provides:

> 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, the Inland Revenue will not pursue liability to tax on a gain that is treated as income of either an individual or a company that is not resident in the UK at any time during the year of assessment or accounting period, as appropriate, in which the gain is chargeable.[5]

The split year concession does not apply; see 5.11(Gains from life policies). The CGT temporary non-residence rule does not apply; see 17.15 (Temporary non-residents).

19.2.3 *Non-resident period relief*

There is a relief for the individual who is UK resident when the gain arises (so he is within the charge) but who has formerly been non-resident. I refer to this as "non-resident period relief". The relief is set out in s.553(3):

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5 For completeness, the concession continues:

> "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" represents the law, rather than a concession. Section 547(1)(d),(e) assume that the charge only applies to an individual or company which is UK resident immediately before the happening of the chargeable event. This will only matter if the Revenue seek to withdraw the concession because of tax avoidance.

> Subject to subsections (5) and (5A) below, on the happening of a chargeable event in relation to a new non-resident policy or a new offshore capital redemption policy, the amount which, apart from this subsection, would by virtue of section 541 or 546C(7)(b) be treated as a gain arising in connection with the policy shall be reduced by multiplying it by the fraction A÷B
> where—
> A is the number of days on which the policy holder was resident in the United Kingdom in the period for which the policy has run before the happening of the chargeable event; and
> B is the number of days in that period.

The relief applies freely where individuals are charged on the gain as being beneficial owners or security owners under s.547(1)(a)[i] or [iii]. It does not help individuals who have had non-resident periods but who are charged as being creators of a trust. It is disapplied by subsections (5) and (5A) where the policy is or was held by non-resident trusts or institutions, with certain transitional exceptions.

19.3 Policy held by trust where creator not taxable

If the "creator" of the trust is alive and UK resident, he will be taxed on the gain: see 19.2 (The charge on individuals).

Section 547 provides:

> (1)(d) if, immediately before the happening of that event,—
> (i) those rights [the rights conferred by the policy or contract] were held on non-charitable trusts, and the person who created the trusts
> [1] was not resident in the United Kingdom or
> [2] had died or
> [3] (in the case of a company or foreign institution) had been dissolved or wound up or had otherwise come to an end, or
> (ia) those rights were held on non-charitable trusts and the circumstances were not such as are mentioned in paragraph (a), (b) or (c) above or sub-paragraph (i) above, or
> (ii) those rights were held as security for a debt owed by trustees,
> subsection (9) or (10) below (as the case may be) shall apply in relation to the amount of the gain ...
>
> [Paragraphing added]

Subsections (9) and (10) set out rules for resident and non-resident trusts respectively.

19.3.1 *UK resident trust*

Section 547(9) provides:

> If, in a case falling within subsection (1) ... (d) above, the trustees were resident in the United Kingdom immediately before the happening of the chargeable event in question, the amount of the gain—
> (a) shall be deemed to form part of the income of the trustees for the year of assessment in which the chargeable event happened; and
> (b) shall be chargeable to income tax at the appropriate rate for that year.

The appropriate rate (except for charities) is the rate applicable to trusts, increased in the FA 2004 to 40%: s.547(9A).

19.3.2 *Non-resident trust*

Non-resident trustees are outside the scope of the charge themselves because s.547(9) (the provision imposing the charge on trustees) applies only to UK resident trustees. Section 547(10) provides:

> If, in a case falling within subsection (1)(d) above, the trustees were not resident in the United Kingdom immediately before the happening of the chargeable event in question, then, for the purpose of determining whether an individual ordinarily resident in the United Kingdom has a liability for income tax in respect of the amount of the gain, section 740 shall apply as if—
> (a) the amount of the gain constituted income becoming payable to the trustees; and
> (b) that income were income arising to the trustees in the year of assessment in which the chargeable event happened.

Section 739 does not apply as the gain is not income in the general sense or treated as income for tax purposes. Section 739 is not needed here as unless the transferor is dead or non-resident he would normally be taxed as the "creator" of the settlement.

19.4 Policy held by “foreign institution”[6]

Section 547 provides:

> (1)(e) if, immediately before the happening of that event, those rights [the rights conferred by the policy or contract] —
> (i) were in the beneficial ownership of a foreign institution, or
> (ii) were held as security for a debt owed by a foreign institution,
> subsection (11) below shall apply in relation to the amount of the gain.
> ...
> (11) In a case falling within subsection (1)(e) above, for the purpose of determining whether an individual ordinarily resident in the United Kingdom has a liability for income tax in respect of the amount of the gain, section 740 shall apply as if—
> (a) the amount of the gain constituted income becoming payable to the foreign institution; and
> (b) that income were income arising to the foreign institution in the year of assessment in which the chargeable event happened.

Section 739 will not apply, because the gain is not income or deemed to be income. This is an omission which gives some scope for tax planning if one is 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.

19.5 Transferor’s defence to s.740

Suppose a foreign company receives a gain within s.740, and the *transferor* receives a benefit. Normally a transferor is outside the scope of s.740: see 13.3 (Position of transferor). There is an argument that the section should not apply even here. However, the resulting anomaly is unlikely to be accepted in a modern Court.

19.6 Foreign domicile defence to s.740

Suppose:

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6 “foreign institution” is defined to mean a person which is a company or other institution resident or domiciled outside the United Kingdom: s.547(13).

(1) a company or trust receives a gain within the scope of s.740; and

(2) a foreign domiciled beneficiary receives a benefit outside the UK.

There can be no defence: the gain (which is deemed to be income for the purposes of s.740) is not "excluded relevant income", because the remittance basis does not apply to these gains. See 13.29 (Excluded relevant income).

19.7 Motive defence to s.740

Suppose a gain aries to a company or trust which qualifies for the motive defence to s.740: see 15.1 (Motive defence). Here there is a conflict between two sections: s.741 states that "section 740 shall not apply" and s.547(11) states that s.740 "shall apply". Which prevails? Robert Venables QC prefers the view that the motive defence prevails.[7] The point is arguable both ways and the outcome of litigation unpredictable.

19.8 Section 660A and life policies

Section 660A ICTA 1988 never has application to a gain arising on the disposal of a life policy or contract. To see why, it is helpful to distinguish:

(1) UK resident settlor;

(2) non-UK resident settlor:
  (a) non-resident trustees;
  (b) UK resident trustees.

The chargeable event provision taxing a UK resident "creator" leaves no scope for section 660A where the settlor is UK resident. Where the settlor is non-resident and the trustees are non-resident, section 660A has no application because the gain arising on the disposal of the life policy or contract is not "income" and so it is not "income arising under a settlement". Where the trustees are UK resident, but the settlor is not

7 *Non-Resident Trusts*, 8th ed., 12B, 3.3.3 (Trustees non-resident).

resident, the gain is deemed to be income of the trustees,[8] but even here s.660A does not apply. In these circumstances the s.660A non-resident settlor defence will apply.[9]

19.9 Planning for immigrant to UK

19.9.1 *Immigrant policyholder who has become resident in the UK*

The advisors of a foreign domiciled person who has recently come to the UK should check whether he or any trust he has created has any life policy or contract. If so, the position needs to be considered carefully.

An assignment of the policy or contract from an individual to a trust (resident or not) does not help, so long as the individual is still here.

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 a chargeable event but this can at least be anticipated and perhaps postponed to a year when the individual is non-resident. A death giving rise to benefits under the policy is also a chargeable event unless the policy is a qualifying policy. In such a case one would be at risk that the individual may die while UK resident, giving rise to the tax charge on his estate.

If a chargeable event is anticipated, the policy or contract could be assigned to a non-resident company, perhaps held by a trust. This postpones the charge to the time that an ordinarily resident individual receives benefits: see 19.4 (Policy held by foreign institution). An assignment for no consideration is not a chargeable event. Another course is for the individual to surrender his policy shortly after becoming UK resident; most of the gain will qualify for non-resident period relief; see 19.2.3 (Non-resident period relief).

Another possibility is that the trust holding the policy or contract is or becomes resident in an area with a suitable double tax treaty.

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8 See 19.3.1 (UK resident trust).

9 That is, the gain is such that if the settlor were actually entitled thereto, he would not be chargeable to income tax by reason of being non-resident: see 10.19 (s.660A non-resident settlor).

19.9.2 *Planning before becoming UK resident*

There are further possibilities if the individual acts before the tax year in which he becomes UK resident. One possibility is to surrender the policies.

19.10 Personal portfolio bonds

Urgent action needs to be taken if the individual (or trust created by him) holds a "personal portfolio bond" as defined in the Personal Portfolio Bonds (Tax) Regulations 1999. This topic, on which the Revenue have issued 36 pages of Guidance Notes,[10] cannot be pursued here.

ESC B53 provides:

> **Personal Portfolio Bonds and individuals not resident in the UK on 17 March 1998**
>
> 11 The Personal Portfolio Bond (Tax) Regulations, S.I. 1999 No. 1029, impose a yearly charge to tax on policies of life insurance, life annuity contracts and capital redemption policies that are personal portfolio bonds within the meaning of those regulations.
>
> 12 In some circumstances it is possible to change the terms of a policy or contract taken out before 17 March 1998 to take it outside the definition of a personal portfolio bond. A person who was not resident in the United Kingdom on that day and who later becomes resident has to make the change before the end of either the first "year" to begin on or after 6 April 1999 or, if later, the first "year" to begin after the policy holder becomes resident in the United Kingdom. "Year", in this context, is as defined in Section 546(4) ICTA.
>
> 13 ICTA makes no provision for splitting tax years in relation to residence. So an individual who becomes resident in the UK during a year of assessment is resident for the whole year. This means that, in an extreme case, the period available to make the change could end very shortly after the policy holder arrives in the UK.
>
> 14 By concession, where an individual comes to the UK to take up permanent residence, or to stay for at least two years, the "year" before the end of which the change has to be made to the policy or contract will be the first "year" to begin on or after the date on which the policy holder first arrives in the UK to take up permanent residence or to stay.

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10 Accessible on *www.inlandrevenue.gov.uk*.

19.11 CGT

Section 210 TCGA 1992 provides an exemption for policies and contracts.

The CGT exemption does not extend to capital redemption policies. This may be because in practice such policies only give rise to income rather than capital gains.

19.12 Situs

On this topic see 35.16 (Insurance policies).

CHAPTER TWENTY

OFFSHORE FUNDS

20.1 Introduction

This subject needs a book to itself. It would be an unrewarding work, however, because the rules are not well observed in practice. The reader who studies this chapter will see why. Changes had been expected in the light of the consultative document "Offshore Funds" (April 2002) but the result in the FA 2004 was merely tinkering. The following focuses on the questions which most often affect foreign domiciliaries.

In outline, the provisions apply to an offshore income gain ("OIG") arising on a disposal of a material interest in a non-qualifying offshore fund.

20.2 Meaning of "offshore fund"

In outline, the definition is provided by s.756A(1):

> a collective investment scheme constituted by—
> (a) a company that is resident outside the United Kingdom;
> (b) a unit trust scheme the trustees of which are not resident in the United Kingdom; or
> (c) arrangements not falling within paragraph (a) or (b) taking effect by virtue of the law of a territory outside the United Kingdom and which under that law create rights in the nature of co-ownership (without restricting that expression to its meaning in the law of any part of the United Kingdom).

An offshore fund is a non-qualifying fund unless it is certified by the Revenue as a distributing fund: see section 760 ICTA 1988. The Revenue publish a list of such funds. Very broadly, the legislation is dealing with funds known as “roll up funds”.

20.3 Meaning of “material interest”

In outline, the definition is provided by section 759(2):

> Subject to the following provisions of this section, a person's interest in a company, unit trust scheme or arrangements is a material interest if, at the time when he acquired the interest, it could reasonably be expected that, at some time during the period of seven years beginning at the time of his acquisition, he would be able to realise the value of the interest (whether by transfer, surrender or in any other manner).

20.4 Meaning of “disposal”

In outline, the position is governed by section 757(2):

> Subject to the following provisions of this section and section 758, there is a disposal of an asset for the purposes of this Chapter if there would be such a disposal for the purposes of the [TCGA 1992].

20.5 “Offshore income gains”

The legislation distinguishes:

(1) Offshore income gains (the offshore funds concept); and

(2) chargeable gains (a CGT concept).

Offshore income gains are computed in accordance with Schedule 28 ICTA 1988.

20.6 The charge to tax

This is governed by section 761 which provides:

> **Charge to income tax or corporation tax of offshore income gain**
> (1) If a disposal to which this Chapter applies gives rise in accordance with section 758 or Schedule 28 to an offshore income gain, then, subject to the provisions of this section, the amount of that gain shall be

treated for all the purposes of the Tax Acts as—

(a) income arising at the time of the disposal to the person making the disposal, and

(b) constituting profits or gains chargeable to tax under Case VI of Schedule D for the chargeable period in which the disposal is made.

20.6.1 *Non-residents*

Section 761(2) brings in a territorial limitation for non-residents:

> Subject to subsection (3) below, sections 2(1) and 10 of the [TCGA 1992] (persons chargeable to tax in respect of chargeable gains) and section 11(2)(b) shall have effect in relation to income tax or corporation tax in respect of offshore income gains as they have effect in relation to capital gains tax or corporation tax in respect of chargeable gains.

Amended as s.761(2) directs, s.2(1) TCGA 1992 provides (so far as relevant):

> ... a person shall be chargeable to [income tax] in respect of [offshore income gains] accruing to him in a year of assessment during any part of which he is resident in the United Kingdom, or during which he is ordinarily resident in the United Kingdom.

By implication, a person not resident (and not ordinarily resident) is not chargeable to IT on offshore income gains. This incorporates the CGT residence rules by reference. The CGT temporary non-residence rule does not apply.

20.6.2 *UK resident foreign domiciled individual*

Section 761(5) introduces a remittance basis for the UK resident, foreign domiciled individual:

> In the case of individuals resident or ordinarily resident but not domiciled in the United Kingdom, section 12 of the [TCGA 1992] (which provides for taxation on a remittance basis) shall have effect in relation to income tax chargeable by virtue of subsection (1) above on an offshore income gain as it has effect in relation to capital gains tax

> in respect of gains accruing to such individuals from the disposal of assets situated outside the United Kingdom.

So amended, s.12 provides:

> **Foreign assets of person with foreign domicile**
> (1) In the case of individuals resident or ordinarily resident but not domiciled in the United Kingdom, [income tax] shall not be charged in respect of [offshore income gains] accruing to them from the disposal of assets situated outside the United Kingdom ... except that the tax shall be charged on the amounts (if any) received in the United Kingdom in respect of those [offshore income gains], any such amounts being treated as gains accruing when they are received in the United Kingdom.

This incorporates the CGT remittance basis by reference. See 17.3 (CGT remittance basis). It is theoretically possible that an offshore fund may be UK situate for CGT purposes but in practice that will not happen.

20.6.3 *UK resident trust*

A UK resident trust is in principle subject to tax on offshore income gains. Tax is charged at the rate applicable to trusts, 40%: see section 764 ICTA 1988.

20.7 Interaction with section 660A: UK resident trust

Suppose the settlor has an interest in a UK resident trust and is UK resident and domiciled. This raises the question of the interaction of sections 660A and 761(1). Section 761(1) states that the offshore income gain:

> shall be treated for all the purposes of the Tax Acts as ... income arising at the time of the disposal to the person making the disposal.

Section 660A states:

> income arising under a settlement during the life of a settlor shall be treated for all purposes of the Income Tax Acts as the income of the settlor and not as the income of any other person …

The OIG accruing to the trustees is not "income" in the general (trust law) sense but since it is income "for all the purposes of the Tax Acts" it must be income for the purposes of section 660A.

There is a conflict between the deeming in section 761 (income deemed to accrue to the person making the disposal) and the deeming in section 660A (income deemed to accrue to the settlor). It is considered that s.660A prevails.

Suppose now that the settlor is not UK domiciled and the OIG is not remitted. The OIG then falls within the foreign domicile defence to section 660A: see 10.8 (Foreign domicile defence to s.660A). It follows that the OIG is then chargeable on the trustees after all.

20.8 Gain accruing to non-resident trustees

Non-resident trustees are not charged on an OIG: see 20.6.1 (Non-residents). Accordingly, where an OIG accrues to a non-resident trust the trust or company is in principle not subject to tax on that gain. However many (too many) anti-avoidance provisions may have effect here.

20.8.1 *Section 660A ICTA 1988*

The effect of s.761(2) (set out above) is considered to be that

(1) the OIG is treated as income of the trustees; but

(2) as non-residents, they are not chargeable on that income.

The significance of this is that the OIG of a non-resident trust are treated as "income arising under the settlement" even though the non-resident trustees are not chargeable. The OIG is therefore in principle within s.660A ICTA 1988 (if the settlor is UK resident[1] and has an interest in the trust.). This is assumed to be so in the drafting of s.762(6) (which provides a partial defence to s.660A discussed below).

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1 A non resident settlor qualifies for the s. 660A non-resident's defence, since the OIG would not be subject to tax if actually received by a non-resident.

20.8.2 *Section 87 TCGA 1992*

Section 762(2),(3) provides:

> (2) Subject to subsections (3) and (4) below, sections 87 to 90 and 96 to 98 of the 1992 Act (gains of non-resident settlements) shall have effect in relation to offshore income gains subject to the following modifications—
> (a) for any reference to chargeable gains, other than the reference in section 87(6), there shall be substituted a reference to offshore income gains;
> (b) in section 87(2) of the 1992 Act for the words "tax under section 2(2)" there shall be substituted the words "income tax by virtue of section 761 of the Taxes Act";
> (c) in section 87(7) the reference to tax shall be construed as a reference to income tax or corporation tax; and
> (d) sections 87(10) and 97(6) shall be omitted.
> (3) In section 87(6) of the 1992 Act, both as it applies apart from subsection (2) above and as applied by subsection (2) above, the reference to chargeable gains shall be construed as including a reference to offshore income gains.

Thus amended, s.87 reads:

> **Attribution of gains to beneficiaries**
> (1) This section applies to a settlement for any year of assessment during which the trustees are at no time resident or ordinarily resident in the United Kingdom.
> (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 [income tax by virtue of section 761 of the Taxes Act] if they had been resident or ordinarily resident in the United Kingdom in the year; and that amount, together with the corresponding amount in respect of any earlier such year so far as not already treated under subsection (4) below or section 89(2) as [offshore income gains] accruing to beneficiaries under the settlement, is in this section and sections 89 and 90 referred to as the trust gains for the year....
> (4) Subject to the following provisions of this section, the trust gains for a year of assessment shall be treated as [offshore income gains] accruing in that year to beneficiaries of the settlement who receive capital payments from the trustees in that year or have received such payments

> in any earlier year.
> (5) The attribution of [offshore income gains] to beneficiaries under subsection (4) above shall be made in proportion to, but shall not exceed, the amounts of the capital payments received by them.
> (6) A capital payment shall be left out of account for the purposes of subsections (4) and (5) above to the extent that chargeable gains [including offshore income gains] have by reason of the payment been treated as accruing to the recipient in an earlier year....
> (7) A beneficiary shall not be charged to [income tax or corporation tax] on offshore income gains treated by virtue of subsection (4) above as accruing to him in any year unless he is domiciled in the United Kingdom at some time in that year....

It is necessary to distinguish the normal s.87 rules and the OIG s.87 rules: The rules are similar but not identical. I refer below to:

(1) the CGT s.87 charge (applying by reference to CGT trust gains)

(2) the OIG s.87 charge (applying by reference to OIG trust gains).

20.8.3 *Interaction of CGT & OIG s. 87 charges*

Section 762(4) deals with a trust which has CGT trust gains and OIG trust gains:

> If, in any year of assessment—
> (a) under subsection (3) of section 87 of the 1992 Act, as it applies apart from subsection (2) above, a chargeable gain falls to be attributed to a beneficiary, and
> (b) under that subsection, as applied by subsection (2) above, an offshore income gain also falls to be attributed to him,
> subsection (4) of that section (gains attributed in proportion to capital payments received) shall have effect as if it required offshore income gains to be attributed before chargeable gains.

That is, the OIG s.87 charge has priority to the CGT s.87 charge.

20.8.4 *Section 739 and 740 charge*

The s.87 OIG charge would not concern a foreign domiciled beneficiary.

However, section 762(5) brings in sections 739 and 740:

> Subject to subsection (6) below, for the purpose of determining whether an individual ordinarily resident in the United Kingdom has a liability for income tax in respect of an offshore income gain which arises on a disposal to which this Chapter applies where the disposal is made by a person resident or domiciled outside the United Kingdom—
>
> (a) sections 739 and 740 shall apply as if the offshore income gain arising to the person resident or domiciled outside the United Kingdom constituted income becoming payable to him, and
>
> (b) any reference in those sections to income of (or payable or arising to) such a person accordingly includes a reference to the offshore income gain arising to him by reason of the disposal to which this Chapter applies.

For a settlor interested trust, s.739 broadly overlaps with s.660A.

The application of s.740 is, however, much wider than the s.87 OIG charge because the s.740 foreign domicile defence is so limited.

20.8.5 *OIG distribution defence to ss.660A, 739, 740*

All the usual foreign domicile defences will apply to s.660A, 739 and 740 charges. Section 762(6), however, provides an additional defence:

> To the extent that an offshore income gain is treated, by virtue of subsection (1) or subsection (2) above, as having accrued to any person resident or ordinarily resident in the United Kingdom, that gain shall not be deemed to be the income of any individual for the purposes of section 739 or 740 or any provision of Part XV.

I refer to this as the OIG distribution defence to s.660A, 739, 740.

This is straightforward in a s.740 case. If a capital payment is made to a UK resident beneficiary:

(1) the beneficiary is subject to tax under s. 87 (if UK domiciled).

(2) the relevant income is reduced by the amount of the capital payment (even if the beneficiary is not UK domiciled.)

In relation to a s.739 and s.660A case, it appears likewise that the settlor/transferor is not charged if (in the same year) capital payments are made to UK resident beneficiaries. A payment in a subsequent year comes too late.

20.8.6 *Payment to non-resident beneficiary*

What about a payment to a non-resident beneficiary? This is no defence to a s. 739 or 660A charge. However, such a payment will:

(1) reduce trust gains (under ordinary principles),[2] and

(2) reduce OIG deemed relevant income if made out of that income.

20.9 Application of remittance basis to Irish offshore funds

A UK resident foreign domiciled individual is taxed:

(1) on Irish source income, on an arising basis;

(2) on Irish situate capital gains, on a remittance basis.

Since the offshore fund rule incorporates the CGT rules, Irish source offshore income gains of an individual are taxed on a remittance basis.

What about an Irish source offshore income gain of a non-resident trust or company in which the settlor is interested, if the settlor is resident and not UK domiciled? The OIG qualifies for the s.739 foreign domicile defence. The defence applies the counterfactual test of whether the settlor would be taxable if he had in fact received the income. See 12.16 (Foreign domicile defence). It follows that the defence incorporates the CGT remittance basis. Irish source OIGs fall within this defence.

20.10 Losses and interaction with CGT

A disposal for the offshore funds rules is generally also a disposal for

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2 The deemed disposal rules of Schedule 4B TCGA 1992 do not apply to OIGs, but the monstrous provisions of Schedule 4C TCGA 1992 may apply.

CGT. Section 763 gives relief against a double charge:

> **Deduction of offshore income gain in determining capital gain**
> (1) The provisions of this section apply where a disposal to which this Chapter applies gives rise to an offshore income gain; and, if that disposal also constitutes the disposal of the interest concerned for the purposes of the 1992 Act, then that disposal is in the following provisions of this section referred to as "the 1992 Act disposal".
> (2) So far as relates to an offshore income gain which arises on a material disposal (within the meaning of Part I of Schedule 28), subsections (3) and (4) below shall have effect in relation to the 1992 Act disposal in substitution for section 37(1) of that Act (deduction of consideration chargeable to tax on income).
> (3) Subject to the following provisions of this section, in the computation of the gain accruing on the 1992 Act disposal, a sum equal to the offshore income gain shall be deducted from the sum which would otherwise constitute the amount or value of the consideration for the disposal.

This legislation only applies where there is an offshore income gain. Where a loss arises on the disposal, there is no relief for income tax.[3] The loss will be allowable for CGT if ordinary CGT principles permit;[4] in practice this means that foreign domiciled individuals and non-residents

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3 Section 762(2)(d) shows that this unfair rule was deliberate.

4 Inspector's Manual 4107, (October 2003) provides:

> "Where the disposal on which an offshore income gain arises is also a disposal for the purpose of CGT, the amount of the offshore income gain is deducted from the consideration for the disposal in order to compute the residual chargeable gain (for example, any gain accruing up to 1 January 1984) (see Examples 1 and 2 at IM4108).
> It is important to remember that, for CGT purposes, the indexation allowance is usually available for the entire period of ownership. As a consequence, where a Part I offshore income gain arises on a disposal, and both the acquisition and disposal take place after 1 January 1984, there will normally be a CGT loss equal to the amount of the indexation allowance (see Example 3 at IM4108). This loss is allowable against other capital gains or may be carried forward under normal rules."

This text was written before the de-indexation of losses in 1993 and ending of indexation relief in 1998. It is relevant as showing that the Revenue (correctly) accept the principle that a disposal of offshore funds may give rise to an allowable loss.

have no loss relief; see 17.18 (Capital losses). The loss is computed on CGT principles (not in accordance with the OIG computation rules of Schedule 28).

CHAPTER TWENTY ONE

WITHHOLDING TAX ON INTEREST

21.1 Introduction

This chapter considers when tax must be deducted at source from the payment of interest. This topic is important to foreign domiciliaries since they (or connected trusts) often take out loans on which tax may be deductible from the interest. This book only considers payments made by individuals and trustees (not companies).

21.2 Obligation to deduct

The obligation is in s.349(2) ICTA 1988. So far as relevant here:

> Subject to subsection (3) below and to any other provision to the contrary in the Income Tax Acts, where any yearly interest of money chargeable to tax under Case III of Schedule D ... is paid—
>
> ...[1]
>
> (c) by any person to another person whose usual place of abode is outside the United Kingdom;
>
> the person by or through whom the payment is made shall, on making the payment, deduct out of it a sum representing the amount of income tax thereon for the year in which the payment is made.

The obligation therefore arises when the following conditions are satisfied:

1 Paragraphs (a) and (b) are not set out here as they concern companies and partnerships including companies.

(1) A payment of “yearly interest of money”.

(2) The interest is chargeable to tax under Schedule D Case III (i.e. has a UK source).

(3) The payment is made to a person whose “usual place of abode” is outside the UK.

21.3 Exceptions to obligation to deduct

21.3.1 *Interest to bank within charge to corporation tax*

Section 349(3) provides a number of exceptions, of which only the first is relevant here:

> Subsection (2) above does not apply—
> (a) to interest payable on an advance from a bank, if at the time when the interest is paid the person beneficially entitled to the interest is within the charge to corporation tax as respects the interest...

21.3.2 *Double tax treaty defence to deduction at source*

Another exception is provided by Regulation 2 Double Taxation Relief (Taxes on Income)(General) Regulations 1970:

> (1) The following provisions of these Regulations shall have effect where, under arrangements having effect under section 497 ICTA 1970,[2] persons resident in the territory with the government of which the arrangements are made are entitled to exemption or partial relief from United Kingdom income tax in respect of any income from which deduction of tax is authorised or required by the Income Tax Acts.
> (2) Any person who pays any such income (referred to in these Regulations as “the United Kingdom 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—

2 Now section 788 ICTA 1988.

(a) not deduct tax, or
(b) not deduct tax at a higher rate than is specified in the notice, or
(c) deduct tax at a rate specified in the notice instead of at the lower or basic rate otherwise appropriate;

and where such notice is given, any income to which the notice refers, being income for a year for which the arrangements have effect, which the United Kingdom 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...

For the procedure see RI 79 and Tax Bulletin 41.

21.3.3 *Short interest*

The duty to deduct tax does not apply to interest which is not "annual" interest (known as short interest). It is not practical to rely on this except for very short term loans.

21.3.4 *Discounts and premiums*

The duty to deduct tax does not apply to profits on discounts and premiums even if such profits may be charged to tax under Schedule D Case III. The Revenue rightly say:

> **Relevant discounted securities: Deduction of tax**
> [October 2003]
> Discounts or premiums payable on the redemption of relevant discounted securities[3] are not payments of interest. Consequently the payments are made without deduction of tax.
>
> (Inspector's Manual 1548)

21.3.5 *Foreign source interest*

Foreign source interest is not subject to obligation to deduct tax.

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3 Discounts and premiums on securities which are not "relevant discounted securities" are also not "interest". However, the distinction between interest and discounts/premiums can be fraught.

CHAPTER TWENTY TWO

DEEMED DOMICILE FOR IHT

22.1 Overview of inheritance tax terminology

One can launch into income tax or CGT knowing nothing about the subject. IHT is more technical. A brief outline for those unfamiliar with IHT is accessible on *www.kessler.co.uk*. I assume the reader is familiar with the following terms.

Term		**Definition**
Transfer of value	:	s.3(a) IHTA
Chargeable transfer	:	s.2 IHTA
Exempt transfer	:	Part II IHTA
PET	:	s.3A IHTA

The "discretionary trusts regime" is the system for taxing (in short) discretionary trusts. This imposes "10 year charges" and "exit charges".

22.1.1 *Domicile and excluded property*

Wherever IHT imposes a charge there is a territorial limitation to it. The territorial limitations are set out in various sections but use the common vocabulary of "excluded property". Excluded property is the subject of the next chapter, and depends on domicile, which is the main subject of this chapter.

22.2 The three classes of domicile for inheritance tax

The general concept of domicile is discussed in Chapter 2. In principle, an individual must have either a UK domicile or a foreign domicile; there is no middle way. But a foreign domiciliary can often secure effective exemption from inheritance tax and can live indefinitely in the UK without acquiring a UK domicile of choice. The inheritance tax code therefore distinguishes the foreign domiciliary who has close UK connections and provides that for most (but not all) purposes, such an individual is to be treated as if he were a UK domiciliary. The IHTA has failed to supply a suitable term for its new conception. In the following chapters I shall refer where necessary to three classes of individuals as:

(1) True or actual UK domiciliaries;

(2) Deemed UK domiciliaries(or deemed domiciliaries); and

(3) True or actual foreign domiciliaries.

22.3 Deemed UK domicile

22.3.1 *The statute*

Section 267(1) IHTA 1984 provides:

> A person not domiciled in the United Kingdom 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 United Kingdom (and not elsewhere) at the relevant time if—
> (a) he was domiciled in the United Kingdom within the three years immediately preceding the relevant time, or
> (b) he was resident in the United Kingdom 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 test and condition (b) as the 17 year residence test.

22.3.2 *The 3 year domicile test*

The first test concerns the person who is actually UK domiciled and who loses his UK domicile. Such a person is deemed domiciled in the UK for three years from the date of his change of domicile. Unlike test (b) this period is not related to years of assessment.

22.3.3 *The 17 year residence test*

The second test concerns the person who is not a true UK domiciliary but who becomes resident here. Once he has been resident in the UK for seventeen out of the last twenty years of assessment he becomes deemed domiciled here under the seventeen year residence test.

Note that the immigrant foreign domiciliary does not need to be present in the UK for seventeen full years. In an extreme case, fifteen years and two days may suffice. An individual who arrives in the UK on 5th April 1983 may arguably be resident in the UK in the year of assessment 1982/83. (Although this seems unlikely, this would be the Revenue view, under paragraph 3.1 of IR20 if the individual came to the UK to live here permanently or intending to stay for three years or more.) If he was still here on 7th April 1998 he may be resident in the tax year 1998/99. The seventeen year residence condition would then be satisfied.

22.3.4 *Comparison of the two tests*

A person who satisfies either test is deemed UK domiciled.

The seventeen year residence test may be stricter than the three year domicile rule. Consider a person who has always been UK resident and domiciled and who ceases to be UK domiciled on 1st August 1998. He ceases to be caught by the three year domicile test on 1st August 2001. However, as he was UK resident in 1998/99, he will still be deemed UK domiciled under the seventeen year residence test until 6 April 2002, the start of the year 2002/03.

By contrast, a UK domiciled person may reside outside the UK for twenty years and then acquire an actual foreign domicile. Such a person is not affected by the seventeen year residence test. But three more years must pass before he ceases to be UK domiciled under the three year domicile test.

22.4 Deemed domiciliary leaving the United Kingdom

Suppose:

(1) a person who is not actually UK domiciled becomes deemed UK

domiciled, having spent eighteen years resident here.

(2) He then ceases to be resident in the UK. In the following tax year he ceases to satisfy the seventeen year test.

Is the person still treated as domiciled here for three years under the three year domicile test? In other words, does the deemed domicile test in (a) apply to a person who was only a deemed domiciliary under (b)? The answer is, no. The better view is that (a) and (b) are independent tests dealing with separate circumstances. This interpretation would be consistent with the reasoning in *Russell v IRC* [1988] STC 195. If that were wrong, then the following absurdity arises. Suppose T, non-resident for many years, ceases to be UK domiciled. In year 1 he becomes deemed domiciled. In year 4 he ceases to be deemed domicile. The Revenue could argue that since he was (deemed) domiciled in year 3, he must wait three more years before he can cease to be deemed domiciled. Then, of course, three years later he is still deemed domiciled. He can never throw off the deemed domicile. This shows that domicile in s.267(1)(a) means true domicile and not deemed domicile. The word should have the same meaning throughout the section.

22.5 Domicile of child of a deemed domiciliary

A child under 16 usually takes the domicile of the father as a domicile of dependency and that domicile changes with the domicile of the father. If the father is treated as UK domiciled under s.267, is the child treated as having acquired a UK domicile of any type? Suppose a man becomes deemed domiciled in the UK at a time when he has a 15 year old son. Does one say that since the father is treated as UK domiciled, the child is likewise treated as having a UK domicile of dependency? The question will not often arise, since the domicile of children and young persons only rarely needs to be ascertained. The author takes the view that the child will not be deemed to be UK domiciled in such circumstances. Section 267 does not affect the real domicile, as it expressly applies only to persons who are not domiciled in the UK and the child's domicile of dependence should remain unaffected. The child's domicile has to be determined first by the general law and only then do his own residential circumstances need to be examined to see whether he is deemed domiciled himself.

22.6 Meaning of "residence" for the purposes of deemed domicile

For the purposes of deemed domicile:

> 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.
>
> (Section 267(4))

Thus in this context "residence" has its normal income tax meaning, whatever that is; see 3.1 (Residence).
However, for years prior to 1993/94 residence is to be determined:

> without regard to any dwelling house available in the UK for his use.
>
> (Section 208(3),(4) FA 1993)

This exception remains significant when determining residence for the years up to 1992/93 which will feature as part of the seventeen year calculation until 2010.

22.7 When deemed domicile does not matter

There are two situations where a deemed domicile rule does not apply: these concern exempt gilts and pre-1975 double tax treaties.

22.7.1 *Exempt gilts*

Estate duty (the forerunner of IHT) had no equivalent of the deemed domicile rule. It did, however, have an exemption for exempt gilts. Such gilts were issued with the condition that they were not liable to any taxation, present or future, if (in short) owned by persons not *actually* UK domiciled. Accordingly s.267(2) IHTA 1984 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 does not apply for the purposes of the exemption allowing exempt gilts to be excluded property. All that the drafter needed to do was to disapply the deemed domicile rule to exempt gilts in issue at the time of the introduction of CTT (now IHT) in the FA 1975. It was not necessary to exclude the deemed domicile rule from 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 act as a further encouragement for foreigners to invest in exempt gilts. A person who is deemed domiciled but not actually domiciled in the UK is subject, in principle, to IHT on all his property except exempt gilts.

22.7.2 *Double taxation agreements*

A similar transitional problem arose in relation to double taxation agreements in force at the time that estate duty was replaced by CTT (now IHT) in the FA 1975. Section 267(2) provides:

> Subsection (1) above ... shall not affect the interpretation of any such provision as is mentioned in section 158(6) above.

This takes us to s.158(6) which refers to double taxation arrangements:

(a) made, or having effect as made, under s.54 F(No 2)A 1945 [which concerned double taxation agreements relating to estate duty], and

(b) in effect immediately before the passing of the IHTA 1984.

Thus, effectively, the deemed domicile rule does not apply to double taxation agreements surviving from the estate duty era. There are four treaties in this category: France, Italy, India and Pakistan. (The drafting would have been easier to follow if the drafter had referred to these treaties by name. But there it is.)

The deemed domicile rule does apply to post-1975 double tax treaties.

22.8 Settlements made on or before 9 December 1974 and other transitional rules

Section 267(3) contains five transitional rules:

> Paragraph (a) of subsection (1) above shall not apply in relation to a person who (apart from this section) has not been domiciled in the

> United Kingdom at any time since 9th December 1974, and paragraph (b) of that subsection shall not apply in relation to a person who has not been resident there at any time since that date; 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,
> (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.

The most important rule is that a deemed domicile is ignored for property settled on or before 9 December 1974.

22.9 Tax planning for the deemed domiciliary

(1) The emigrant deemed domiciliary

An individual who has emigrated from the UK remains an "emigrant" deemed domiciliary for three years. His inheritance tax planning, if in good health, is simple; he should refrain from making any gifts until he has obtained the status of a true foreign domiciliary. If he wishes to make substantial gifts before then he might consider purchasing exempt gilts or some other property which qualifies as excluded property. Deathbed planning would be the same. In addition he might consider taking out a loan to purchase excluded property: see 27.6 (Borrowing and acquisition of excluded property).

(2) The immigrant deemed domiciliary

The immigrant deemed domiciliary is the foreign domiciliary who has resided for a long period in the UK. His scope for planning is greatly restricted; he should really take proper steps before the statutory deadline when his deemed domicile arises.

If the individual is domiciled (in reality) in the Isle of Man or in the Channel Islands then he has some scope for acquiring excluded property in the form of exempt saving certificates: see 23.5 (Individual domiciled in Channel Islands or Isle of Man). Otherwise it may be possible to cease to be UK resident for the necessary period of three tax years so that the deemed domicile rules cease to apply.

CHAPTER TWENTY THREE

EXCLUDED PROPERTY FOR IHT

23.1 Introduction

Excluded property is an appropriate term to describe property which is broadly excluded from the scope of inheritance tax. Sections 6 and 48 IHTA 1984 provide the definitions of the term. The reasoning behind the rather complex rules may be better appreciated if the following points are borne in mind.

(1) The starting point of the legislation is that property situated out of the UK owned by a foreign domiciliary is excluded property.

(2) A separate definition of excluded property is needed for settled property since such property does not have a straightforward beneficial owner. The statute adopts a simple (perhaps too simple) test which is to look at the domicile of the settlor at the time the settlement was made.

(3) The definition is then extended to include certain government stocks, AUTs and OEICs with a view (rightly or wrongly) to encouraging investment in these assets.

(4) The scheme of the IHTA is to ignore reversionary interests in settled property and certain other assets. The drafter achieves this with an economy of language by providing that such assets also qualify as excluded property and thus enjoy the benefit of exemptions designed primarily as territorial exemptions.

This chapter sets out the rules. The implications for tax planning are discussed at 26.1 (Creating excluded property).

23.2 Non-settled property: general excluded property rule

Section 6(1) IHTA 1984 provides:

> Property situated outside the United Kingdom is excluded property if the person beneficially entitled to it is an individual domiciled outside the United Kingdom.

This is the main category of excluded property.

Excluded property status depends on the domicile of the individual at the time a transfer of value is made. Likewise, excluded property status depends on the location of assets at that time only. It is irrelevant that the assets may previously have been situate in the UK. If a foreign domiciled individual transfers his property out of the UK the moment before he dies, or the moment before he makes a gift of the property, he obtains the full benefit of excluded property status: see *Kwok Chi Leung Karl v Commissioner of Estate Duty* [1988] STC 728. On the situs of assets, see 35.1 (Situs of assets).

23.3 Non-settled property: exempt gilts

A second category of excluded property consists of certain British government securities (also called FOTRA securities,[1] and popularly known as "exempt gilts"). Exempt gilts are situated in the UK and so cannot qualify as excluded property under the general principle above. Section 6(2) IHTA 1984 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.

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1 "Free of Tax to Residents Abroad".

23.3.1 *Conditions for exemption*

The conditions for exemption are not stated in the IHTA. The conditions must be:

(1) authorised by the relevant statutory provision; and

(2) set out in the prospectus for the particular gilts concerned.

The statutory authority is in the following terms. (I only set out the provisions so far as relevant for inheritance tax and omit the income tax exemption):

> F(No.2)A 1931 s.22(1)
> Any securities issued by the Treasury under any Act may be issued with the condition that …
> (b) so long as the securities are in the beneficial ownership of persons who are neither domiciled nor ordinarily resident in the United Kingdom, neither the capital thereof nor the interest thereon shall be liable to any taxation present or future.
>
> FA 1940 s.60(1)
> The power of the Treasury under s.22 F(No. 2)A 1931 to issue securities with the condition as to exemption from taxation specified in that section shall extend to the issuing of securities with that condition so modified, whether as to the extent of the exemption or the cases in which the exemption is to operate, as the Treasury may specify in the terms of the issue.
>
> FA 1996 s.154(1)
> The modifications which, under s.60 of the FA 1940, may be made for the purposes of any issue of securities to the conditions about tax exemption specified in s.22 of the F(No. 2)A 1931 shall include a modification by virtue of which the tax exemption contained in any condition of the issue applies, as respects capital, irrespective of where the person with the beneficial ownership of the securities is domiciled.

It will be seen that the statutory provisions do not specify the condition for exemption. So the details must be found in the prospectus for each gilt concerned.[2]

Before 6 April 1998 some gilt-edged securities 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[3] issued before 6th April 1998 without FOTRA conditions shall be treated in relation to times on or after that date as if—
> (a) it were a security issued with the post-1996 Act conditions; and
> (b) those conditions had been authorised in relation to the issue of that security by virtue of s.22 of the F(No. 2)A 1931….
> (5) In this section "the post-1996 Act conditions" means the FOTRA conditions with which 7.25% Treasury Stock 2007 was first issued by virtue of s.22 of the F(No. 2)A 1931.[4] ...
> (7) This section does not apply to any 3½% War Loan 1952 Or After which was issued with a condition authorised by virtue of s.47 of the F(No. 2)A 1915.

There are, therefore, two classes of exempt gilts for IHT purposes, with different conditions attached:

(1) Gilts where the condition requires the individual to be domiciled[5] 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

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2 Prospectuses can be found on *www.dmo.gov.uk/gilts/public/prospectus/index.htm*

3 "Gilt-edged securities" has the CGT definition: see s.161(6).

4 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".

5 Deemed domicile is irrelevant for this purpose: see s.267(2) IHTA 1984. 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 if the owner was not (actually) UK domiciled. The deemed domicile rule could not have been applied to those gilts. Although new gilts could have been made subject to a deemed domicile rule, the decision was made to treat all gilts in the same way.

condition set out in the prospectus.

(2) where the condition requires the beneficial owner to be ordinarily resident outside the United Kingdom 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.

CTO Advanced Instruction Manual para. G.52 sets out a list of the gilts where the requirement is that the beneficial owner is neither domiciled nor ordinarily resident in the UK. Para.53 sets out a list of gilts where the requirement is that the beneficial owner is ordinarily resident outside the UK (domicile irrelevant). However, it would be wise to check the prospectus in each case.

23.3.2 *Ownership*

The CTO Advanced Instruction Manual provides:

> **G.34 Type and ownership**
> Government securities are not considered to be in relevant ownership for the purposes of their exclusion from IHT unless, at the date of the transfer concerned, they are **in fact** registered in the name(s) of the transferor or, where the securities are settled property, of the trustees. The text at this point has been withheld under the Code & Practice on Access to Government Information.

There is no basis for this in the statute: it appears that gilts in the name of a nominee may qualify for relief. It is conceivable that the conditions in the prospectus of particular gilts imposed this condition but this does not seem to be the case.

In practice, register the gilts in the name of the transferor or the trustees to avoid dispute. Perhaps the withheld text makes the point that a person who contracts to buy exempt gilts and dies before paying for them does not qualify for the exemption and the Inspectors are instructed how to identify false claims for relief.

The CTO Manual continues:

> **G.35 Late purchases**
> If a worthwhile amount is at stake (see GEM 7.6.2)[6] you should investigate the possibility of a last-minute purchase. Except where the available information (e.g. inclusion of sufficient income/interest) reasonably rules out that possibility, you should seek specific confirmation that the securities concerned were in fact registered in the transferor's, or the trustee's, name(s) at the date of the relevant transfer.

The same point applies.

23.3.3 *Interest and tax repayment on exempt gilts*

The CTO Advanced Instruction Manual provides:

> **G.47 Exclusion of interest on exempt securities**
> The exclusion for exempt securities can also apply to certain payments etc of interest on the securities. Payments that qualify for the exclusion are:
> [1] warrants or coupons for interest already received but not encashed at the date of the relevant chargeable event
> [2] apportionment of interest due up to, but receivable after, the date of the chargeable event
> [3] in the case of a trust, any interest payments already encashed but held – at the date of the chargeable event – by the trustees pending distribution in the administration of the trust. This is so even if no separate moneys can be identified as relating directly to interest on exempt securities.
> The **exclusion for interest does not apply** to any warrants or coupons already encashed, or payments of interest already received, by the beneficiary in his lifetime, in connection with any chargeable event occurring after the encasement or the receipt. This is so whether he is the absolute owner of the exempt securities or a beneficiary under a trust.

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6 Understandably, the Revenue view on what is "worthwhile" in this context is not in the public domain.

This is correct, but point [3] seems generous. The Manual continues:

> **G.48 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.

This is generous.

23.3.4 *Practical use of exempt gilts*

The exemption is useful for individuals who are:

(1) UK domiciled (or deemed domiciled);

(2) not ordinarily resident in the UK (so they can satisfy the conditions for exemption).

23.4 Authorised unit trusts and OEICs

Sections 6(1A) and 48(3A) IHTA 1984 provide:

> 6(1A) A holding in an authorised unit trust and a share in an open-ended investment company is excluded property if the person beneficially entitled to it is an individual domiciled outside the United Kingdom.
>
> 48(3A) Where property comprised in a settlement is a holding in an authorised unit trust or a share in an open-ended investment company—
> (a) the property (but not a reversionary interest in the property) is

excluded property unless the settlor was domiciled in the United Kingdom 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.

This applies from 16 October 2002 and represents successful lobbying by the investment management industry and a pragmatic decision by the Government: see 1.1 (Policy issues in foreign domiciliary taxation). A non-resident non-domiciled individual will now not mind (for tax) whether he purchases a UK or a foreign AUT or OEIC. However, a UK resident foreign domiciled individual will prefer a foreign investment fund to a UK one, so that income and gains from the fund will be taxed on the remittance basis.

23.5 Individual domiciled in Channel Islands or Isle of Man

Section 6(3) IHTA 1984 provides a fourth category of excluded property:

> Where the person beneficially entitled to the rights conferred by any of the following, namely—
> (a) war savings certificates;
> (b) national savings certificates (including Ulster savings certificates);
> (c) premium savings bonds;
> (d) deposits with the National Savings Bank or with a trustee savings bank;
> (e) a certified contractual savings scheme within the meaning of section 326 of the Taxes Act 1988;
>
> is domiciled in the Channel Islands or the Isle of Man, the rights are excluded property.

The deemed domicile rule does not apply for the purposes of this section: see s.267(2) IHTA 1984.

The CTO Advanced Instruction Manual correctly states:

> **G.56 Other relevant points**
>
> Other points to note are:
>
> - the exclusion applies not only to securities etc owned by a domiciled Islander absolutely but also to any settled securities in which he has

a beneficial interest in possession[7]

- the exclusion does not extend to settled securities in which there is no interest in possession, i.e. which are held on discretionary trusts
- the relevant domicile is that of the transferor (and not the transferee) of the securities, at the time of the transfer
- the deemed domicile provisions of IHTA 1984, s 267(2) do not apply. Accordingly the transferor's domicile has to be determined under general law.

The author is unable to offer any reason for this exemption. It could be particularly useful for an individual who is:

(1) domiciled in the Channel Islands or the Isle of Man, and

(2) deemed UK domiciled (so in principle within the UK IHT net), and

(3) ordinarily resident in the UK (so the ordinary exempt gilts exemption is not available).

23.6 Visiting forces

A fifth category of excluded property is also only mentioned for completeness. This concerns emoluments and tangible movable property of members of visiting forces (other than British citizens, British Dependent Territories citizens or British Overseas citizens) and certain staff of allied headquarters. For details see s.155 IHTA 1984.

23.7 Settled property: general excluded property rule

Section 48(3) IHTA 1984 provides:

> Where property comprised in a settlement is situated outside the United Kingdom—
>
> (a) the property (but not a reversionary interest in the property) is excluded property unless the settlor was domiciled in the United Kingdom 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.

7 See 23.9 (Excluded property and the IP settlement).

This is the main category of settled excluded property, roughly corresponding to the main category of non-settled excluded property. Four important consequences arise from the definition.

First, the resident and domicile status of the beneficiaries is completely irrelevant for this purpose. Secondly, the residence of the trustees is equally irrelevant.

Thirdly, excluded property status depends on the domicile of the settlor at the time the settlement was made. A later change of domicile is ignored.[8] Contrast the IT and CGT position. The identity of the settlor is therefore crucial: see 34.2.1 (IHT definition of "settlor").

Fourthly, the location of the assets comprised in the settlement only matters at the moment a charge arises; provided the assets are then situated abroad, it is irrelevant that they may previously have been situated in the UK. So trustees could transfer the settled property out of the UK the moment before the death of a life tenant, or the occasion of a ten year charge, and obtain the full benefit of excluded property status: see *Kwok Chi Leung Karl v Commissioner of Estate Duty* [1988] STC 728.

23.8 Settled property: exempt gilts

Exempt gilts held by trustees may also be excluded property. Section 48(4) provides:

> Where securities issued by the Treasury subject to a condition of the kind mentioned in subsection (2) of section 6 above are comprised in a settlement, that subsection shall not apply to them; but the securities are excluded property if—
>
> (a) a person of a description specified in the condition in question is entitled to a qualifying interest in possession in them, or
>
> (b) no qualifying interest in possession subsists in them but it is shown that all known persons for whose benefit the settled property or income from it has been or might be applied, or 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.

This exemption corresponds to the exempt gilts exemption for non-settled

8 See 23.10 (Initial interest of settlor or spouse) for an exception where the settlor or his spouse has an initial interest in possession in the settled property.

property.[9] Under this exemption the domicile of the settlor is irrelevant; one must look at the ordinary residence of the beneficiary and, if appropriate, his domicile.

The CTO Advanced Instruction Manual correctly states:

> **G.41 Application of all settled property, not just exempt securities**
> The conditions concerning the application of settled property and its income relate to all the property comprised in the particular settlement and not just to the exempt securities.
> The words "has been or might be applied" mean that you will need to consider both post and future or potential application of the property and its income.
> **G.42 Disregard unknown person(s)**
> 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 of an existing beneficiary) might become a beneficiary in the future.
> **G.43 Disregard UK charities**
> In the case of *Von Ernst and Cie SA v IRC* [1980] 1 WLR 468 the Court ruled **that any payment or potential payment** from the settled property to an incorporated UK charity – to be used by the charity for its charitable purposes – would not be an application for the "benefit" of the charity. Accordingly you should not deny the exclusion for exempt securities merely because a UK charity (whether incorporated or not) has received or might receive any of the settled property or income from it.

23.9 Excluded property and the interest in possession settlement

As we have seen, there are two definitions of excluded property:

(1) "the s.6 definition" defines excluded property for non-settled property.

(2) "the s.48 definition" defines the term for settled property.

9 See 23.3 (Non-settled property: exempt gilts).

Property is either settled or not, so the definitions appear to be mutually exclusive. However, a settlement under which a beneficiary has an interest in possession raises a doubt. Property held in an IP settlement is certainly settled property (so *prima facie* the s.48 definition should apply). However, s.49(1) IHTA 1984 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.

So should the property be treated as non-settled property and the s.6 definition be applied?

The answer is provided in part by s.48:

> (3) Where property comprised in a settlement is situated outside the United Kingdom—
>
> ...
>
> (b) section 6(1) above applies to a reversionary interest in the property but does not otherwise apply in relation to the property.
>
> (4) Where securities issued by the Treasury subject to a condition of the kind mentioned in subsection (2) of section 6 above are comprised in a settlement, that subsection shall not apply to them; ...

Thus the s.48 definition overrides the s.6 definition. The operation of these rules can be illustrated by two examples:

(1) Suppose a foreign domiciled beneficiary has an interest in possession in a settlement made by a UK domiciled settlor. The trust property is situated outside the UK.

The trust property is not excluded property as s.48(3) excludes the operation of s.6(1).

(2) Suppose the reverse situation – a UK domiciled beneficiary of a settlement created by a foreign domiciled settlor. The trust property is again situated outside the UK.

The tax position is now reversed. The trust property would not be excluded property under s.6(1) but it does qualify under s.48(3). Section 48(3) excludes s.6(1) so the trust property is excluded property.

An individual domiciled in the Channel Islands or the Isle of Man enjoys a third category of excluded property: see 23.5 (Channel Islands and Isle of Man domicile) above. If such an individual was entitled to an interest in possession in qualifying certificates, the certificates would not be excluded property under s.48(4). But the property does qualify as excluded property under s.6(3) since the individual is to be treated as if he were beneficially entitled. In this case there is no express provision that s.48 must override s.6. Section 48 and s.6 do not contradict each other; rather they offer two alternative routes to attain excluded property status. Such settled property is therefore excluded property.

23.10 Initial interest of settlor or spouse

Special rules apply where the settlor or spouse have an interest in possession in a trust when it is made. The basic rule is set out in s.80(1) IHTA 1984:

> Where a settlor or his spouse is beneficially entitled to an interest in possession in property immediately after it becomes comprised in the settlement,
> [a] the property shall for the purposes of this Chapter be treated as not having become comprised in the settlement on that occasion;
> [b] but when the property or any part of it becomes held on trusts under which neither of those persons is beneficially entitled to an interest in possession, the property or part shall for those purposes be treated as becoming comprised in a separate settlement made by that one of them who ceased (or last ceased) to be beneficially entitled to an interest in possession in it.
>
> (Paragraphing added)

Thus where the settlor or spouse has an initial interest in possession, s.80 imposes three fictions ("the s.80 fictions"):

(1) It provides an artificial time at which trust property is treated as becoming settled (different from the actual time).

(2) It may provide an artificial person who is treated as the settlor

(different from the real settlor).

(3) It may provide that a single settlement is treated as two (or more) separate settlements.

23.10.1 *Initial interest of settlor or spouse: excluded property rule*

Suppose:

(1) In Year 1, H settled property on W for life.

(2) In Year 2, W dies.

(3) The property is then held on discretionary trusts.

(4) There is subsequently a 10 year or exit charge.

In this example H is the actual settlor and Year 1 is the actual date of commencement. However, applying the s.80 fictions, the settlement 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 be used for tax avoidance. Therefore where s.80 applies, s.82 imposes a further condition relating to excluded property. This provides:

> **Excluded property**
> (1) For the purposes of this Chapter ... property to which section 80 ... applies shall not be taken to be excluded property by virtue of section 48(3)(a) above unless the condition in subsection (3) below is satisfied (in addition to the conditions in section 48(3) that the property is situated outside the United Kingdom 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 United Kingdom when that settlement was

made.

The "settlement first mentioned" in s.80 is the settlement actually made by H. (The separate settlement deemed to have been made by W must be the second settlement mentioned in s.80.)

In relation to excluded property, s.82 prevents the "artificial settlor" fiction from benefiting the taxpayer. It may however benefit the Revenue. Where:

(1) the settlor or his spouse has an initial interest in possession, and subsequently

(2) the settled property is held on trusts where neither of them has an interest in possession,

it is necessary to look at the domicile of the settlor at the time when the settlement was originally made *and* at the domicile of the life tenant at the time his or her interest in possession came to an end in order to determine whether the trust property is excluded property. Both must be domiciled out of the UK in order to qualify for excluded property status.

23.10.2 *Living with s.80*

The s.80 rules apply only for the purposes of "this Chapter": the discretionary trust regime. They have no wider application.

If s.80 applies, then, in the circumstances of the example above one may have a settlement whose property:

(1) is excluded property for general IHT purposes; but

(2) is not excluded property for the purposes of the discretionary trust regime.

Such a trust should remain "interest in possession" in form.

23.10.3 *Avoiding s.80*

A simple solution is to arrange that the settlement is discretionary at the outset, i.e. the settlor and spouse do not have an initial interest in possession. This is easy if the property to be given to the settlement is not UK situate. If the trust property is UK situate, it may be easier to live with s.80 than to take complex steps to avoid it.

23.10.4 *Section 80 transitional rules*

Section 80(3) provides:

> This section shall not apply if the occasion first referred to in subsection (1) above occurred before 27 March 1974.

"The occasion first referred to above" is the occasion when the property becomes comprised in the settlement. So section 80 does not apply to property settled before 27 March 1974.

23.10.5 *Commentary*

What is the purpose of the three s.80 fictions? Dymond explains:

> The [discretionary trust regime] would not work well where the settlor or his spouse has the first interest in possession under a settlement commencing after 26 March 1974. In such a case there will be no chargeable transfer when the settlement was made and so no occasion to value the settled property for CGT or IHT at that time. If a charge arose nearly 10 years later, it might be difficult to ascertain the value at the commencement of the settlement, as required by section 86(5)(a) IHTA 1984, because important evidence might have been lost or destroyed. It might also not be easy to ascertain the settlor's cumulative total at that time as required by section 64(4)(b) IHTA 1984. The same difficulty with the settlor's cumulative total might occur at the time of the 10 year charge, because of section 66(5)(a).
>
> *(Dymond's Capital Taxes*, para.19.700)

Section 80 solves this valuation problem but the reader may agree with the author that the cure is worse than the disease. This does explain why the section 80 fictions only apply for the purposes of the discretionary trust regime.

23.11 Same settlor adds property to trust after change of domicile

Suppose:

(1) a settlor creates a trust while not UK domiciled; and

(2) the same settlor adds funds to the trust later when UK domiciled.

Is the added property (if situate outside the UK) "excluded property"? CTO Advanced Instruction Manual: paragraph G.13:

> **G.13 Time when settlement made**
> The legislation refers to the settlor's domicile "at the time the settlement was made". You should proceed on the basis that, for any given item of property held in a settlement, the settlement was made when that property was put in the settlement. Consult your specialist advisor/the Enterer in Scotland if this view is challenged.
> Example
> S, when domiciled abroad, creates a settlement of Spanish realty. Later he acquires a 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.[10]

The relevant time in s.48(3) is not "the time when the property was settled"; it is "the time the settlement was made". The Revenue 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 the Revenue's view that where a person adds property to an existing settlement made by him two

10 This view is repeated in RI 166.

separate settlements are deemed to exist.[11] But since two separate settlements do not exist, 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 Revenue view leads to a more sensible result. But the legislation is so clearly inconsistent with the Revenue view that even a purposive construction cannot assist.

Section 43 IHTA 1984 provides:

> (1) The following provisions of this section apply for determining what is to be taken for the purposes of this Act to be a settlement, and what property is, accordingly, referred to as property comprised in a settlement or as settled property.
> (2) "Settlement" means any *disposition or dispositions* of property, whether effected by instrument, by parol or by operation of law, or partly in one way and partly in another, whereby the property is for the time being—
>> (a) held in trust for persons in succession or for any person subject to a contingency, or
>> (b) held by trustees on trust to accumulate the whole or part of any income of the property or with power to make payments out of that income 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. ...
>>
>> (Emphasis added)

Perhaps the Revenue argument is that because "a settlement" means any disposition of property, each disposition represents a new and separate settlement. However, the words "any disposition or dispositions of

11 See para. 24.4 (Two settlors for IHT: the separate settlements fiction). If this fiction is applied when there are two settlors, the same fiction could in principle apply when the settlor adds property to his own existing settlement.

property" indicate that more than one disposition can create a single settlement, not separate settlements. This is now confirmed by *Rysaffe v IRC* [2003] STC 536. Further, the Revenue 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 1984 and the many references to added property in the surrounding sections.

The Revenue view is not consistent with s.49(5) FA 1977. This section clearly distinguished between:

(1) "the time when a settlement was made", and

(2) "the time when [added] property was settled".

It did so in the context of excluded property. The section is now repealed but the fact that the drafter took this view in 1977 remains relevant.

Dymond (I think) dismisses the Revenue's view:

> When a settlor adds property to a settlement previously made by him it may be necessary to consider whether the addition counts as a new settlement. It if does, the settlor's domicile has to be determined as at the time of the addition; but if not, his domicile at the date of the original settlement remains in point and any subsequent change of domicile is irrelevant.[12]

However, it may take litigation before they will amend their published stance on this issue. Until the point is clear, trustees should follow this advice in RI 166:

> **Trust records**
> The trustees of a settlement should keep adequate records to enable any necessary attribution of the settled property to be made if ...the settlor has added further assets to the settlement after it was made...

Suppose a settlor creates a trust when UK domiciled and adds property to it when foreign domiciled. On my view, none of the property is excluded property. However, the Revenue must abide by their statement (at least

12 *Dymond's Capital Taxes*, para. 30.202. The authors are former officers of the Board of Inland Revenue, though the book has no official authority.

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 the Revenue have the worst of both worlds. Of course, a well advised settlor will not find himself in this situation, but it does arise from time to time by accident.

23.12 Adding property to settlement after acquiring UK domicile: tax planning

It may be possible to avoid this problem if a foreign domiciled person contracts to assign future acquired property to a trust; provided that the contract is made while non-UK domiciled, domicile at the time of the transfer may not matter.

23.12.1 *Same settlor adds property to company held by trust after acquisition of UK domicile*

If:

(1) A settlor creates a trust while domiciled outside the UK;

(2) The settlor becomes UK domiciled; and

(3) The settlor gives property to a company owned by the trust,

then the Revenue'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.

23.13 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—
>
> – 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";
- 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 interests in possession—ss 68(5), 66(4) and 69(3).

This is correct, but in practice these points will rarely be significant.

CHAPTER TWENTY FOUR

IHT CONSEQUENCES OF TRANSFERS BETWEEN TRUSTS AND ADDING TO TRUST FUNDS

24.1 Introduction

This chapter considers the IHT consequences[1] of transfers between trusts and adding property to trusts. There are three tiers of rules:

(1) General principles of trust law and tax law which apply in the absence of specific IHT provisions.

(2) A specific IHT provision which applies for most purposes of IHT trust taxation: s.44(2) IHTA 1984.

(3) Specific IHT provisions which apply for IHT discretionary trust ("DT") taxation: sections 81–82 IHTA 1984.

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 quantum of a ten year charge.

24.2 Trust law background

There are two distinct ways by which property can move between

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1 CGT and s.740 ICTA 1988 may need consideration. Another issue (straightforward and not dealt with here) is that the transfer may be a transfer of value under s.52 IHTA 1984 or may give rise to an exit charge under s.65 IHTA 1984.

settlements (without a person becoming beneficially entitled to the property in the meantime):

(1) Trustees may exercise a power to transfer trust property to another trust.[2] (Assume for the purpose of discussion that trustees have such a power; in any particular case the terms of the trust would need to be reviewed.)

(2) (a) A beneficiary who is entitled to a contingent or reversionary interest in the trust fund of trust A may assign that interest to trust B; and

(b) the trustees of trust B in due course become absolutely entitled to the trust fund of trust A.

24.3 General tax principles

The general tax principles are set out in 34.6 (Appointment from old trust to B followed by gift to new trust by B) and 34.7 (Transfer from trust A to trust B by exercise of trustees' power). The conclusions are as follows:

(1) If trustees exercise a power to transfer property from trust A to trust B, then, at least to the extent of the transferred property, the settlor of trust A is a settlor of trust B.[3]

(2) If a beneficiary with a valuable reversionary interest under trust A transfers this interest to trust B, then, at least to the extent of the interest transferred, he is a settlor of trust B.

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2 This needs to be distinguished from the situation where trustees exercise a power to vary the terms on which they hold trust property without a transfer to another trust. The distinction is a trust law concept. A discussion is beyond the scope of this book: see *Dymond's Capital Taxes*, 16.230.

3 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.

24.4 Two settlors for IHT: the separate settlements fiction

Section 44(2) IHTA 1984 provides:

> Where more than one person is a settlor in relation to a settlement and the circumstances so require, this Part of this Act (except s.48(4) to (6)) shall have effect in relation to it as if the settled property were comprised in separate settlements.

I refer to this as "the separate settlements fiction". The fiction is needed because IHT taxation of trusts assumes that every settlement has one settlor; instead of making provisions for a trust with multiple settlors, the scheme is to regard such trusts as multiple trusts.

The exception for the purposes of s.48(4) to (6) concerns exempt gilts and is not discussed here; see 23.8 (Settled property: exempt gilts).

The separate settlements fiction is expressed to apply for the purposes of Part III of the IHTA (not generally), but all the important provisions which govern trust tax are in Part III.[4]

The words "and the circumstances so require" show that the drafter was aware that the separate settlements fiction would not always be appropriate. It is unfortunate that he did not formulate the circumstances in which this would be the case.

When the separate settlements fiction applies, the settled property is treated as being in separate trusts (which I call "notional trusts"). Unfortunately the statute does not tell us:

(1) what is to be regarded as the trust property of the notional trust;

(2) when the notional trust is to be regarded as made;

(3) who is to be regarded as the settlor of the notional trust.

Context and common sense must fill that gap.

4 The separate settlements fiction has to be repeated in s.201(4) IHTA 1984 in order to apply it to s.201 (because that is not in Part III).

24.5 B adds property to A's trust

Suppose:

(1) an individual ("A") creates a trust ("the real trust"), and

(2) another individual ("B") adds property to it.

The separate settlements fiction applies, and one imagines that there are two notional trusts. Common sense suggests:

(1) Notional trust A is regarded as if:

(a) it holds the property given by A;

(b) it was made at the time A made the real trust; and

(c) A is its sole settlor.

(2) Notional trust B is regarded as if:

(a) it holds the property given by B;

(b) it was made at the time B added property to the real trust; and

(c) B is its sole settlor.

It is suggested that the same applies if B adds value indirectly to the real trust (e.g. by a gift to a company held by the trust). B is a "settlor" in the general tax sense; see 34.8 (Provision of property for company held by trust). The "circumstances" require the real trust to be regarded as two separate notional trusts. A division of the trust property of the real trust into two parts representing the value given by A and the value given by B is just about possible though not easy.

24.6 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").

This issue usually arises in the context of failed tax planning of the kind discussed at 34.18 (Tax planning to create settlement with foreign domiciled settlor).

There are then two settlors: an indirect settlor (A) and a direct settlor (B). See 34.4 (Gift to B followed by gift to trust by B). Both have provided the *same* property.

The IHT analysis is not clear. On one view the separate settlements fiction applies so that the settled property in the real trust is treated as being comprised in separate trusts. On this view the consequence is said to be that:

(1) Notional trust A:

   (a) holds *all* the trust property of the real trust;

   (b) A is its sole settlor;

   (c) I do not know when proponents of this view would say that notional trust A was made. It would either be at the time A gave the property to B or the time that B settled it, and this poses perhaps another difficulty with this view.

(2) Notional trust B:

   (a) also holds *all* the trust property of the real trust;

   (b) B is its sole settlor;

   (c) was made at the time B created the real trust.

The main difficulty with this analysis is that it leads to double taxation and the separate settlements fiction which only applies "if the circumstances so require" should not be used to give that result. I therefore prefer the view that the circumstances do not "so require" and the separate settlements fiction does not apply. We have therefore one real settlement with two settlors. What is the position for excluded property if A is foreign domiciled and B is not? It will be recalled that settled property is excluded property "unless *the settlor* was domiciled in the UK at the time the settlement was made". A technical argument would be that one cannot say that "the settlor" was domiciled in the UK unless both settlors were domiciled here. No modern court is likely to accept that (at least in a tax avoidance context). The solution here must surely be to read the word "the settlor" in this context as meaning "the settlor or one of the settlors".[5] In that case the trust property is only excluded property if A and B are both foreign domiciled.

Another possible view is that one should identify A as the "real" settlor and infer that B should not be regarded as a settlor.

24.6.1 *The Revenue view*

RI 166 provides:

> **Several persons contribute to a single settlement**
> ...
> [Section 44(2)] is similar in terms to FA 1975 Sch 5 para 1(8), which was considered by Chadwick J in *Hatton v IRC* [1992] STC 140. In the light of the decision in that case [the Revenue] 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
> [2] that
> [a] where a clear, or reasonably sensible, attribution of settled property between the contributions made by several settlors is possible, there will be a separate settlement, with its own attributed assets, for each contributor for IHT purposes;
> [b] if such an attribution is not feasible, each separate settlement will comprise all the assets of the single, actual settlement.
>
> **Trust records**
> It follows from the comments above that the trustees of a settlement should keep adequate records to enable any necessary attribution of the settled property to be made if ... two or more persons have contributed funds for the purposes of the settlement.
>
> (Paragraphing added)

5 Applying the rule of construction that the singular includes the plural.

In practice it is perhaps better for one person not to add property to a settlement made by another, especially if one settlor is, and the other is not, UK domiciled: this avoids the complication of the separate settlements fiction. But in a straightforward case there should not be any difficulty as long as record keeping is adequate.

24.7 Transfer from trust made by A to trust made by B

Suppose:

(1) A gives property ("A's fund") to trust A ("real trust A").

(2) B gives property ("B's fund") to trust B ("real trust B").

(3) The trustees of real trust A transfer A's fund to real trust B.

Real trust B then has two settlors (in the general tax sense) A and B. It is suggested that the separate settlements fiction applies and one imagines that there are two notional trusts. Notional trust A is regarded as if:

(1) it holds the property provided by A;

(2) A is its sole settlor;

(3) The important question is: at what time is notional trust A regarded as being made? The choice is:

 (a) at the time that real trust A was made;

 (b) at the time of the transfer to real trust B.

Let us see which view makes more sense. The possibilities are as follows:

A is UK domiciled when he made real trust A and dead at the time of the transfer to real trust B. It has been suggested that in these circumstances A's fund can be excluded property after the transfer. The argument is:

(1) Notional trust A is regarded as made at the time of the transfer to real trust B.

(2) A is regarded as not "domiciled in the United Kingdom" at that time (because a dead person has no domicile).

Both these propositions are doubtful. The view that notional trust A is regarded as made at the time real trust A was made avoids obvious anomalies and is to be preferred.[6]

A is UK domiciled when he made real trust A and foreign domiciled at the time of the transfer to real trust B. If I am right that notional trust A is regarded as made at the time that real trust A was made, A's fund cannot become excluded property after the transfer.

A is foreign domiciled when he made real trust A and UK domiciled at the time of the transfer to real trust B. Likewise, if I am right, A's fund need not cease to be excluded property after the transfer.

So it is suggested that wherever A is domiciled at the time he made real trust A, there is in principle no IHT advantage or disadvantage from a transfer to another trust made by B after the death or change of domicile of A.

24.8 Transfer from trust made by A to another trust made by A

Now suppose:

(1) A gives property to trust A1.

(2) A gives property to trust A2 (a separate trust).

(3) The trustees of trust A1 transfer property ("the transferred property")

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6 This view is also consistent with the principle in *Muir v Muir* [1943] AC 468. If (contrary to my view) notional trust A is regarded as made at the time of the transfer to real trust B, after the death of A, it is possible to carry through the fiction and regard A as having at that time the domicile he had:
(1) at the time of his death; or
(2) at the time he made real trust A.
Another view is that s.44(2) only applies if the circumstances so require, and they do not so require; but adopting my approach, s.44(2) gives a sensible result.

to trust A2.

Trust A2 has only one settlor, A, and the separate settlements fiction does not apply to it. The possibilities are as follows:

A is UK domiciled when he made trust A1 but not when he made trust A2. It is suggested that the transferred property in trust A2 may qualify as excluded property. Trust A2 *does* satisfy the condition that the settlor was foreign domiciled at the time that *this* settlement was made.

A is foreign domiciled when he made trust A1 and UK domiciled when he made trust A2. The result is reversed.

Thus there is a distinction between:

(1) transfer from trust made by A to a trust made by B (change of A's domicile irrelevant); and

(2) transfer from trust made by A to another trust made by A (change of A's domicile significant).

This is anomalous but the anomaly naturally follows from the fact that the separate settlements fiction applies in case (1) and not in case (2).

24.8.1 *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 1984. The transferred property may be excluded property if A is living and foreign domiciled at the time of the transfer, even though A was UK domiciled when he made trust A1.

What if A is dead at the time of the transfer? On a literal reading, one might argue that (regardless of the domicile of A during his life) the settlor A was not UK domiciled when trust A2 was made, since a deceased person has no domicile. The scope for tax avoidance would make that result unacceptable to a court in a case where A was UK domiciled at the time he made trust A1 and at the time of his death. A Court is likely to regard A as retaining after his death the domicile he had during his life. This is not as much of a stretch of the law as first appears. If a company can be regarded as having a domicile (by analogy to the domicile rules of a living individual) why not a deceased person? However, it is suggested that the trust property in trust A2 may be excluded property if A was not UK domiciled at the time of his death.

24.9 The same settlement fiction: section 81

Section 81(1) IHTA 1984 provides:

> **Property moving between settlements**
> Where property which ceases to be comprised in one settlement becomes comprised in another then, unless in the meantime any person becomes beneficially entitled to the property (and not merely to an interest in possession in the property), it shall for the purposes of this Chapter be treated as remaining comprised in the first settlement.

I call this "the same settlement fiction".

What is the purpose of the same settlement fiction? It must be intended to counter tax avoidance based on moving property between settlements. A simple example arises where a trust is approaching its 10 year anniversary. The trustees might transfer the trust property to another discretionary trust, whose 10 year anniversary is many years ahead. Alternatively they might appoint an interest to a beneficiary who transfers that interest to a new trust. This might avoid the 10 year charge on the first trust. Section 81 neatly counteracts both these by deeming the property to remain in the first trust. This explains why the same settlement fiction applies only for the purpose of IHT discretionary trust taxation ("this Chapter" is Chapter III Part III IHTA 1984).

24.9.1 *Section 81: excluded property rule*

Where s.81 applies, s.82 imposes an additional condition for trust property to qualify as excluded property. This provides:

> **Excluded property**
> (1) For the purposes of this Chapter ... property to which section ... 81 above applies shall not be taken to be excluded property by virtue of section 48(3)(a) above unless the condition in subsection (3) below is satisfied (in addition to the conditions in section 48(3) that the property is situated outside the United Kingdom and that the settlor was not domiciled there when the settlement was made).
> ...
> (3) The condition referred to in subsection (1) ... above is ...
>> (b) in the case of property to which subsection (1) or (2) of section 81 above applies, that the person who is the settlor in relation to the second of the settlements mentioned in the subsection concerned,
>
> was not domiciled in the United Kingdom when that settlement was made.

Since this only applies for the purposes of discretionary trust taxation, one must distinguish:

(1) excluded property for ordinary IHT purposes; and

(2) excluded property for the purposes of discretionary trust tax ("DT excluded property").

The consequences of s.82(3)(b) depend on the circumstances of the transfer.

24.9.2 *Transfer from trust made by A to another trust made by A*

Suppose:

(1) A gives property to trust A1.

(2) A gives property to trust A2 (a separate trust).

(3) The trustees of trust A1 transfer property ("the transferred property") to trust A2.

The possibilities are as follows:

A is not UK domiciled when he made trust A1 but UK domiciled when he made trust A2. The transferred property in trust A2 is not excluded property under general IHT principles. See above.

A is UK domiciled when he made trust A1 but not UK domiciled when he made trust A2. The transferred property may be excluded property under general IHT principles. However, section 82 prevents the transferred property in trust A2 from qualifying as DT excluded property. (This is probably an accidental consequence of the wording, because if the drafter had had the point in mind he would have made s.82 IHTA 1984 apply for all IHT purposes and not only for the purposes of discretionary trust taxation.)

In short, for the transferred property to qualify as DT excluded property, A must be domiciled outside the UK at the time he made trust A1 and trust A2.

24.9.3 *Transfer from trust made by A to trust made by B*

Suppose:

(1) A gives property ("A's fund") to a settlement ("real trust A").

(2) B gives property ("B's fund") to a separate settlement ("trust B").

(3) The trustees of real trust A transfer A's fund to trust B.

For general IHT purposes, A's fund is regarded as in a notional trust and may be excluded property if A was not UK domiciled when real trust A was made. See 24.7 (Transfer from trust made by A to trust made by B). At first sight the position for the purposes of DT tax seems to be different:

(1) A's fund is treated as remaining comprised in real trust A (applying the same settlement fiction); and

(2) A's fund can only be excluded property if:

  (a) A is foreign domiciled at the time real trust A was made; and

(b) B is foreign domiciled at the time trust B was made

(applying the s.82 rule).

There is a better view. On these facts the separate settlements fiction of s.44(2) applies. A's fund is treated for IHT as if it were transferred to a separate notional trust. The same settlement fiction applies as if there is a transfer from real trust A to the separate notional trust deemed to be made by A at the time (I think) of real trust A. So, for DT tax purposes, A's fund may be excluded property if A is not UK domiciled at the time he made trust A. That is, the s.82 rule does not add anything to the general excluded property rule. The domicile of B is irrelevant. That gives a fair result and is consistent with what I take to be the purpose of s.82; see below.

A similar result applies if the transfer is to a company held by trust B.

24.9.4 *B transfers equitable interest to another settlement*

The position is different if:

(1) A gives property ("A's fund") to a settlement ("trust A").

(2) B has an equitable interest under trust A (perhaps a reversionary or contingent right to trust capital).

(3) B assigns his equitable interest to a separate settlement ("trust B").

(4) Trust B becomes entitled to A's fund (perhaps because the reversionary interest falls into possession or the contingency is satisfied).

B is in principle the settlor of trust B for general tax purposes. The position for the purposes of DT 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 DT 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).

24.9.5 *Purpose of section 82(3)(b)*

What is the purpose of s.82(3)(b)? The s.81 fiction would benefit the taxpayer in a situation where the facts are as in 24.9.4 (B transfers equitable interest to another settlement) and:

(1) A is not UK domiciled; and

(2) B is UK domiciled.

Under the general law, B would in principle be the settlor of trust B, but applying the s.81 fiction A would be the settlor! Section 82 counteracts this tax advantage. If I am right in 24.9.3 (Transfer from trust made by A to trust made by B), then s.82 works fairly neatly.

An incidental result is to restrict (but not wholly prevent) tax advantages on a transfer from trust A1 to A2 where A was UK domiciled when he made trust A1 but foreign domiciled at the time he made trust A2; see 24.9.2 (Transfer from trust made by A to another trust made by A).

24.9.6 *Section 81 transitional rules*

Section 81(2),(3) sets out three transitional rules:

> (2) Subsection (1) above shall not apply where the property ceased to be comprised in the first settlement before 10th December 1981; but where property ceased to be comprised in one settlement before 10th December 1981 and after 26th 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 10th December

1981.

24.10 Same settlor adds property to trust after change of domicile

On this topic see 23.11 (Same settlor adds property after acquisition of UK domicile).

CHAPTER TWENTY FIVE

RESERVATION OF BENEFIT

25.1 Introduction

Here is a rendezvous of questions and question marks! A full discussion needs a book to itself. This chapter concentrates on difficult but important issues which commonly arise in relation to the foreign domiciliary. CTO Advanced Instruction Manual Chapter D contains much fascinating material which cannot be set out here for reasons of space. I refer to the provisions as the GWR provisions (Gift with Reservation).

25.2 The statute

Section 102(1) FA 1986 provides:

> ... this section applies where, on or after 18 March 1986, an individual disposes of any property by way of gift and either—
> (a) possession and enjoyment of the property is not bona fide assumed by the donee at or before the beginning of the relevant period; 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;
> and 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.

There are two sets of conditions:

(1) There has to be a disposal of property by way of gift. There are three separate elements here; a *disposal*, of *property*, which must be *by way of gift*.

(2) Condition (a) or (b) above must be satisfied.

25.3 "Property subject to a reservation"

Section 102(2) provides:

> 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.

I refer to property subject to a reservation as "GWR property".

25.4 Disposals before 18th March 1986

If one is dealing with disposals made before 18th March 1986 there is no need to consider the GWR rules; they only apply to disposals after that date. The CTO Advanced Instruction Manual states correctly at D.22:

> 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 need to be considered.

25.5 When is there a "disposal by way of gift"?

There are some general issues on the meaning of a "disposal by way of gift". Is the surrender of a lease or life interest a "disposal"? Or the giving of consent to an exercise of a power of advancement or appointment? Is a sale at an undervalue "by way of gift"? Or a transfer to a settlement in which the settlor has an interest in possession? But such questions only occasionally arise in relation to foreign domiciliaries and are outside the scope of this book. 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".

25.6 When is there a reservation of benefit?

The words used in the statute are remarkably obscure. While in most cases the matter will be clear enough there are significant areas of uncertainty. Some of these doubtful areas have been resolved for practical purposes by Revenue statements.

25.6.1 *Gift to discretionary trust, settlor a beneficiary*

One point is of particular importance to a foreign domiciliary. Suppose an individual makes a gift into a discretionary trust of which he is one of the beneficiaries. Is there a reservation of benefit? I argued in the first edition of this book that there is, and this is confirmed in *Eversden v IRC* 75 TC 340 (no appeal was made on this point).

It is considered that the same applies where an individual makes a gift to a discretionary trust under which:

(1) the settlor is not included in the class of beneficiaries; but

(2) the trustees have power to add the settlor to the class of beneficiaries.[1]

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1 The Revenue's view of this is, however, equivocal. The CTO Advanced Instruction Manual provides at D.74: "The question of whether the possibility that As name might be added to the class is a reservation is one which can be determined only on the particular facts. Any case where the point is material should be referred to the Controller's Personal Assistant, or Enterer in Scotland."

25.6.2 *Gift from A to B followed by gift to trust by B*

The position is different where:

(1) A makes a gift to B.

(2) Later, by an independent transaction, B creates a discretionary trust under which A is a beneficiary (or where A can be added as a beneficiary).

In these circumstances A is *not* the settlor. It is considered that there is no reservation of benefit just because A is a discretionary beneficiary. There will be a reservation of benefit if A actually receives a benefit.

25.7 GWR on transfers between spouses and on gift of 100% BPR or APR property

See 30.6 (GWR on inter-spouse gift) and 30.7 (Inter-spouse gift of 100% BPR or APR property).

25.8 IHT on the disposal by way of gift

A gift which is a chargeable transfer will give rise to a charge to IHT (assuming it exceeds the nil rate threshold) whether or not it is a gift with a reservation. The reservation of benefit does not affect the existence or nature of this charge; just on the death of the donor there may be a further charge to tax. The Inheritance Tax (Double Charges Relief) Regulations 1987 mitigate a double charge. This chapter gives no consideration to the IHT which might arise on a gift; it only considers the GWR aspects.

25.9 Gift of excluded property

Section 102 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 certainly 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 section 3 IHTA 1984 does so obliquely. It 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 a certain property for the purposes of section 3(1) does not mean that the disposition is not a "disposal by way of gift". However, a purposive construction suggests otherwise. It is absurd that there should be a charge to tax in circumstances where:

(1) a foreign domiciliary with no UK connection makes a gift of excluded property to another person with no UK connection and enjoys some benefit; and

(2) the foreign domiciliary dies many years later at a time when property representing the property given is situate in the United Kingdom.

Nobody would expect the foreign domiciliary (or his executors) to comply or to be able to comply with an obligation to pay IHT in such circumstances. The purpose of section 3(2) IHTA 1984 is to take excluded property out of the scope of inheritance tax and a gift of excluded property is by implication ignored: it is not "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.

On a literal construction, an inter-spouse gift of excluded property made by a foreign domiciled individual may fall within the reservation of benefits rules. A gift of excluded property is not a transfer of value, so outside the scope of s.18! 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 1984, are deemed not to be by way of gift.[2]

Such property is nevertheless "subject to a reservation" and so qualifies for the GWR exemption to the pre-owned asset rules.

25.10 GWR continuing until donor's death: the deeming provision

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 1984 Act as property to which he was beneficially entitled immediately before his death.

In the following discussion, s.102(3) is referred to as "the deeming provision"; the donor is not in fact beneficially entitled to the property subject to the reservation but the property is treated as if he were so entitled.

It is necessary here 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.

By s.4(1) IHTA 1984:

> 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.

By s.5(1):

> .... a person's estate is the aggregate of all the property to which he is beneficially entitled, except that the estate of a person immediately before his death does not include excluded property.

Since the donor is treated as beneficially entitled to the property subject to the reservation, that property is treated as part of his estate unless it is

2 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 1984 and not s.102(5)(d) FA 1986; but it is not necessary to pursue that here.

excluded property at the time of the death. Even when the GWR rule applies, therefore, the effect on the donor's estate depends upon the application of the excluded property rules.

25.11 Absolute gift subject to GWR: operation of excluded property rules on death of donor

Suppose:

(1) A, a donor, gives property to B, an individual, outright.

(2) There is a reservation of benefit: A enjoys benefits at the time of his death.

(3) The property is not UK situate at the time of A's death.

A is treated as if he were beneficially entitled to the property at the time of his death. It forms part of his estate unless it is excluded property at that time. How do the excluded property rules work in these circumstances?

Here we are concerned with non-settled property. The relevant rule is that:

> Property situated outside the United Kingdom is excluded property if the person beneficially entitled to it is an individual domiciled outside the United Kingdom.
>
> (Section 6(1) IHTA 1984)

The puzzle here is caused by the deeming provision. In the example above, B is *in fact* beneficially entitled to the property. A is *treated* as beneficially entitled. Who is "beneficially entitled" for the purpose of applying the excluded property rule; is it A or is it B? This does not matter if A and B are both foreign domiciled, but it does if one is and the other is not. One common case is in a gift from a UK domiciled spouse to a foreign domiciled spouse: see 30.6 (Reservation of benefit on inter-spouse gift).

The answer is to be found by applying the general rule of construction which applies to deeming provisions:

> If you are bidden to treat an imaginary state of affairs as real, you must surely, unless prohibited from doing so, also imagine as real the consequences and incidents which, if the putative state of affairs had in fact existed, must inevitably have flowed from or accompanied it.
>
> (Lord Asquith, *East End Dwellings Co Ltd v Finsbury Borough Council* [1952] AC 109 at 132)
>
> ... because 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....
>
> *(Marshall v Kerr* 67 TC 56 at 79)

Applying this principle it is submitted that the domicile of 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 B is irrelevant. This conclusion is confirmed by the context. It would be absurd if the taxation of A depended on the domicile of B. The taxation of A should depend on his own domicile position.

25.11.1 *Outright gift: conclusion*

In the case of an outright gift subject to a reservation at the time of the donor’s death, the gifted property is excluded property if:

(1) the donor is domiciled outside the UK at the date of death; and

(2) the property is not UK situate at that time.

For the purposes of the excluded property rule, therefore:

(1) The domicile of the donor at the time of gift is irrelevant (contrast the position where the gift is made in trust: see 25.12 (GWR to discretionary trust) below.

(2) The *situs* of the property at the time of the gift is irrelevant to the operation of the excluded property rules on the death of the donor.

The Revenue accept this analysis; CTO Advanced Instruction Manual D.8 provides:

> *Example 1*
> The donor, an Australian, gives Australian shares to his Australian son but continues to enjoy the dividends until his death ten years later. He dies domiciled in Australia.
> The property is property subject to a reservation and is therefore deemed to be part of the donor's death estate. However, the property is situate outside the UK and the donor, who is treated as beneficially entitled to it, was domiciled outside the UK at his death. The property is therefore excluded property within IHTA 1984, s 6(1) and escapes the GWR charge.

The same applies to gifts to companies, including companies held by trusts.

25.12 Discretionary trust: GWR and excluded property rules

Suppose:

(1) S (not UK domiciled) gives property to a discretionary settlement; and

(2) there is a reservation of benefit – perhaps because S is one of the beneficiaries; and

(3) the property is not UK situate at the time of the death of S.

S is treated as if he were beneficially entitled to the property at the time of his death. It forms part of his estate unless it is excluded property at that time. How do the excluded property rules work in these circumstances?

25.12.1 *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 first view is simple. The property subject to a reservation is in fact settled property, so apply the settled property rules set out in s.48(3) IHTA 1984:

> Where property comprised in a settlement is situated outside the United Kingdom—
> (a) The property... is excluded property unless the settlor was domiciled in the United Kingdom 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 second view is more subtle. The property subject to a reservation is to be treated as property to which the donor is "beneficially entitled". Apply the deeming provision to its logical conclusion: if a person is beneficially entitled to property, it is not settled property. So on this view, where an individual makes a gift to a settlement with reservation of benefit, and dies, the property is excluded property for the GWR rules if:

(1) the donor was domiciled outside the UK at the time of his death. (The domicile of the donor at the time the settlement was made is irrelevant for GWR, though it is relevant for other purposes); and

(2) the property is not situated in the UK at the time of death.

I call this "the Non-settled Property Solution".

25.12.2 *The correct solution*

The Non-settled Property Solution seems persuasive at first glance, and has support from no less an authority than Robert Venables QC.[3] Nevertheless it was until recently almost universally accepted 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. The Asquith dictum cited above is merely a general canon of construction from which "only limited assistance can be derived in choosing between alternative interpretations of the Act".[4]

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.)

That this is the correct construction is confirmed by section 49(1) which provides that:

> A person beneficially entitled to an interest in possession in settled property shall be treated for the purposes of this Act as *beneficially entitled* to the property in which the interest subsists.

No-one suggests that property to which section 49(1) applies is not to be treated as settled property for the purposes of the GWR rules. The wording of the deeming provision in s.102(3) is materially the same.

The correctness of this is also confirmed if one considers a trust under which the settlor has an interest in possession. See 25.13 (Settlement in which donor has an interest in possession).

It has been said that a purposive construction favours the Non-settled

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3 *Inheritance Tax Planning*, 3rd edition, para. D.15.3 (Immigrant settlors); and "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*.

4 *Russell v IRC* [1988] STC 195 at p.205.

Property Solution: the purpose of the GWR rules is to put the donor in the same position as if he had not made the gift. This is the general purpose in the case of gifts by UK domiciliaries. However, arguments on purposive construction only run when one knows the general purpose and is confident that the general purpose applies in the particular circumstances of the case. This argument *assumes* that that purpose necessarily extends to the foreign domiciliary – which begs the question. Perhaps Parliament intended there to be a difference between the two cases. One cannot apply a purposive construction unless the application of the purpose is clear.[5]

Until 2001 the Revenue consistently agreed with the Settled Property Solution. *Law Society's Gazette* 1986 page 3728 provided:

> **Question:**
>
> 'G' a non-domiciliary gifts excluded property into a discretionary settlement under which he is in the class of beneficiaries. 'G' dies domiciled in the United Kingdom. Are the "excluded property" assets in the settlement treated as part of 'G's estate?
>
> **Answer from The Controller, Capital Taxes Office**:
>
> Here it seems to me that the settled property would be "property subject to a reservation" in relation to the settlor. Accordingly it would fall within S102(3) of the Finance Act 1986 to be treated as property to which he was beneficially entitled immediately before his death. The effect would be to lock the property into the settlor's estate within the meaning of S5(1) of the IHTA 1984 which is subject to the exception for "excluded property". It would follow that in the case of settled property, relief for foreign assets could continue to be available under section 48(3).

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5 In the battle of the anomalies the Revenue would no doubt 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 the Revenue 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.

The same point was made in the CTO Advanced Instruction Manual D.8:

> *Example 2*
> The donor, who is domiciled in Australia, puts foreign property into a discretionary trust under which he is a potential beneficiary. He dies five years later domiciled in England and without having released the reservation.
> The property is property subject to a reservation and is therefore deemed to be part of the donor's death estate. *However, as he was domiciled outside the UK at the time the settlement was made, the property will be excluded property, under IHTA 1984, s 48(3), if still situate outside the UK at the date of death.*

Astonishingly, the text was changed (without a public announcement) about October 2001. The last sentence now reads:

> Any cases where this is the situation must be referred to the Litigation Team.

This wording suggests the Revenue have reversed their view and adopted the Non-settled Property Solution. However, the Revenue have said informally that they are merely reconsidering their position on this point and have not reached a final view. Perhaps the delay since then suggests they are having second thoughts.

It is understood that if the Revenue change their former view, no tax would be sought where taxpayers have relied on the previous view but the exact details of this transitional relief have not been decided. It is considered that if the Revenue do change their mind, they will eventually be defeated in the Courts so the issue of transitional relief will not arise.

Now the text of the Manual has changed, taxpayers can no longer continue to rely on the old earlier "official" statements of the Revenue view. The "old" view is restated in the 2003 Background Paper on domicile at 2.8 but this should not be relied upon. The authors were probably not aware of the current Revenue position, and their statement does not bind the Revenue.

Trustees should bear in mind that even adopting the Settled Property Solution, there will arguably[6] be a charge to IHT on the death of a settlor

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6 See 25.9 (Gift of excluded property).

who enjoys a benefit over trust property if at the time of his death:

(1) There is UK situated trust property; and

(2) Property was given to the trust after 18th March 1986.

If the settlor is a beneficiary it is safer not to invest directly in UK situate property during his life.

25.13 Settlement in which donor has an interest in possession

Suppose:

(1) S (not UK domiciled) creates a settlement;

(2) S has an interest in possession in his settlement at the time of his death;

(3) the settled property is (accordingly) subject to a reservation;

(4) the property is not UK situate at the time of the death.

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, *to the extent that the property would not, apart from this section, form part of the donor's estate immediately before his death*, that property shall be treated for the purposes of the 1984 Act as property to which he was beneficially entitled immediately before his death.
>
> (Emphasis added)

The words in italics are here called "the donor's estate exemption to the GWR rule".

Adopting the Settled Property Solution, the position is easy to understand:

(1) the settled property is excluded property under s.43(3), ignoring s.102(3);

(2) accordingly, apart from s.102(3), it does not form part of the estate of S immediately before his death; see s.5(1);

(3) accordingly, the donor's estate exemption to the GWR rule does not apply and the deeming provision in s.102(3) does apply; but

(4) this does not matter as the property is excluded property for GWR purposes and treated as outside the estate of S at the time of this death.

Adopting the Non-settled Property Solution, the position is as follows:

(1) the settled property is excluded property under s.43(3), ignoring s.102(3);

(2) accordingly, as before, apart from s.102(3), it does not form part of the estate of S immediately before his death;

(3) however, applying s.102(3) and the Non-settled Property Solution, it is not excluded property so *does* form part of the estate of S immediately before his death.

Thus the property is simultaneously excluded for one purpose and not excluded for another. This is possible but complex and clumsy and suggests that something is wrong with the Non-settled Property Solution.

25.14 Gift to foreign domiciled donee who creates a settlement

Suppose:

(1) A makes an outright gift to B.

(2) B makes a gift of that property to a settlement.

(3) A is a beneficiary of that settlement and enjoys benefits so that there is a reservation of a benefit in relation to A's gift.

(4) B (and not A) is the settlor of the settlement; see 34.4 (Gift to B followed by gift to trust by B).

Now which set of excluded property rules are applied? It is suggested that one must apply the rules applicable to settled property for the reasons given in 25.12 (GWR to discretionary trust). 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).

25.15 Cesser of benefit during donor's lifetime

So far we have considered the position where the benefit continues until the death of the donor. Section 102(4) provides that when property ceases to be subject to a reservation:

> the donor shall be treated for the purposes of the [IHTA 1984] as having at that time made a disposition of the property by a disposition which is a potentially exempt transfer.

This subsection has been misunderstood. Suppose property ceases to be subject to a reservation; e.g. a donor ceases to be a beneficiary of a trust he has created, and becomes excluded from all benefit. The donor is treated as having made a potentially exempt transfer. This would seem to be a serious matter for the foreign domiciliary until one asks: What is the value transferred by this potentially exempt transfer? If the property is excluded property then the value transferred is nil: see s.3 IHTA 1984. It does not matter that a disposition is deemed to be a potentially exempt transfer if no value is thereby transferred. No charge to tax can arise.

The Revenue view is tentative. They say:

> **D.8 Example 2**
> The donor, who is domiciled in Australia, puts foreign property into a discretionary trust under which he is a potential beneficiary. He dies five years later domiciled in England and without having released the reservation....
>
> **D.9 Reservation ceasing in donor's lifetime**
> ...
> Had the donor in Example 2 in D.8 attained an English domicile after the gift and then released the reservation during his lifetime, it is arguable that the release would have been a PET which became a chargeable transfer on the death within seven years. The release would thus have triggered a charge which would not have arisen had the release not been made.[7] Any case in which such a charge is thought to arise, or any enquiry about the possibility of such a charge arising, should be referred to the Litigation Team.

The point is "arguable" but the argument is considered to be wrong.

If, however, the property is UK situate (and so not excluded property) then there might arguably be a potentially exempt transfer under s.102(4), FA 1986. If so, should the donor die within seven years the potentially exempt transfer matures into a chargeable transfer and a charge to tax will arise.

7 This sentence reflects the Settled Property Solution which was the official Revenue view before October 2001. When the text of D8 was changed about October 2001, this sentence should have been deleted as it is now inconsistent with what goes before. No doubt it will be tidied up eventually.

CHAPTER TWENTY SIX

IHT PLANNING BY CREATING EXCLUDED PROPERTY

26.1 Basic principles

A foreign domiciliary should endeavour to secure, as far as possible, that his assets are situated outside the UK so that they qualify as excluded property and fall outside the inheritance tax net. The foreign domiciliary's property becomes excluded property the moment that it becomes non-UK situate; there is no qualifying period such as is required for other inheritance tax reliefs. In this way an imminent tax charge may vanish almost miraculously. The same applies to trustees of a settlement made by a foreign domiciliary. The question is: how is the individual's property to be transferred abroad?

The transfer abroad of £ Sterling from a UK bank account poses no problem. The transfer of bearer instruments abroad raises no problem. The transfer abroad of foreign currency in a UK bank account abroad needs careful consideration as to CGT. Chattels could be physically moved abroad but that may not be practical.

Any UK asset could be sold and the proceeds remitted abroad. This is simple and satisfactory for inheritance tax; however, a sale may be ruled out by CGT or commercial reasons.

If the foreign domiciliary does not wish assets to be sold, he might give them to a company owned wholly by him. The shares in the company should not be UK situate; see 35.2 (Registered shares and securities: situs for IHT) and 35.6 (Bearer shares and securities). 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 Ltd v Commissioner of Estate Duty*[1] the Hong Kong Court of Final Appeal refused to apply the *Ramsay* doctrine to arrangements made by the taxpayer to create property situated abroad (in this case situated outside Hong Kong). The gift would, of course, be a disposal for CGT purposes and hold-over relief would not normally be available. Accordingly, this option will only be a satisfactory solution either if no capital gain arises or if hold-over relief is available.[2]

26.2 UK situate shares and securities

It is possible to turn UK situate shares and securities into non-UK situate assets; see 17.12 (CGT planning by turning UK situate into non-UK situate property).

26.3 Discretionary trusts

A discretionary trust is subject to IHT on its ten year anniversaries. If the settlor is not UK domiciled when he made the trust, all that matters for IHT is the situs of the trust fund on that date.[3] The trustees may safely invest in the UK for a number of years, provided that, by the deadline, they hold foreign situate assets.

In principle this short term planning may be extended indefinitely:

(1) As each ten year anniversary approaches the trustees could sell the UK trust property (or even mortgage it) and invest in excluded property.

(2) Immediately after the anniversary they might sell and revert to UK investments.

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1 Accessible from *www.info.gov.hk/jud/guide2cs/html/cfa/judmt/index.htm*.

2 A gift to the company by way of *donatio mortis causa* solves the CGT problem: section 62(5) TCGA 1992. But such a gift is not effective for inheritance tax purposes. The donor retains the right of revocation which would not be excluded property on his death.

3 Note also the possible tax charge on the death of the settlor, under the gift with reservation rules, if the property is UK situate: see 25.12 (Distribution trust: GWR and excluded property rules) and following.

In practice such a course would invite a *Ramsay* attack by the Inland Revenue.[4] Ideally the trustees should look for a different strategy such as holding the UK assets in a foreign registered company.

26.4 Interest in possession trusts

Trustees of an interest in possession trust made by a foreign domiciliary may invest in UK property. The property will not be excluded property but there would be no tax charge until the beneficiary's death.[5] If the beneficiary's health begins to fail the trustees could invest in excluded property. Providing they do so before the moment of death – even on the day or hour before death – then there would be no inheritance tax on the death: see 23.7 (Settled property) above.

To convert trust property to excluded property should not be difficult. The trustees may sell it but there is no need to do so. It will be sufficient if they transfer it to a foreign registered company whose shares are held by the trustees. If the trustees are not resident in the UK no CGT arises on the disposal; if the trustees are resident in the UK this will only be a satisfactory solution if the assets qualify for hold-over relief or they are not pregnant with gain.

The only inheritance tax risk in this strategy is that the life tenant might die so suddenly that no steps to save tax can be taken. This risk is reduced (but not eliminated) if the spouse exemption is available. It might be possible to take out insurance. In principle it is clearly undesirable to allow a beneficiary in poor health to retain an interest in possession in non-excluded property. When the property does not produce income (such as a dwelling house) the trustees may appoint an interest in possession to another person, perhaps an adult child of the beneficiary. The beneficiary may then continue to live in the property with the consent of the child. The child need only be given a revocable interest in the property. The trust law aspects of this proposal would need careful consideration.

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4 A similar point has often been litigated in the US: see *Holly Springs Savings & Insurance Co v Board of Sup'rs of Marshall County* 52 Miss. 281, 24 Am. Rep. 668 (1876); *Jones v Steward County*, 10 Neb. 154, 4 N.W. 946 (1880); *Mitchell v Leavenworth County* 91 US. 206, 23 L. Ed. 302 (1875) (US Supreme Court); *Re People's Bank of Vermont, Ill.*, 203 Ill 300, 67 N.E. 777 (1903).

5 Or until the death of the beneficiary and spouse, if the spouse exemption applies.

26.5 IHT planning for trustees of settlement with UK domiciled settlor

When the settlor is UK domiciled, trust property is not normally excluded property even if the beneficiary is foreign domiciled.

26.5.1 *Beneficiaries not ordinarily resident*

If the life tenant is ordinarily resident out of the UK, the trustees might choose to invest in exempt gilts. The trust property would then be excluded property. See 23.8 (Settled exempt gilts).

Likewise if all the known beneficiaries of a discretionary trust are ordinarily resident abroad. This option is not available if any of the beneficiaries are domiciled or ordinarily resident in the UK. A deed of appointment might be needed to satisfy these conditions. This would give rise to an exit charge unless the settlor is foreign domiciled when the settlement was made: see s.65(8) IHTA 1984. However, the amount of the charge may be moderate or small.

26.5.2 *UK settlor: foreign domiciled beneficiary*

The best option – if practical circumstances allow – is to bring the present settlement to an end by appointment to the foreign domiciled beneficiary absolutely. Watch CGT. The tax taint of a UK settlor may then be laid to rest.

26.5.3 *Life tenant domiciled in Channel Islands or Isle of Man but deemed UK domiciled*

For this rare case, see 23.5 (Individual domiciled in Channel Islands or Isle of Man).

CHAPTER TWENTY SEVEN

IHT PLANNING THROUGH DEBTS DEDUCTIBLE FOR IHT

27.1 Introduction

This chapter is concerned with IHT deductions for debts. One could write a short book on this important[1] and sometimes misunderstood topic. This chapter sets out basic principles and their application to foreign domiciliaries. There is some fascinating material in the lengthy Chapter W of the CTO Advanced Instruction Manual (Deductions against Value) which cannot be discussed here for reasons of space.

When dealing with debts it may also be necessary to consider other issues:

(1) whether the debt is a UK situate asset, relevant for CGT and IHT position of the owner of the debt; see 35.1 (Situs);

(2) whether interest on the debt has a UK source, relevant for:

(a) the recipient of the interest who may suffer UK income tax; and

(b) the payor, who may be required to deduct tax;

see 6.10 (Situs of source of interest) and 21.1 (Withholding tax on interest).

Consistent with the patchwork nature of UK tax law, different (though

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1 Not just for foreign domiciliaries; see e.g. Peter Erane's comments on the double trust debt scheme: *Taxation*, Vol.150 p.397 (30 January 2003).

overlapping) considerations apply in these contexts.

27.2 Deduction for liability of individual

The starting point is s.5(3) IHTA 1984:

> 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.

This general rule has four exceptions. The first is in s.5(5) 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 a liability is normally incurred for full consideration.[2] For instance, if an individual *borrows* money, the liability to repay the lender is in principle outside the scope of s.5(5), because it is a debt incurred for full consideration. By contrast, if an individual gratuitously covenants to pay money to a person, his liability to pay under that covenant is not taken into account for IHT.

Section 162(1) 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.

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.

2 For a discussion of the meaning of "consideration" in tax legislation, see *Venables and Kessler on the Taxation of Charities* (4th ed., 2003) para 20.5 (Meaning of 'consideration').

27.3 Section 103 FA 1986

The last and most important exception is where the anti-avoidance provision of s.103 FA 1986 applies. This arises (in short) where an individual owes a debt to a person to whom he has previously made a gift.

The section was described in *McDougal v IRC* 31 ATC 153 as "intricate and involved in expression". It must be split up into separate parts in order to distil the sense. Section 103 begins:

> **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, section 103 disallows the deduction for the liability to a certain extent. The section then goes on to explain the extent of the disallowance:

> ... to an extent proportionate to the value of any of the consideration given for the debt or incumbrance which consisted of—
> (a) property derived from the deceased; or
> (b) consideration (not being property derived from the deceased) 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 section 103(1) works like this.

(1) One needs to identify the consideration given for the liability.

(2) One asks to what extent the consideration consists of the type of consideration described in section 103(1)(a) and (b).

(3) To that extent the consideration is in principle disallowed. (There are two defences to the section 103 disallowance. I will come to those later.)

27.3.1 *Section 103(1)(a) disallowance*

One needs first of all to ascertain whether the consideration was "property derived from the deceased". If so, it is disallowed under s.103(1)(a). The expression "property derived from the deceased" is defined in section 103(3):

> In subsections (1) and (2) above "property derived from the deceased" means, subject to subsection (4) below,
> [a] any property which was the subject matter of a disposition made by the deceased, either by himself alone or in concert or by arrangement with any other person or
> [b] which represented any of the subject matter of such a disposition, whether directly or indirectly, and whether by virtue of one or more intermediate dispositions.
>
> (Paragraphing added)

The CTO Advanced Instruction Manual gives this example at W.2:

> **Example 1**
> On 19 March 1987 A gives his brother B £25,000.
> On 25 April 1987 A borrows back from B £25,000.[3]
> On 7 April 1994 A dies.
> 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.
> IHTA 1984, s 103(1)(a) was therefore enacted to disallow a debt to the extent that the consideration for it consisted of property derived from the deceased.

27.3.2 *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. One then asks whether this is a person:

3 [Not part of Manual] It is assumed that this £25,000 is, or represents, the £25,000 given to B.

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). The CTO Advanced Instruction Manual gives this example at W.2:

Example 2
Consideration given by any person whose resources at any time included property derived from the deceased
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.[4]
On 7 April 1994 A dies, at which time B retains the land which is non-income producing.
Again the PET has dropped out of cumulation so that no claim arises.
And IHTA 1984, s 103(1)(a) is ineffective since the consideration for the debt was not derived from the deceased.
To counter this FA 1986, s 103(1)(b) has been drafted in wide terms. It forbids or restricts the deduction of liabilities to the extent that the consideration given for them consisted of consideration given by any person:
– who was at any time entitled to any property derived from the deceased
  or
– whose resources at any time included any property derived from the deceased.

Because of the words "at any time", FA 1986, s 103(1)(b) applies to property derived from the deceased before as well as on or after 18 March 1986.

27.3.3 *The section 103(2) defence to section 103(1)(b)*

Section 103(2) offers a defence to the section 103(1)(b) disallowance.[5] 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 the value of the consideration

4 It is assumed that this £25,000 does not represent the land.
5 Section 103(2) does not override the section 103(1)(a) disallowance.

given, or of that part thereof, as the case may be, exceeded that which could have been rendered available by application of all the property derived from the deceased, 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.

The CTO Advanced Instruction Manual explains at W.3:

Subs. (2) acts as a curb upon FA 1986, s 103(1)(b). It does this by permitting a deduction to the extent that the **value** of the consideration for the debt is shown **by the parties** to have exceeded the amount available by the application of all the property derived by the creditor from the deceased.

For this purpose, the following property derived from the deceased is disregarded:

FA 1986, s 103(2)(a)

(a) property included in the consideration given, i.e. falling within subs. (1)(a)

FA 1986, s 103(2)(b)

(b) property shown by the parties to be derived from the deceased under a disposition which was not made with reference to, or with a view to enabling or facilitating, the giving of the consideration or the recoupment of its cost.

Example 3

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.

N.B. In such a situation it is open to the parties to claim that the whole of the debt should be allowed on the grounds that the gift was not made to facilitate the loan. It is for the parties to establish this.

27.3.4 *The section 103(4) defence to section 103(1)(a) and (b)*

Section 103(4) provides a defence to the s.103(1`)(a) and (b) disallowance:

> If the disposition first-mentioned in subsection (3) above was not a transfer of value and 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.

27.3.5 *Section 103(5) deemed PET*

Section 103(5) provides:

> If, before a person's death but on or after 18th 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 1984 Act 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 domiciled person. However, the principle of territorial limitation requires that some exception is implied. The best solution is that the deemed potentially exempt transfer should be regarded as not only "equal to the money or money's worth" but made out of the money or money's worth. Thus, if the individual is not UK domiciled at the time he repays the debt, *and* the debt is repaid out of non-UK situate property, then no tax charge arises. This would be consistent with the similar provision in section 102(4) FA 1986.

27.4 The amount of deduction for a debt

Section 162(2) IHTA 1984 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.

27.5 Deduction for debt of foreign domiciled individual

A UK domiciled individual will not usually mind whether a deduction for his liabilities is set against UK or foreign property as it is usually all subject to IHT.

Suppose a foreign domiciled person with a liability that is deductible for IHT has:

(1) UK situate 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.

27.5.1 *Debt is incumbrance*

Section 162(4) IHTA 1984 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.

27.5.2 *Debt not an incumbrance*

Section 162(5) IHTA provides:

> Where a liability taken into account is a liability to a person resident outside the United Kingdom which neither—
> (a) falls to be discharged in the United Kingdom,[6] nor
> (b) is an incumbrance on property in the United Kingdom,
> it shall, so far as possible, be taken to reduce the value of property outside the United Kingdom.

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 relationship between ss.162(4) and (5)? It is considered that (4) is applied first. Any 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 value of the liability exceeds the value of the property, does one apply the principles of s.162(5).

CTO Advanced Instruction Manual shows that the Revenue accept this:

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6 For the place where a liability falls to be discharged, see *Chitty on Contracts*, 18th ed, 1999 para 22-054 (place of payment). In outline, the place is that specified in the contract, or (if not specified) the residence of the creditor. Further consideration is needed for a contract governed by foreign law .

W.10. Where there is excluded property

Where debts due to United Kingdom creditors for which deduction can properly be taken are payable out of both excluded and other property, you should in general allow deduction in full against the non-excluded property. This does not however apply, in view of IHTA 1984, s 162(4), to the extent that the debts constitute an encumbrance on the excluded property.

Foreign element

W.11. UK debts - but foreign and UK property

Where the transferor's estate comprises assets partly situate in the UK and partly situate outside it, and he owes debts:

a) to creditors resident solely in the UK
   or
b) charged on property in the UK
   or
c) contracted to be paid therein

you should deduct the "UK" debts primarily against the UK assets and the deficiency, if any, against the assets situate elsewhere. ...

W.12. Foreign debts

Debts not falling within the above paragraph (i.e. debts to a person resident outside the UK which are neither charged on property in the UK nor contracted to be paid therein) are the subject of IHTA 1984, s 162(5). They are to be deducted primarily against foreign property. So far as is material (for example, for purposes of calculating the ceiling for Double Taxation Relief) the debts in any one country should be set against the assets in that country, and any excess set proportionally against the assets in other foreign countries.

Note the need to comply with the Bills of Sale Acts if securing loans on chattels.

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 the debt a UK source for income tax.

27.5.3 *Foreign tax debts*

On Revenue practice, see CTO Advanced Instruction Manual W.13.

27.6 Planning: borrowing by individual[7] and acquisition of excluded property

Example :

F is not UK domiciled and owns UK situate property worth £1 million. He faces an IHT charge on that amount on his death.

F borrows £1 million charged on the UK property and deposits that sum outside the UK ("the offshore deposit").

The value of his UK situate property is reduced by £1m and the value of his excluded property is increased by £1m. No IHT liability arises on the death of F.[8]

This may be useful "deathbed" planning since it avoids liability to IHT even if F dies immediately after it has been carried out. It also avoids the need for a CGT disposal (and the opportunity for a CGT free uplift on death is preserved).

Of course, the debt must not be charged on the offshore deposit. There could in principle be a back-to-back loan to minimise interest charges.

Technically the proposal cannot be faulted. Will the *Ramsay* principle apply? The risk varies depending on exactly how the arrangement is set up.

27.7 Debt from life tenant to interest in possession trust

27.7.1 *Debt owed by non-settlor life tenant to trust*

Suppose trustees have lent money to the life tenant (not the settlor). At first glance, the position seems to be:

(1) The life tenant can claim a deduction for the debt on his death.

(2) The benefit of the debt is an asset of the trust fund, and therefore usually part of the estate of the life tenant.

These two factors, the deduction and the asset, normally cancel each other

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7 See also 27.10 (Planning: borrowing by trustees and acquisition of excluded property).

8 Except so far as property prices rise.

out and the position ends up at neutral. Where, however, the benefit of the debt is excluded property (i.e. foreign domiciled settlor at the time the settlement was made and the debt not UK situate) then one would appear at first sight to have the happy position of:

(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 section 49(1) IHTA 1984 and Lord Asquith's familiar dictum in *East End Dwellings Co. Ltd v Finsbury Borough Council* [1952] AC 109[9] and continues:

> If one applies Lord Asquith's dictum, what is deemed to happen when the settlor[10] in fact borrows money from the trustees? As he is deemed to own the money before it is borrowed, he cannot borrow it from himself. The transfer of the money to himself is a non-event for inheritance tax purposes. His estate is subject to no debt, as a man cannot owe a debt to himself. The question of any such debt being treated as non-deductible in computing the value of his estate for inheritance tax purposes therefore does not arise. Conversely, however, the settled property does not include the right to sue the settlor for the money borrowed, as a man cannot have a right against himself.[11]

I respectfully agree. A practical solution may be to arrange that the debt is not due to the trustees, but to a company owned by the trustees.

27.7.2 *Debt owed by settlor to trust or trust subsidiary*

A debt owed by the settlor to a trust is in principle non-deductible by virtue of s.103 FA 1986. Likewise a debt due to a trust subsidiary (i.e. a company wholly owned by trustees which holds beneficially what might in substance be regarded as trust assets).

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9 These are set out in 23.9 and 25.11 respectively.

10 Venables is considering the position of a settlor life tenant but the same applies to a non-settlor life tenant.

11 "An IHT Trap for Settlors of Non-UK Resident Trusts", Robert Venables QC, OTPR, vol 4, issue 3, p.165.

27.7.3 *Debt owed by life tenant settlor to interest in possession trust*

Suppose the debt is owed by the life tenant settlor to the trustees. At first glance the unhappy result is that the debt is disallowed under section 103, and the trustees nevertheless hold an asset which (unless excluded property) would fall to be part of the settlor's estate. The Revenue do not appear to take this point. They probably accept the Venables view set out in paragraph 27.7.1 above that the debt and the asset of the trust cancel each other out and both are ignored.

27.8 Debts to and from trusts

Do not confuse two situations:

(1) The situation where an individual owes a debt to trustees (e.g. the trustees have lent money to the individual). Here:

- (a) the individual may seek to claim an IHT deduction for the burden of the debt in his estate;

- (b) the trustees have an asset, the benefit of the debt (which may or may not be excluded property).

(2) The reverse situation where trustees owe a debt to a person (e.g. an individual has lent to the trustees). Here:

- (a) the individual owns an asset in his estate, the benefit of the debt, which may or may not be excluded property;

- (b) the trustees or beneficiaries may seek to claim 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.

27.9 Deduction for debts of trustees

Where a trustee has incurred a liability as trustee, he may in principle[12] reimburse himself out of the trust fund. No beneficiary can prevent this. For this purpose the trustee has a lien over the trust fund. See Underhill and Hayton, *Law Relating to Trusts and Trustees*, 16th edition 2003, Chapter 18. This is the background one must bear in mind in construing the IHT legislation.

27.9.1 *Lifetime termination of an interest in possession*

Let us consider first the position where the trustees have borrowed funds and an interest in possession terminates during the lifetime of the life tenant. There is of course a transfer of value and the value transferred is:

> equal to the value of the property *in which his interest subsisted*.
>
> (Section 52(1) IHTA 1984, emphasis added)

What is "the property in which his interest subsists"? In my view it is not the settled property; it is the property subject to the trustees' lien. For the trustees' lien takes priority over the interest of the life tenant. The trustee's 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 gross value, less the value of the lien. In this valuation exercise we are not strictly claiming a "deduction" for the lien. We are simply ascertaining what the market will pay for the property.

Section 5(3), (4) IHTA 1984 is not relevant here since we are not valuing a person's "estate".

27.9.2 *Termination of interest in possession on death*

Now consider the position where an interest in possession terminates on the death of the life tenant. Here inheritance tax is charged on the value of the estate of the individual: s.4 IHTA 1984. This takes us to two further sections:

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12 One exception is where the trustee has committed a breach of trust. In the discussion here, it is assumed that is not the case.

> A person's estate is the aggregate of all the property to which he is beneficially entitled.
>
> (Section 5(1) IHTA 1984)
>
> A person beneficially entitled to an interest in possession in settled property shall be treated as beneficially entitled to *the property in which the interest subsists*.
>
> (Section 49(1) IHTA 1984, emphasis added)

Once again, what is the property in which the interest subsists? The answer, as before, is that "the property in which the interest subsists" is the settled property subject to the lien. So the debt is taken into account in valuing the property.

There is nothing in the terms of s.5 IHTA 1984 to alter this conclusion. Section 5(3) provides:

> 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.
>
> (Emphasis added)

This is not relevant since we are not concerned with the person's liabilities, but with the trustees' liabilities, or rather, with their lien.[13]

Section 5(5) provides:

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13 One cannot draw out of this subsection an inference that liabilities are to be disregarded for all purposes except in determining the value of a person's estate. The scheme of the Act does not require this; on the contrary, to do so leads to some extraordinary results. It is easy to think of examples. Suppose A owns a house worth £100 subject to a mortgage or lien of £50, not incurred for value. A gifts the house to B; B takes subject to the charge, but does not assume personal liability. The asset in B's estate is worth £50, not £100. Section 5(3) does not require one to ignore the liability. Suppose the gift were to an interest in possession trust; it would be odd if the result were different.
Suppose A owns shares in a company, which has liabilities, not incurred for value. One would never say that those liabilities must not be taken into account in valuing the shares in the company.

> 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 apply to trustees, who are not the "transferor". Section 103(1) FA 1986 provides:

> ... if, in determining the value of a person's estate immediately before his death, account would be taken, apart from this subsection, of a liability consisting of a debt *incurred by him* or an incumbrance created by a disposition *made by him*, that liability shall be subject to abatement.

This does not apply as we are not concerned with a debt or disposition made by the individual.

27.9.3 *Incumbrances*

Section 162(4) IHTA 1984 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 my conclusions above are correct, there is no need to rely on s.162(4). That subsection is concerned only with the question of *where* an allowable liability is to be allowed: i.e. is it to be deducted from an estate or trust fund generally or from the value of particular property.

However, if my view were wrong, then s.162(4) is the basis of another argument that the trustees' liability must be deducted from the gross value of the settled property. For the trustees' lien over the trust fund is an "incumbrance" in the usual sense of the word, which is:

> a claim, lien or liability, attached to property.[14]

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14 *Jones v Barnett* [1899] 1 Ch 620 citing Wharton's law lexicon. Section 272 IHTA 1984 provides that:

> "'Incumbrance' includes any heritable security, or other debt or payment secured upon heritage."

The terms "heritable security" and "heritage" are terms of Scots law, not known in English law. So this definition is intended solely to explain the meaning of the word in relation to Scots law matters (because, no doubt, the word "incumbrance" is not

For these reasons, on the natural wording of the statute, one reaches the conclusion that trustees' liabilities must be taken into account in valuing the trust fund.

This is very strongly supported by two further arguments. First, the contrary view, that trustees cannot deduct their liabilities, is manifestly absurd in its consequences and one which any Court would be most reluctant to accept. Secondly, this conclusion is supported by the estate duty cases. The estate duty provisions form the basis of the current inheritance tax provisions so the cases are of persuasive authority. The line of reasoning set out above was exactly that accepted in these cases. See s.7(1) Finance Act 1894; *Cowley v IRC* [1899] AC 198; *De Feyne v IRC* [1916] 2 Ir R 456; and *Dymond's Death Duties*, 15th edition 1973, volume 1 page 861.

27.9.4 *Contrary arguments*

What, then, is the argument that trustees' liabilities cannot be deducted? *McCutcheon on Inheritance Tax*, 3rd edition 1988, paragraph 13-54B made the point that:

> The trustees do not have an "estate" within the meaning of section 5, because they are not beneficially entitled to any property. Therefore section 5(3) does not authorise the setting off of their liabilities against the trust fund.

This is so. But if the view taken in this work is right, that one is simply valuing property subject to a lien, one does not need any statutory authority to deduct liabilities except s.160 IHTA 1984 (market value.) In particular one does not need s.5(3). So the difficulty disappears.

27.9.5 *Deduction for trustees' liabilities: conclusion*

The Revenue appear to accept in practice that trustees' liabilities are taken

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used in Scots law). Thus this definition does not shed any light on the meaning of the word "incumbrance", which bears its normal English law meaning.

into account for IHT purposes.[15] This is so even in relation to nil rate band debt arrangements, and offshore trusts, which the Revenue might well regard as tax avoidance.

27.9.6 *Against which property is deduction set?*

Where a trust has a UK domiciled settlor one may not usually mind whether a deduction for a trust debt is set against UK or foreign property as it is all subject to IHT. Where it does matter (e.g. where a trust with a foreign domiciled settlor has UK and excluded property) the principles are as follows:

(1) If the liability is charged on specific trust property, the deduction is set against that property.

(2) If the liability is not charged on specific trust property, it is nevertheless an incumbrance as the trust fund as a whole (see above) so it is deducted from the trust assets *pro rata*. The place of payment and residence of creditor are not relevant, and s.162(5) does not apply.

27.10 Planning: borrowing by trustees[16] and acquisition of excluded property

Example (1) Foreign domiciled settlor; trust owns non-excluded property:

T is the life tenant under a trust made by a foreign domiciliary. The trust owns UK situate property worth £1 million. The trustees face an IHT charge on that amount on his death.

The trustees borrow £1 million charged on the UK property and deposit that sum outside the UK.

In principle, the value of the UK situate property is reduced by £1m. The value of excluded property is increased. No IHT liability arises on the

15 See for instance CTO Advanced Instruction Manual W.43 (contemplating a deduction for accrued but unpaid fees of trust corporations) and W.56 (deduction for trustees' costs).

16 See also 27.6 (Planning: borrowing by individual and acquisition of excluded property).

death of T.[17]

Example (2) UK domiciled settlor but foreign domiciled beneficiary:

T is the life tenant under a trust made by a UK domiciliary. Trust property is not excluded property. T is not UK domiciled.

The trustees could solve this problem by transferring the trust property to T absolutely, but if the trust is UK resident, this may have an unacceptable CGT cost.

The trustees borrow £1 million and advance that sum to the beneficiary, who deposits it outside the UK.

In principle, the value of the trust property is reduced by £1 million. T's property is excluded property, and no IHT liability arises on the death of T.

These examples may be useful "deathbed" planning since it avoids liability to IHT even if T dies immediately after it has been carried out. Will the *Ramsay* principle apply? It depends how the arrangement is carried out. More care is needed than for equivalent planning by an individual.

27.11 Deduction for funeral expenses

Section 172 IHTA 1984 provides:

> In determining the value of a person's estate immediately before his death, allowance shall be made for reasonable funeral expenses.

Reference should be made for completeness to the CTO Advanced Instruction Manual:

> **W.20. Foreign domiciliaries and funeral overseas**
> As indicated at W.12 above, funeral expenses are not a liability of the estate and express provision has been required to ensure that they are deductible. You should bear in mind that the estate does not include 'excluded property', so that it would be inappropriate, even where the funeral of a non-UK domiciliary took place overseas, to refuse the

17 Except so far as property prices increase.

deduction of those expenses from the UK estate. Moreover, although at first sight IHTA 1984, s 162(5) might seem to justify the deduction of such expenses from the **non-UK** estate, that sub-section cannot apply as funeral expenses are not a liability for the purposes of IHTA 1984, s 5 or IHTA 1984, s 162.

(Original emphasis)

CHAPTER TWENTY EIGHT

IHT PLANNING BEFORE AND AFTER A CHANGE OF DOMICILE

28.1 IHT planning in anticipation of acquiring UK domicile

The basic strategy for the foreign domiciliary is to transfer his assets to a trust. If he has a foreign domicile when he makes the settlement, trust property situated outside the UK will be excluded property and will retain that status indefinitely, even if the settlor himself later becomes domiciled here. This has been common practice since 1975, and the Revenue accept it.

28.1.1 *The time limit*

The foreign domiciliary who creates his trust before acquiring a UK domicile will find that neither he nor his descendants need be troubled by IHT on the trust property. The opportunity, once missed, cannot be regained so it is desirable to ascertain the exact moment when a UK domicile is acquired. There are three possibilities:

(1) The individual who has decided to make his permanent home in the UK will acquire a UK domicile as soon as he arrives here. Such an individual must carry out his tax planning before setting foot in this country.

(2) The individual who arrives here to take up residence without such an intention will acquire a UK domicile when he later forms the intention to live here permanently. He must carry out his tax planning before his mind is made up. In practice, he should do so as soon as possible and preferably while his long term intentions remain unclear.

(3) The individual who arrives and remains residing in the UK without deciding to live here permanently will acquire a deemed UK domicile after fifteen to seventeen years' residence here: see 22.3 (Deemed UK domicile). This is the long-stop deadline for this basic IHT planning, although limited planning opportunities remain available for the deemed domiciliary; see 22.9 (Tax planning for the deemed domiciliary).

28.1.2 *Form of trust*

A suitable trust will take the following form:

(1) Income to be accumulated or paid to someone other than the settlor or his spouse for three months;[1]

(2) Subject thereto income is to be paid to the settlor for his life;

(3) Subject thereto the trust fund is to be held on discretionary trusts for the benefit of the family of the settlor.

Trust income will belong to the life tenant but (if not UK domiciled) he may mandate the trustees to retain the income and add it to capital. This may be useful to avoid "relevant income"; see 13.11 (Is income of life tenant "relevant income"?).

A simple discretionary settlement is also a possible form. For a full discussion of the drafting issues, see *Drafting Trusts and Will Trusts*, 6th ed., 2002 (James Kessler QC).

28.2 General strategy for trustees of trust with foreign domiciled settlor

There are two general points. The first is to avoid UK situate property, at least when it matters: see 26.1 (IHT planning by turning UK situate into non-UK situate property).

Trust property in a settlement created by a true foreign domiciliary can

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1 Provision (1) is necessary to prevent the settlor having an initial interest in possession which could have inconvenient results if the settlor were to become domiciled in the UK: see 23.10 (Initial interest of settlor or spouse).

remain effectively out of the inheritance tax net so long as the trust continues to exist. The trustees should be reluctant to appoint trust capital to a beneficiary who is or may become UK domiciled; that property may cease to be excluded property. On the contrary, all possible steps should be taken to maintain the life and value of the trust. If necessary, steps should be taken to extend its life by exercising powers of appointment or advancement.

If a UK domiciled beneficiary has substantial assets in his own estate then it may be worth adopting a policy of gradually realising his own assets while allowing his trust fund to accumulate or invest for capital growth. The beneficiary might gradually realise his free capital, or perhaps use it to purchase an income tax efficient annuity.

28.3 IHT planning: trusts made by UK domiciled settlor who later acquires foreign domicile

What is the best form of tax planning where a settlor has made a settlement while United Kingdom domiciled and later acquires a foreign domicile? If nothing is done the trust property cannot be excluded property.

A good solution is to transfer the trust property back to the settlor. That may be impractical if:

(1) the settlor is not a beneficiary, or

(2) commercial or foreign tax or UK CGT considerations make this course unattractive.

In such a case, a second best but workable solution may be:

(1) the settlor creates a new trust; and

(2) the trustees of the old trust transfer the trust property to the new trust.

See 24.8 (Transfer from trust made by A to another trust made by A).

A third best solution involves loans: see 27.10 (Borrowing by trustees and acquisition of excluded property).

CHAPTER TWENTY NINE

IHT ON DEATH: WILLS AND IOVs

29.1 Will drafting: general strategy

There has always been considerable scope for tax saving through a carefully drafted Will.

29.1.1 *Foreign domiciled testator: UK domiciled beneficiaries*

The Will should in principle provide that the estate is held on trust for the beneficiaries so that the trust property situated outside the UK will remain excluded property.

29.1.2 *UK domiciled testator: foreign domiciled beneficiaries*

Here, conversely, the testator should in principle give his estate to beneficiaries absolutely so that the property may qualify as excluded property in their hands.

29.2 IHT spouse exemption

Section 18 IHTA 1984 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,
> [b] so far as the value transferred is not so attributable, to the extent that that estate is increased.
> (2) If, immediately before the transfer, the transferor but not the transferor's spouse is domiciled in the United Kingdom the value in

respect of which the transfer is exempt ... shall not exceed £55,000 less any amount previously taken into account for the purposes of the exemption conferred by this section.[1]

(Paragraphing added)

I refer to this as the IHT spouse exemption.

29.2.1 *Meaning of "spouse"*

The CTO Advanced Instruction Manual states:

M.224 Definition of "spouse"
The IHT legislation does not define "spouse" so the general law applies. The exemption applies to transfers between persons who are lawfully married to each other at the time of the transfer, whether on death or in lifetime.
Spouses include:
- persons who are validly married but separated
- parties to a valid polygamous marriage. The marriage confers the IHTA 1984, s 18 exemption on all the spouses' benefits which qualify under IHTA 1984, s 18. Where the IHTA 1984, s 18(2) limit applies because of the spouses' foreign domicile, the **total** exemption (including any similar lifetime exemptions) may not exceed the IHTA 1984, s 18(2) limit.

The following are **not** spouses:
(England and Wales)
- persons who are living together but not lawfully married, however long the relationship may have lasted

(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

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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 *Venables and Kessler on the Taxation of Charities* (4th ed., 2003) Chapter 21.

friends and relatives that they are married. They are then presumed to be so in fact even 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 IHTA 1984, s 18(1) in either a death or lifetime situation the questions should be referred to ITG. ...

- parties to a bigamous marriage
- persons who were formerly lawfully married but divorced before the date of death/transfer.

Holland v IRC [2003] STC (SCD) 43 is a startling test case in which a cohabitee contends that she should be entitled to the IHT spouse exemption under Human Rights principles, discrimination between married and unmarried couples being in breach of article 14 ECHR (Prohibition of discrimination). If ultimately successful – and the prospects of success seem greater than before[2] – the consequences for the tax system will be of volcanic proportions.[3] It will need several further cases to determine the various human rights issues. What about a same sex couple? Their claim is arguably stronger since they cannot marry or obtain the tax advantages of marriage.[4] What about a married man separated from his wife and living with another "as man and wife"? What about the settlement provisions? Where will it stop?

29.3 IHT spouse exemption on death of a foreign domiciliary

Suppose:

(1) H (not UK domiciled) dies leaving:
 (a) UK property (not excluded property), and
 (b) foreign situate property (which is excluded property).

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2 See the comments of the Joint Committee on Human Rights discussed at 32.1 (Pre-owned Assets).

3 Canada has had to face up to this issue: see e.g. the Ontario Act to Amend Certain Statutes because of the Supreme Court Decision in *M v H* (1990) and *Drafting Trusts & Will Trusts in Canada*, Kessler & Hunter, 1st ed para. 4.4.

4 The tax treatment of Civil Partnerships remains to be resolved. The Civil Partnerships Bill contains no provisions so that civil partners are regarded as unmarried for tax purposes.

(2) Part of H's estate passes[5] to his widow W.

This raises the interesting question of the interaction of the excluded property rules and the IHT spouse exemption. The relevant statutory provisions of the IHTA 1984 provide:

> **4 Transfers on death**
> (1) On the death of any person tax shall be charged as if, immediately before his death, he had made a transfer of value and the value transferred by it had been equal to the value of his estate immediately before his death.
>
> **5 Meaning of estate**
> (1) For the purposes of this Act a person's estate is the aggregate of all the property to which he is beneficially entitled, except that the estate of a person immediately before his death does not include excluded property.

The following propositions are clear:

(1) IHT is charged as if H made a transfer of value ("the deemed transfer of value").

(2) The estate of H immediately before his death did not include his excluded property.

(3) The value transferred by the deemed transfer of value is equal to the value of H's estate (which is the value of the UK situate property).

Suppose, first, that on the death of H only his foreign situate (excluded) property passes to his spouse. Does the spouse exemption apply? Section 18(1) IHTA 1984 provides:

> A transfer of value is an exempt transfer to the extent that the value transferred is
> [a] attributable to property which becomes comprised in the estate of the transferor's spouse or,
> [b] so far as the value transferred is not so attributable, to the extent that

5 By will, by survivorship or by the relevant succession law; this makes no difference.

that estate is increased.[6]

(Paragraphing added)

The deemed transfer of value is not exempt under s.18(1)[a]. There is "property which becomes comprised in the estate of the spouse". However, the value transferred is not attributable to that property. That leaves the exemption in s.18(1)[b]. A transfer of value is an exempt transfer to the extent that the estate of the spouse is increased. The estate of the spouse is increased on the death of H.[7] It is therefore considered that the spouse exemption does apply on a plain reading of the words.[8] 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 lifetime gift of excluded property by H to his spouse would not qualify for the spouse exemption. But of course in such a case the spouse exemption is not needed.[9] If the contrary view were adopted, then the practical consequence should not be to raise more funds for the Revenue, but only to pose a trap for taxpayers and their advisers.

Now suppose H leaves W a pecuniary legacy. CTO Advanced Instruction Manual M.210 provides:

> **Deceased domiciled outside the UK**
> Where the will of a person domiciled abroad disposes of his UK estate and some or all of his world estate, exemption for pecuniary legacies to his spouse or to a qualifying charity should be given against the UK estate in the proportion which that bears to the world estate, and not wholly against the UK estate. ...

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6 In the case considered here the restriction in section 18(2) does not apply since H (the transferor) is not domiciled in the UK.

7 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) person's estate includes his excluded property.

8 Exemption is given to the extent of the value of the property given to W.

9 The end result is consistent with the exemption for funeral expenses; see 27.11 (Deduction for funeral expenses).

This is correct in relation to charities. The IHT charity exemption is more narrowly worded. But for spouses, it is not consistent with the words of s.18(1)[b]. It is suggested that the spouse exemption applies to the full extent of the pecuniary legacy. It makes no difference whether the pecuniary legacy is subsequently paid out of UK or foreign situate property.

Chapter III Part II IHTA 1984 (Allocation of Exemptions) does not shed much light on the issue. Section 36 provides that these rules apply where (*inter alia*) s.18 IHTA 1984 applies:

> in relation to a transfer of value but the transfer is not wholly exempt …

In the circumstances we are envisaging, the transfer will be "wholly exempt" if the value given to the spouse equals the value of the UK situate property. What happens if the value given to the spouse is less than the value of the UK situate property so the transfer is not wholly exempt? Let us assume that what the spouse receives is a "specific gift" as defined in s.42(1). Section 38(1) provides that:

> Such part of the value transferred shall be attributable to specific gifts as corresponds to the value of the gifts …

This confirms the view taken above.

29.4 Implications for drafting will of foreign domiciliary

29.4.1 *Gift to spouse by will*

Where a foreign domiciled testator has non-excluded property and excluded property, and is married so the IHT spouse exemption is available, the safe strategy will be:

(1) to give the non-excluded property to:
  (a) the spouse; or
  (b) a trust where the spouse has an interest in possession (better where the spouse is UK domiciled).

(2) to give excluded property to other persons.

A pecuniary legacy to the spouse should be charged on non-excluded property. Watch the drafting.

This course should avoid a dispute with the Revenue. However, it is not necessary.

29.4.2 *Charitable gifts by will*

Where a foreign domiciled testator has non-excluded property and excluded property, the correct strategy will be:

(1) to give the non-excluded property to UK charities;

(2) to give excluded property to other persons.

A pecuniary legacy to the charity should be charged on non-excluded property.

29.5 Instruments of variation ("IOVs")

The CTO Advanced Instruction Manual provides:

> **P.61 No bona fide variation**
> Attempts to reduce the tax on death without there being a bona fide variation may take different forms, for example...
> (3) a deceased who dies domiciled outside the UK may leave property in this country to chargeable beneficiaries and excluded property (such as government securities and foreign property) to the spouse. A variation may then be used for the spouse's entitlement to be switched from excluded property to the ordinary UK estate without any change in the amount the spouse receives.
> You should refer cases of the third type immediately above to the TA Team Leader 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".[10] Section 142(5) IHTA 1984 expressly envisages an IOV relating to excluded property.

10 It would be different if there was an arrangement under which the spouse later swapped the UK property for the excluded property.

A variation of this kind cannot sensibly be challenged if properly carried out. If the author's view of the spouse exemption is right, however, an IOV would not be necessary. (It may nevertheless be desirable as a useful precaution where a will has not been drafted in the manner recommended above.)

29.6 IHT account on death of foreign domiciliary

See 36.2 (IHT account on death of foreign domiciled individual).

CHAPTER THIRTY

MARRIAGE OF UK DOMICILIARY AND FOREIGN DOMICILIARY

30.1 Introduction

This chapter considers the position of a marriage between a UK domiciled individual and a foreign domiciled spouse. It is necessary to consider the various taxes separately.

30.2 Restriction on IHT spouse exemption for foreign domiciled spouse

Section 18(1) IHTA 1984 normally provides complete exemption for transfers between husbands and wives; see 29.2 (IHT spouse exemption). Section 18(2) imposes an important exception:

> If, immediately before the transfer, the transferor but not the transferor's spouse is domiciled in the United Kingdom 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

the exemption is restricted to £55,000 only.[1] While it is generally true that a foreign domicile is a passport to tax saving, this is one circumstance in which a foreign domicile does represent a serious drawback.

This restriction does not apply the other way round, where the foreign domiciled individual makes a transfer to his UK domiciled spouse. (Nor should it apply in those circumstances because such a transfer brings assets which would have been outside the realm of IHT within its scope.)

The restriction does not apply where both spouses are not domiciled in the UK. The restriction may be modified by double tax treaties if a spouse is domiciled in an appropriate treaty country.

Transfers which do not qualify for the spouse exemption will be PETs unless some other exemption is in point.

One solution to this problem is to wait until the foreign domiciled spouse becomes deemed UK domiciled under s.267 IHTA 1984: see 22.3 (Deemed UK domicile).

It is arguable that the restriction is contrary to the Human Rights Act 1998. We will know a little more when *Holland v IRC* has become final. It is also arguable that the restriction is in breach of EU law, where the spouse is domiciled in another EU state.

30.2.1 *Interaction of £55,000 spouse exemption and other exemptions*

An inter-spouse gift within the £55,000 limit will *not* be a PET. Section 3A(1)(b) IHTA 1984 provides that a PET is a transfer of value "which, apart from this section, would be a chargeable transfer". So if one spouse makes a gift to the other, that gift uses up the £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.

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1 CTO Advanced Instruction Manual M.225 states:

"The £55,000 limit applies to:

- the value before grossing
- the cumulative total of all transfers to a spouse, or spouses, domiciled outside the UK. So you should take into account the amounts allowed under earlier transfers in which the IHTA 1984, s 18(2) limitation applied in considering whether the £55,000 is exceeded
- transfers on or after 9 March 1982...

Where the £55,000 limit is exceeded, you should allocate the exemption in the manner which is most favourable to the spouse. Factors you should bear in mind include the incidence of tax and the availability of BR, AR or other reliefs."

The position is different for a gift within section 11 IHTA 1984 (dispositions for maintenance of family). 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 limit.

The position is less clear for a transfer (outside section 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 better to fit the scheme of the legislation.

30.3 Application of IHT spouse exemption on death

On this topic see 29.3 (IHT spouse exemption on death of a foreign domiciliary).

30.4 Exemption when spouse or widow of settlor becomes entitled to settled property

The termination of an interest in possession (during the life of the life tenant) is a transfer of value under s.52 IHTA 1984. Section 53(4) IHTA 1984 provides:

> Tax shall not be chargeable under section 52 above if on the occasion when the interest comes to an end—
> (a) the settlor's spouse, or
> (b) where the settlor has died less than two years earlier, the settlor's widow or widower,
> becomes beneficially entitled to the settled property and is domiciled in the United Kingdom.[2]

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 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 1984 sets out similar rules for the termination of an interest in possession on the death of the life tenant.

2 Section 53 goes on to set out some exceptions not discussed here.

30.5 Disposition for maintenance of spouse

Where the spouse exemption does not apply, another exemption may sometimes fill the gap. An inter-spouse gift may qualify for relief under s.11(1) IHTA 1984:

> A disposition is not a transfer of value if it is made by one party to a marriage in favour of the other party ... and is—
> (a) for the maintenance of the other party ...[3]

This would normally apply, in particular, to the common case where an individual gives a half share in the family home to his spouse. The most basic requirement of "maintenance" is to have a secure roof over one's head.[4]

A gift which is within s.11 IHTA 1984 (Disposition for family maintenance) is outside the scope of the reservation of benefit 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 1984. 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 s.18, and so would come within the reservation of benefit rules even if both spouses were UK domiciled.)[5]

30.6 Reservation of benefit on inter-spouse gift

The reservation of benefit rules[6] do not generally apply on gifts from one

3 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).

4 Lump sum payments can constitute "maintenance". Contrast section 2(1) (b) Inheritance (Provision for Family Dependants) Act 1975 (formerly section 1(4) (Inheritance (Family Provision) Act 1938) which states that lump sum payments may constituted "maintenance" for the purpose of the Act. This is also assumed in Sch 15 para 10(1)(d) FA 2004.

5 If my view were wrong the further anomaly would arise that gifts of qualifying investments to charity would fall within the scope of GWR, because such gifts fall within s.12 IHTA 1984 and not s.102(5)(d) FA 1986; but it is not necessary to pursue that here.

6 See 25.1 (Reservation of benefit).

spouse to another. The reason is that s.102(5) FA 1986 provides:

> 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 1984 Act,—
> (a) section 18 (transfers between spouses) ... ;

Where a UK domiciled individual makes a gift to a foreign domiciled spouse, and the spouse exemption is restricted to £55,000, a gift over that limit will be within the scope of the gifts with reservation rules, unless some other exemption is in point.[7]

One solution to this problem is to sell assets at market value, so there is no disposal by way of gift.

When a foreign domiciled individual makes a gift of excluded property to his spouse, s.18 and s.102(5)(a) do not apply; but such gifts are outside the scope of GWR; see 25.9 (Gift of excluded property).

30.6.1 *Operation of GWR rule on inter-spouse gift*

Suppose:

(1) H (UK domiciled at all times) makes a gift to W (foreign domiciled at the time of the gift).

(2) The gift does not qualify for the IHT spouse (or any other) exemption and H continues to enjoy benefits from the property until his death. Accordingly:

   (a) The gift is a PET (but assume H survives seven years so no tax charge arises on the PET).

   (b) The gifted property is "subject to a reservation".

On the death of H, on these facts, the position is governed by s.102(3) FA 1986:

7 Such as the disposition for family maintenance exemption: see 30.5 (Disposition for maintenance of spouse).

> That property shall be treated for the purposes of the 1984 Act as property to which [H] was beneficially entitled immediately before his death.

The property is not excluded property (even if W is foreign domiciled at the time of the death of H).[8] So H will in principle be subject to inheritance tax on the property on his death.

The interesting question is whether the spouse exemption applies on the death of H. It is considered that the spouse exemption would apply if the facts are as set out above, and, in addition:

(3) W retains the property at the time of her death, and

(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 spouse exemption does not apply. 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,
> [b] so far as the value transferred is not so attributable, to the extent that that estate is increased.

On the facts of this example, in reality, the conditions of the relief are not satisfied. The property subject to the reservation does not "become" comprised in the estate of the spouse; nor (at least as a general rule) can it be said that on the occasion of the death of H, the estate of the spouse is 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 through the deeming.[9] If one deems, as s.102(3) requires, the property subject to the reservation to be property to which H was beneficially entitled, it would normally follow that one must deem the estate of W to be increased

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8 See 25.11 (Absolute gift subject to GWR: operation of excluded property rules on death of donor).

9 See 25.11 (Absolute gift subject to GWR).

by reason of the death of H. The conclusion is supported by considering the object of the GWR rules. The object is to put the donor in the same position as if he had not made the gift. If H had not made his gift then (on the facts of the above example) he would in principle qualify for the spouse exemption.

30.6.2 *Remedial tax planning where there has been a gift with reservation of benefit*

The spouse exemption will not apply if W is not UK domiciled at the time of the death of H. 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; or

(2) W gives the property back to H; or

(3) W settles the property: see 30.11.2 (Gift to foreign domiciled spouse, followed by settlement by spouse).

30.7 Inter-spouse gift of 100% BPR or APR property

This section considers a gift of property qualifying for 100% business or agricultural property relief from a UK domiciled spouse to a non-UK 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.

30.7.1 *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 1984 provides:

> **Transfers within seven years before death of transferor**
> (1) Where any part of the value transferred by a potentially exempt transfer which proves to be a chargeable transfer would (apart from this section) be reduced in accordance with the preceding provisions of this Chapter, it shall not be so reduced unless the conditions in subsection (3) are satisfied.

The conditions which must be satisfied are set out in subsection (3):

> The conditions referred to in subsections (1) and (2) above are—
> (a) that the original property was owned by the transferee throughout the period beginning with the date of the chargeable transfer and ending with the death of the transferor; and
> (b) except to the extent that the original property consists of shares or securities to which subsection (3A) below applies that, in relation to a notional transfer of value made by the transferee immediately before the death, the original property would (apart from section 106 above) be relevant business property.

In brief, BPR is lost unless the property is retained by the donee for seven years. (There is an exception for replacement property which is not discussed here.)

30.7.2 *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 1984 (small gifts); or

(2) s.18 IHTA 1984 (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 1984 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 1984 and s.102 FA 1986.

30.7.3 *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[10] 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 1984 (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.

30.8 Other relevant exemptions

The normal expenditure exemption (s.21 IHTA 1984) may also be in

10 Though there is a possibility of reinvestment relief in this case: see s.113B IHTA 1984.

point. Gifts which qualify for this exemption are still within the reservation of benefit rule.

30.9 Divorce settlement between foreign domiciled and UK domiciled spouse

Suppose:

(1) H transfers assets to W in order to settle a divorce claim, and

(2) The transfer is outside the IHT spouse exemption.[11]

Section 10 IHTA 1984 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 transfer of value from H to W falls within section 10 IHTA 1984 and is not a transfer of value for IHT purposes.

There is a theoretical Revenue argument that the condition in section 10(1)(b) IHTA 1984 is not satisfied. The argument would be that a divorce settlement cannot be "such as might be expected to made in a transaction at arm's length between persons not connected with each other" since persons not connected with each other would not be in a divorce situation. In my view this argument is not correct. It is the old question of how far one carries the fiction of a deeming provision. The argument carries it too far because it reaches a conclusion which does not fit in with the scheme of the Inheritance Tax Act. A passage in the

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11 This may be because H is UK domiciled and W is not; or because the transfer is made after the marriage is dissolved by decree absolute.

Revenue Manual[12] (while not explicit) suggests that the Revenue do not take the point.

30.10 Payments into and out of a joint account held by a mixed marriage

30.10.1 *Introduction*

One could write a thesis on this fascinating topic. The problems do not arise in relation to a UK domiciled husband and wife because transfers between them qualify for spouse exemption. Problems do arise for a mixed marriage. Similar problems arise for joint accounts of unmarried couples.

There is an important distinction between:

(1) an account on which either husband or wife can draw a cheque;

(2) an account on which both husband and wife must sign a cheque.

This book only considers the first type of account.

30.10.2 *The banking law background*

First of all one must ascertain the rights of the joint holders of the bank account. It would need a chapter to analyse the relevant case law here,[13] but the starting point is *Re Bishop* [1965] Ch 450 at p.456:

> Where a husband and wife open a joint account at a bank on terms that cheques may be drawn on the account by either of them, then, in my judgment, in the absence of facts or circumstances which indicate that the account was intended, or was kept, for some specific or limited

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12 "**H.10 No gratuitous benefit**
...
Example 2
Dispositions made on divorce for the benefit of a former spouse, whether under a Court Order or as a result of arm's length negotiations, are normally within IHTA 1984, s 10."

13 For a summary see *Dymond's Capital Taxes*, para. 10.400. 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).

> 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.

This may be displaced by a contrary intention of the spouses, but in practice spouses often operate joint accounts without needing to give any close consideration to the ownership of the money, a search for that intention is unrealistic, and the principle set out above applies.

30.10.3 *Revenue practice*

The Revenue practice (or some of it) is set out in the CTO Advanced Instruction Manual:

> *Joint bank accounts (Outside Scotland)*
>
> **A.80. Practice**
>
> Application of the statutory provisions to joint bank and building society accounts can be particularly difficult. In practice:
>
> – you should normally regard each of the joint account holders as beneficially entitled to the proportion of the account which is attributable to his contributions
> and
> – 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.

The true legal position is, however, far from clear. You should refer to your Team Leader any case in which the parties dispute this practice. You should also avoid questions and arguments on this subject unless the amount of tax at stake is substantial. You should modify this approach where this is necessary to give effect to the realities of the situation.

Example

A, B and C share a joint account. They all contribute to it. A dies and his proportion of the account accrues by survivorship to B and C. After A's death, the entitlement of B and C should take into account A's contributions.

The text at this point has been withheld under the Code of Practice on Access to Government Information

A.81. Restriction on claim

With joint accounts 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; see e.g., *Re Bishop* [1965] Ch 450. You should not use this right of withdrawal to claim tax (e.g. by reference to the definition of 'property' in IHTA 1984, s 272 or the 'general power' provision in IHTA 1984, s 5(2)) on a share of the account greater than that which results from the practice at A.80.

A.82. Lifetime

Where A places money in a joint account in the names of A and B as beneficial joint tenants and retains the right to withdraw the whole of it, as a general rule there will not be a transfer of value 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 of value at that time.

Refer to your Team Leader any case where:

– there is such a withdrawal

or

– it is claimed that there was an immediate gift when the money was paid into the joint account, or there is evidence that an immediate gift was intended

or

– the position is more complicated, e.g. where withdrawals need both signatures.

The text at this point has been withheld under the Code of Practice on

Access to Government Information

(Emphasis added)

30.10.4 *What is the state secret?*

The Code of Practice on Access to Government Information authorises the Government to withhold "information whose disclosure would prejudice the assessment or collection of tax ... or assist avoidance or evasion".[14] It is amazing that something as innocuous as the straightforward operation of a joint account should fall within this category.

What is it that the Revenue do not want us to know? The author guesses that the withheld text makes the following points. In strictness both holders are taxed on the basis that the whole of the joint account is in the estate of both.[15] However, that result is so absurd the Revenue cannot enforce it (and the Courts would strive to reach a different result if they tried, difficult though this would be to reconcile with established principles). In consequence the Revenue operate an unpublished concession, the boundaries of which are not defined, but which gives them the freedom to attack joint account arrangements where they think appropriate.[16] In the circumstances there is some scope for tax avoidance but not a lot can be done about that.

Payment into an account is not a disposal by way of gift so the GWR rule does not apply.

30.11 IHT planning for mixed marriage

30.11.1 *Simple gift to foreign domiciled spouse*

A simple and obvious short and medium term strategy is:

(1) the UK domiciled spouse should give assets to his foreign domiciled spouse absolutely;

(2) the foreign domiciled spouse keeps the assets in a form where they are

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14 The Code of Practice is accessible at *www.lcd.gov.uk/foi/ogcode981.htm*.

15 This was accepted without discussion in *IRC v Melville* [2001] STC 1271.

16 See e.g. *O'Neill v IRC* [1998] STC (SCD) 110.

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 30.6.1 (Operation of GWR rule on inter-spouse gift). This often makes simple gifts impractical.

30.11.2 *Gift to foreign domiciled spouse, followed by settlement by spouse*

A more sophisticated IHT strategy is:

(1) the UK domiciled spouse gives assets to his foreign domiciled spouse; and

(2) the foreign domiciled spouse subsequently gives the assets to a settlement.

In principle the property in the settlement may be excluded property. One advantage of this is if the donee spouse later becomes UK domiciled: see 28.1 (IHT planning in anticipation of acquiring UK domicile). Another advantage is CGT planning: see 17.14 (CGT planning before acquisition of asset or trade). A third advantage is that this should avoid the gifts with reservation rule.[17] Of course this strategy only works if the UK domiciled spouse is not a settlor: see 34.18 (Tax planning to create settlement with foreign domiciled settlor).

30.12 CGT spouse exemption

Section 58 TCGA 1992 provides (with immaterial exceptions):

> **Husband and wife**
> (1) If, in any year of assessment, and in the case of a woman who in that year of assessment is a married woman living with her husband, the man disposes of an asset to the wife, or the wife disposes of an asset to the

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17 See 25.14 (Gift to foreign domiciled donee who creates a settlement). It may also be possible to avoid this by giving the spouse an interest in possession; see 25.13 (Settlement in which donor has IP).

> man, both shall be treated as if the asset was acquired from the one making the disposal for a consideration of such amount as would secure that on the disposal neither a gain nor a loss would accrue to the one making the disposal.

I refer to this as the CGT spouse exemption. This exemption applies regardless of the domicile of the spouses. It applies to sales at market value as well as gifts.

Watch out for the consequences of the transfer for CGT taper relief: see TCGA Schedule A1 para.15.

The relief does not apply to (1) unmarried couples or (2) married couples living apart. Whether this is consistent with the Human Rights Act may become clearer after *Holland v IRC* [2003] STC (SCD) 43.

30.13 CGT planning for mixed marriage

30.13.1 *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 CGT strategy is:

(1) The UK domiciled spouse transfers[18] the asset to his foreign domiciled spouse.

(2) The foreign domiciled spouse may be in a position to sell the asset without CGT: see 17.1 (CGT on individuals).

Watch *Furniss v Dawson*!

30.13.2 *Gift to foreign domiciled spouse followed by company or settlement by spouse*

A more sophisticated CGT strategy is:

18 The transfer may be a gift or a sale at market value. The latter avoids the IHT problems discussed at 30.2 (Restriction on IHT spouse exemptions for foreign domiciled spouse) and 30.6 (Reservation of benefit on inter-spouse gift) but take care on implementation. The spouse may need independent legal advice.

(1) The UK domiciled spouse transfers[19] the asset to his foreign domiciled spouse.

(2) The foreign domiciled spouse then gives the asset to a trust.

This offers the CGT advantages discussed in 17.13 (CGT planning before disposal of foreign situate asset). The problems discussed in 30.11 (IHT planning for mixed marraige) arise. If the object is CGT planning and not long term IHT planning, a better planning strategy here may be:

(1) The UK domiciled spouse transfers the asset to his foreign domiciled spouse.

(2) The foreign domiciled spouse acquires a non-resident company.

(3) The foreign domiciled spouse gives the asset to that company.

There is no trust, so no issue of "who is a settlor" arises. Take great care that the company can be proven to be non-resident!

30.13.3 *Asset yielding a loss*

The opposite point arises if the foreign domiciled spouse owns a foreign situate asset which will give rise to a loss. The loss on the disposal will not be allowable. See 17.18.2 (Loss on disposal by foreign domiciliary). Accordingly:

(1) The foreign domiciled spouse transfers the asset to his UK domiciled spouse.

(2) The UK domiciled spouse disposes of the asset.

The UK domiciled spouse should be in a position to realise an allowable loss.

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19 See above footnote.

30.14 Income tax planning for mixed marriage

A simple and obvious strategy is:

(1) the UK domiciled spouse should give assets to his foreign domiciled spouse absolutely; and

(2) the foreign domiciled spouse invests in property giving rise to foreign investment income which is not remitted.

The inter-spouse gift, strictly, satisfies the transfer of asset conditions. The transferor would then fall within s.739 ICTA 1988 since he has "power to enjoy" his wife's income. This is because s.742(9) provides:

> For the purposes of section 739 to 741—
> (a) a reference to an individual shall be deemed to include the wife or husband of the individual;

However, RI 201 provides relief:[20]

> 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 by virtue of the provisions of s 743(3).

The gift could also be a "settlement" for the purposes of s.660A ICTA 1988. However, s.660A(6) normally provides relief:

> The reference in subsection (1) above to a settlement does not include an outright gift by one spouse to the other of property from which income arises, unless—
> (a) the gift does not carry a right to the whole of that income, or
> (b) the property given is wholly or substantially a right to income.
> For this purpose a gift is not an outright gift if it is subject to conditions, or if the property given or any derived property is or will or may become, in any circumstances whatsoever, payable to or applicable for

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20 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.

the benefit of the donor.

CHAPTER THIRTY ONE

THE FAMILY HOME AND ITS CHATTELS

31.1 Ownership by foreign domiciliary

There are many ways to arrange the ownership of a UK family home of a foreign domiciled individual. The first possibility is that the individual should own the property directly. This has the attraction of simplicity. Also, some UK banks are said to be unwilling to lend to offshore companies. This may also be necessary, or at least desirable, in order to secure that the owner of a long lease acquires the right to enfranchisement.

The main disadvantage is that the property is in the individual's estate and in principle within the scope of IHT on his death. One possible method to mitigate this problem is to provide by will that the property should pass to the individual's surviving spouse, or to a trust under which she has an interest in possession. That normally postpones IHT until the occasion of the death of the survivor of the individual and his spouse: see 29.2 (IHT spouse exemption).

The risk of IHT may quite simply be covered by insurance. Watch that the insurance policy is not subject to IHT on the death of the individual. Perhaps arrange that the policy is not UK situate[1] (so the policy is excluded property) or transfer the policy to a trust (under which the individual is excluded). The amount to be insured will need to be reviewed from time to time in line with house inflation and possible changes in the rate of IHT.

It should be possible to transfer the property to a company so as to acquire excluded property status, even at very short notice, if the death of the owner became imminent. Watch SDLT. So in practice the IHT risk is limited to the risk of the sudden death of the individual (or the sudden

1 See 35.16 (Insurance policies)

joint deaths of individual and spouse).

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 section 222 TCGA 1992.

Take care to avoid a taxable remittance, if the purchase price is paid out of foreign income or chargeable gains within the scope of the remittance basis.

Similar points apply to chattels in the home except there is no CGT exemption, apart from the exemption for chattels under £6,000: s.262 TCGA 1992.

31.2 Direct ownership by non-resident interest in possession trust

This avoids a CGT charge on a disposal, if the private residence exemption is not fully available, for instance if:

(1) the grounds exceed the "permitted area"; or

(2) there is another private residence which qualifies for the relief; or

(3) in relation to chattels which do not qualify for exemption.

This also avoids the need for an English grant of probate after the death of the individual. The IHT position is broadly the same as absolute ownership by the foreign domiciled individual. This is only practical, however, 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 the Revenue may argue that there is a charge on the death of the settlor under the GWR rules; see 25.9 (Gift of excluded property).

31.3 Direct ownership by discretionary trust

In principle a discretionary trust could hold the UK home between ten year anniversaries. This might be a convenient short or medium term way to hold a family home. This is only practical, however, where:

(1) the settlor is dead; or

(2) the settlor has no interest in the settlement; or

(3) the settlor can be excluded from a sub-fund (which will hold the UK home); or

(4) the settlement was made before 18 March 1986.

Otherwise the Revenue may argue that there is a charge on the death of the settlor under the GWR rules; see 25.9 (Gift of excluded property).

Care would be needed to ensure that the occupier did not acquire an interest in possession in the "discretionary" trust by virtue of his residence in the property. For the Revenue views, see SP 10/79. The practical solution may be to arrange a lease of the property to the beneficiary at a nominal rent.

31.4 Loan secured on property

It clearly makes IHT sense for any existing loans to be secured on the UK property. It is also possible to borrow in order to mitigate IHT: see 27.1 (IHT planning through debts deductible for IHT). Commercial borrowing is likely to be an expensive solution to the IHT problem but borrowing from a friendly trust may be practical.

31.5 Ownership by non-resident company: property law aspects and IHT advantages

For inheritance tax, the obvious strategy is for the UK home of a foreign domiciliary to be owned beneficially by a foreign company. The shares in the company are not UK situate, and qualify as excluded property for IHT. The company would usually be held by an offshore trust.

An argument that an arrangement of this kind was a sham was rejected in *Skylarks v Shah* [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.

31.6 Ownership by non-resident company: CGT

The company will not be subject to CGT or corporation tax on chargeable gains provided it is not resident.

If the company is owned by an individual, the gains will be treated as accruing to the individual under s.13 TCGA 1992. This does not apply if the individual is not UK domiciled. (In the case of a UK domiciled individual, it is an interesting question whether private residence relief could apply to give exemption to the s.13 charge.)

If the company is held by a trust, the gains would be "trust gains". Again, this is not a problem so far as capital payments from the trust are received only by foreign domiciled or non-resident beneficiaries.

31.7 Family home held by company: benefit in kind charge[2]

The charge on living accommodation is to be found in ss.97 and 102 ITEPA 2003:

> **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

2 For the law before 2003/04 see a predecessor of this chapter which is accessible on *www.kessler.co.uk*. The Employment Income Manual contains much interesting material on these provisions which cannot be set out here for lack of space or direct relevance.

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".

31.8 Some defined terms

The provisions swarm with defined terms. Several of the terms are misleading in that they do not carry anything like their natural meaning, so the effective tax charge is different from what it might appear to be.

31.8.1 *"By reason of the employment"*

The expression "by reason of the employment" is extended by s.97(2) so it does not mean "by reason of the employment" at all:

> Living accommodation provided for any of those persons by the employer is to be regarded as provided by reason of the employment ...[3]

31.8.2 *"Family" and "household"*

The definitions are in s.721 ITEPA 2003:

> (4) For the purposes of this Act the following are members of a person's family—
> (a) the person's spouse,
> (b) the person's children and their spouses,
> (c) the person's parents, and
> (d) the person's dependants.

Illegitimate children do not count as "children"; see s.721(6). This is

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3 The subsection continues:
"unless—
(a) the employer is an individual, and
(b) the provision is made in the normal course of the employer's domestic, family or personal relationships."
The exception is not relevant here.

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 may of course qualify as "household" if they are dependants. Section 721 provides:

> (5) 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.

31.8.3 *"Employer" "employee" and "employment"*

Section 5 ITEPA 2003 extends the concept of "employment" to include officers (e.g. directors who may not as a matter of employment law be employees). This provides:

> **Application to offices and office-holders**
> (1) The provisions of the employment income Parts that are expressed to apply to employments apply equally to offices, unless otherwise indicated.
> (2) In those provisions as they apply to an office—
> (a) references to being employed are to being the holder of the office;
> (b) "employee" means the office-holder;
> (c) "employer" means the person under whom the office-holder holds office.

31.9 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.[4] The reasoning continues to apply to the ITEPA 2003. The unfairness of this to a shadow director who does no work for the company did not unduly concern the

4 This reversed an earlier unreported Special Commissioners' decision which held that these 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*.

House of Lords because of the countering unfairness to the Revenue of the case where the services of a shadow director were as valuable as a full-time employee. It appears that two equal wrongs make a right to tax.

Employment Income Manual 11413 states:

> **11413. Living accommodation: Avoidance area: Shadow directors**
> A person in accordance with whose directions or instructions the directors of a company are accustomed to act is deemed to be a director of that company by Section 67(1) ITEPA 2003. 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 2003 in the same way as if the individual had held a formal appointment as a director. ...
> Many shadow directors are individuals who, although not domiciled in the UK, have come to work and reside here. In order to avoid a possible charge to inheritance tax, which could be imposed if such an individual died whilst working in the UK, an arrangement is made to set up an offshore company that owns the UK property in which the individual lives. Where the individual is a shadow director of that offshore company Section 97(2) ITEPA 2003 deems the UK property to be provided to the shadow director by reason of the deemed employment.

Until now the Revenue have only taken the point in a relatively small number of cases. This is probably because taxpayers (if they have considered the matter at all) have taken the view on their facts that they are not shadow directors. The Revenue have themselves had to identify the cases suitable for investigation, but they now seem to be doing this.

31.10 The cash equivalent: sections 105 and 106 computations

The charge is on the "cash equivalent". Section 103 ITEPA 2003 explains:

> **Method of calculating cash equivalent**
> (1) The cash equivalent is calculated—
> (a) under section 105 if the cost of providing the living accommodation does not exceed £75,000; and
> (b) under section 106 if the cost of providing the living accommodation exceeds £75,000.

Thus there are two methods of calculating the cash equivalent, here called a section 105 computation and a section 106 computation. This is for historical reasons, the section 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.

31.11 Cost of providing accommodation

One needs to know the "cost of providing living accommodation":

(1) in order to decide between the s.105 and s.106 computation;

(2) in order to make the s.106 computation (if applicable, as it usually is).

This expression is defined in s.104:

> **General[5] rule for calculating cost of providing accommodation**
> For any tax year the cost of providing living accommodation is given by the formula—
>
> $$A + I - P$$

In short, A is **A**cquisition cost, I is **I**mprovement cost, and P is **P**ayments received in return. In full detail:

> A is any expenditure incurred in acquiring the estate or interest in the property held by a person involved in providing the accommodation,[6]
> I is any expenditure incurred on improvements to the property which has been incurred before the tax year in question by a person involved in providing the accommodation, and
> P is so much of any payment or payments made by the employee to a person involved in providing the accommodation as represents—
> (a) reimbursement of A or I, or
> (b) consideration for the grant to the employee of a tenancy or sub-tenancy of the property.

5 For the exception see 31.14 (Revaluation).

6 The expression "person involved in providing the accommodation" is defined in s.112 ITEPA 2003.

31.12 Accommodation costing £75,000 or less: section 105 computation

Section 105 applies where the cost of providing accommodation does not exceed £75,000. This was a meaningful figure when the legislation was introduced in 1983 but inflation, the Chancellor's friend, has whittled away the real value of this limit so it must be exceptional now to find a purchase of less than £75,000. One might think the s.105 computation was a dead letter and one can turn directly to s.106. But s.106 refers back to s.105 so one needs to make the s.105 computation even in a s.106 case.

Section 105 ITEPA 2003 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.

31.12.1 "*Rental value of the accommodation*"

Section 105 provides:

> (3) The "rental value of the accommodation" for the taxable period is the rent which would have been payable for that period if the property had been let to the employee at an annual rent equal to the annual value.
> (4) But if the person at whose cost the accommodation is provided pays rent for the whole or part of the taxable period at an annual rate greater than the annual value—
> (a) subsection (3) does not apply to that period or (as the case may be) that part of it; and
> (b) instead the "rental value of the accommodation" for that period or part is the rent payable for it by that person.

> (5) If the rental value of the accommodation for the taxable period does not exceed any sum made good by the employee as mentioned in subsection (2)(b), the cash equivalent is nil.

The key expression is "annual value". This is defined in s.110 ITEPA 2003 but it is not usually necessary to refer to that for UK property. ITEPA Explanatory Note states:

> 404. [Section 110] does not affect the Inland Revenue practice of using the gross rateable value as a proxy for "annual value". That practice will continue. The main use of this section is to provide guidance on how to arrive at the annual value of properties for which rent is not paid and in practice is only needed in cases where no gross rateable value can be found.[7]

The Employment Income Manual provides at para 11434:

> The amount of annual value for United Kingdom 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	(For years before 1987/8 see the SE Manual)	100/270 × the 1985 gross rating value

7 Likewise at Change 23:
"These provisions [ss.110 and 207 ITEPA 2003] 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."

Anywhere in the United Kingdom	No gross rating value set	Ask the appropriate District Valuer to confirm any estimated figure provided by the employer that you want to check.[8]

For the formula to convert a net rating value figure to a gross rating value figure see EIM11438.

Thus for most purposes the s.105 computation is rateable value less sums "made good" to the employer. That is usually a tiny 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 re-write did not think it appropriate to express all this in the statute. That would expose the rules as incoherent.

31.12.2 *"Making good"*

The Employment Income Manual provides:

> **21120. The benefits code: What is meant by "making good"**
> "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

8 The Manual continues:
"If no such estimate is provided or the estimate is not acceptable the District Valuer will provide a (not negotiated) figure. If the taxpayer does not accept that figure the District Valuer will try to agree a figure with the taxpayer. For the procedure for referring to the District Valuer see EIM11437."

> - 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). In any case where the taxpayer argues that an interest-free loan has been made to his employer specifically to make good the cost or value of a benefit, make a submission to Personal Tax (Technical), Solihull.
>
> As regards "making good" by waiver of remuneration see EIM21122.
>
> **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.

This is as generous a position as the law allows.

Does the employee make good the cost by paying the cost of maintenance and insurance? Section 110 ITEPA envisages that this expenditure will be paid by the employer. However, the maintenance of the building is probably not a "sum" made good. The Revenue Manual is equivocal:

> **11439. Living accommodation: annual value of United Kingdom property: Employee responsible for repairs or insurance.**
>
> ...
>
> An employee may be responsible for the cost of repairs or insurance under the terms of his or her lease or employment. If an employee claims an adjustment to the annual value (derived from the table in EIM11434) because the facts of an employee's case are not those envisaged by Section 110 ITEPA 2003, make a full report to Personal Tax (Technical), Solihull.

It is clearly "making good" if:

(1) the company pays the costs of maintenance and insurance; and

(2) the individual repays cash to the company.

31.13 Accommodation over £75,000: section 106 computation

Section 106 ITEPA 2003 provides:

> **Cash equivalent: cost of accommodation over £75,000**
> (1) The cash equivalent is calculated under this section if the cost of providing the living accommodation exceeds £75,000.
> (2) To calculate the cash equivalent—
> *Step 1* Calculate the amount that would be the cash equivalent if section 105 applied (cash equivalent: cost of accommodation not over £75,000).

See above.

> *Step 2* Calculate the following amount ("the additional yearly rent")—
> ORI × (C – £75,000)
> where—
> ORI is the official rate of interest in force for the purposes of Chapter 7 of this Part (taxable benefits: loans) on 6th April in the tax year, and
> C is the cost of providing the accommodation calculated—
> (a) in accordance with section 104 (general rule for calculating cost of accommodation), or
> (b) in a case where section 107 applies (special rule for calculating cost of providing accommodation), in accordance with that section instead.

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) paragraph (b) only applies if, in respect of the taxable period, the rent paid by the employee in respect of the accommodation to the person providing it exceeds the rental value of the accommodation for that period as set out in section 105(3) or (4)(b), as applicable, and
(b) "the excess rent" means the total amount of that excess.

In short, the charge is (1) the s.105 computation (rateable value less sums made good) and (2) (what I call) the s.106 computation (official rate of interest on purchase price less £75,000) less rent.

This works (more or less) where the s.105 computation is based on the nominal amount of rateable value. It gives double taxation where the s.105 computation is based on actual market rental value. ESC A91 gives relief here:

> *Living accommodation provided by reason of employment*
> ...2. Where the charge to tax under [s.105 ITEPA 2003] is calculated by reference to the annual rent the property might fetch on the open market, the Revenue will not seek an additional charge under [s.106 ITEPA 2003].

Although paragraph 1 of this concession is obsolete because it has been enacted by ITEPA, this part of the concession is still in effect.

31.14 Revaluation in cases of delayed occupation

Normally the s. 106 computation is based on the employer's acquisition cost (i.e., historic cost). Market value of the property later is not relevant. This rule could favour the taxpayer or the Revenue, 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 2003 provides:

> **Special rule for calculating cost of providing accommodation**

(1) This section contains a special rule for calculating the cost of providing living accommodation which—
 (a) operates for the purposes of step 2 of section 106(2) (calculating the additional yearly rent), and
 (b) accordingly only operates where the cost of provision for the purposes of section 106(1) (as calculated under section 104) exceeds £75,000.

In practice condition (b) will almost always be satisfied (except perhaps for property purchased many years ago).

(2) This section applies if, throughout the period of 6 years ending with the date when the employee first occupied the accommodation ("the initial date"), an estate or interest in the property was held by a person involved in providing the accommodation.
It does not matter whether it was the same estate, interest or person throughout.

In short, this condition is that the property has been owned by the company for six years before the employee moves in.

(3) For any tax year the cost of providing the living accommodation for the purposes mentioned in subsection (1)(a) is given by the formula—
 MV + I – P

In short, MV is **M**arket **V**alue; I is **I**mprovement cost; P is **P**ayments in return. In full detail:

MV is the price which the property might reasonably be expected to have fetched on a sale in the open market with vacant possession as at the initial date,
I is any expenditure incurred on improvements to the property which has been incurred during the period—
(a) beginning with the initial date, and
(b) ending with the day before the beginning of the tax year, by a person involved in providing the accommodation, and
P is so much of any payment or payments made by the employee to a person involved in providing the accommodation as represents—
(a) reimbursement (up to an amount not exceeding MV) of any

expenditure incurred in acquiring the estate or interest in the property held on the initial date,

(b) reimbursement of I, or

(c) consideration for the grant to the employee of a tenancy or sub-tenancy of the property.

This may arise where:

(1) a foreign domiciliary (or trust) purchases a company holding a property acquired more than six years previously;

(2) an individual then occupies the property and becomes a shadow director.

Next is an anti-avoidance provision to block an obvious scheme to devalue MV:

(4) In estimating MV no reduction is to be made for an option in respect of the property held by—
  (a) the employee,
  (b) a person connected with the employee, or
  (c) a person involved in providing the accommodation.

Lastly, for completeness, there is transitional relief where the employee first occupied the property before 31 March 1983: para.21 Sch.7 ITEPA 2003.

31.15 Accommodation provided for more than one employee

Section 108 ITEPA 2003 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.

31.16 Ways to avoid benefit in kind

Ways to avoid the entire benefit in kind charge are:

(1) to ensure that the occupier is
   (a) not an officer (i.e. not a director or company secretary, which is straightforward);
   (b) not an employee (which should be straightforward); and
   (c) not a "shadow director"; or

(2) not to use a company.

A way to avoid the s.106 charge is to reimburse the company for its expenditure.

I will consider these in turn.

31.17 Who is a shadow director?

Section 67(1) ITEPA 2003 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".[9]

This has been explained in *Secretary of State for Trade and Industry v Deverell* [2001] Ch 340 at p.354:

> (1) The definition of a shadow director is to be construed in the normal way to give effect to the parliamentary intention ascertainable from the mischief to be dealt with and the words used. In particular, as the purpose of the Act is the protection of the public and as the definition is used in other legislative contexts, it should not be strictly construed because it also has quasi-penal consequences in the context of the

9 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.

> 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 the point can fairly be made that *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[10] 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 one company holding 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. 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

10 The dangerous and beguiling word "real" is normally an indication of vague if not sloppy legal analysis.

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.[11]

> (4) Non-professional advice may come within that statutory description. The proviso excepting advice given in a professional capacity[12] appears to assume that advice generally is or may be included.

This is equally extraordinary, for the concepts of "direction" and "instruction" are 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 so 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 much light on the general meaning of "shadow director".

> 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.

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11 For other examples of the "label" doctrine, see *Drafting Trusts and Will Trusts*, James Kessler QC, Sweet & Maxwell, 6th ed., para.18.3.

12 See s.67(2) ITEPA 2003:

> "... 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."

> (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 tone of the passage is wholly negative. In determining the issue of "shadow directorship":

(1) The understanding or expectation of the parties is *not* conclusive.

(2) The label attached by the parties is *not* conclusive.

(3) The fact that the communication is "advice" is *not* conclusive (except in the case of professional advice).

(4) The fact that the properly appointed directors surrender their discretions or act in a "subservient" role is *not* essential.

This does not answer the question: how *does* one identify a shadow director? The mere fact that there is a stream of communications from the individual to the company, which is acted on by the company, is not conclusive. The author regularly sends "communications" to the internet bookshop Amazon, and Amazon act on those communications without fail. Yet the author is not a shadow director of Amazon.

It is considered, therefore, 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.

Suppose a person treats the property owned by the company as his own and has no dealings with the directors: he just ignores them. They do nothing (except perhaps charge their fees). In such a case the company may be a sham (or nomineeship). Whether or not that is so, the individual is not a shadow director. He gives no instructions.

A non-resident person may be a "shadow director".

31.17.1 *When is an agent of a company a shadow director?*

The Revenue accept 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 (for the purposes of CGT trust residence). See 4.5.2 (Delegation to UK agent). It is suggested that a similar principle applies in the context of shadow directorship. An agency agreement under which the occupier of a property was responsible for routine maintenance matters on behalf of the company would not make the individual a "shadow director" as long as the decision to enter into contract was properly made by the directors and the directors properly supervise the work of the individual. This should not be difficult if the directors understand their duties are to all beneficiaries of the trust (not just to the settlor) and if the individual occupier of the property also understands this. It would be different if the agency agreement covered matters not usually delegated by an investment company to an agent.

31.17.2 *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 the court may classify as "directions or instructions". So it would normally be difficult to arrange 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. (Watch SDLT.)

The trustees may reason that if the life tenant dies, the UK property would not be excluded property and a charge to inheritance tax would arise – the liability for which would fall on the trust fund. In discharge of their fiduciary duty they could transfer the property to a foreign company to create excluded property and protect the trust from the liability. The point is that the occupier has *not* instructed or even requested the company to purchase the property for him.[13]

It would be best if the directors and trustees were separate persons. All communications should be through the trustees and not the directors of the company. If the foreign domiciliary desires to sell and, perhaps, purchase another property, he should communicate his wishes to the trustees. Then:

(1) The trustees could put the company into liquidation. The liquidator would sell the property.

(2) Alternatively, the trustees may prefer to sell the company. That has stamp duty advantages, and would be attractive for a purchaser who is a foreign domiciled individual or non-resident trust.

The procedure may then be repeated for a new purchase. In these circumstances it would continue to be difficult for the Revenue to argue that the occupier was a shadow director.

31.18 Reimbursement as solution to IT charges

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 payment of rent or arranging that the individual is not a shadow director).

31.18.1 *Who makes the reimbursement*

Note that only reimbursement made by the employee is deductible. For example, if

(1) a company purchases property;

13 I am grateful to Peter Vaines for this suggestion.

(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.

31.19 Property purchase financed by the foreign domiciliary

Sometimes a company structure is set up specifically for the purpose of purchasing the home. That is, under a pre-organised arrangement:

(1) The individual agrees in principle to purchase a property.

(2) The individual:
   (a) lends the purchase price to a company, or
   (b) transfers the purchase price to a trust which lends the purchase price to a wholly owned company.

(3) The company makes the purchase.

This section considers whether a background of this kind offers a defence to the income tax charge.

31.19.1 *"Making good" and s.105 computation*

The section 105 computation allows a deduction for:

> any sum made good by the employee to the person at whose cost the accommodation is provided that is properly attributable to its provision.

The taxpayer would have to show that the interest foregone on the interest free loan from the individual (directly or indirectly to the company) is:

(1) a "sum", and
(2) "makes good" the provision of the accommodation.[14]

Whether the interest foregone "makes good" the provision of accommodation is a question of fact. Assuming the reason the interest is foregone is to enable the company to provide the accommodation, this condition should be satisfied.

Whether the interest foregone is a "sum" is a question of law; it is suggested that the word should not be construed strictly or technically, and an amount of interest foregone may be a "sum".[15]

In the course of some general and uncontroversial comments on "making good"[16] the Revenue Manual provides at SE 21120:

> In any case where the taxpayer argues that an interest-free loan has been made to his employer specifically to make good the cost or value of a benefit, make a submission to Personal Tax (Technical), Solihull.

31.19.2 *Loan to company as defence to section 106 computation*

Sums "made good" are not deductible as such in the section 106 computation. Rent is deductible in a section 106 computation but the interest foregone on an interest-free loan is not rent. No-one suggests that the company would be taxable under Schedule A!

It has been suggested that a company financed by an interest-free loan has not incurred expenditure. If this is so then it is a complete answer to the section 106 charge because the figure A in the formula for the cost of providing accommodation is reduced to zero. The suggestion is raised in Stephen Brandon's *Taxation of Non-UK Resident Companies and their Shareholders*, Key Haven Publications, paragraphs 5.3.3.8 to 5.3.3.15 citing *Wicks v Firth* [1983] STC 25 at 31:

> The scholarships were provided at the cost of ICI and not at the cost of the Trustees because the Trustees with moneys supplied by ICI were only performing fiduciary duties …

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14 It is assumed that the interest foregone exceeds the annual or rateable value of the accommodation, which will normally be the case.

15 See the discussion on "sum" in 7.24 (Chattels brought to the UK).

16 See 31.12.2 ("Making good").

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*.

31.19.3 *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.[17] However, the interest foregone on the loan is not "reimbursement". In addition, it is also not a "payment".

31.19.4 *Release of loan*

A possible solution would be for the individual to release the debt which is due to him from the company.

Statute requires a "payment" representing a reimbursement. It is a moot point whether the release of the debt would be a "payment". One should take the cautious view that it may not be. The matter should be dealt with as follows:

(1) The individual transfers the funds to the company. They should be received in the company's bank account. This should be accompanied by a letter to the company saying: "I have today procured the payment of £X to your account. This is reimbursement for the expenditure you have incurred in acquiring [the property]. However, I require repayment of the debt due to me of £X."

(2) The company may then use its funds to repay its debt due to the individual.

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17 See 31.18 (Reimbursement as solution to IT charges).

Although this is a circular transaction (the payment being matched by immediate repayment) that does not nullify it for tax purposes: compare *MacNiven v Westmoreland* [2001] STC 237.

If the company incurs additional improvement expenditure in the future, this should be matched by further reimbursements so the total cost of providing the living accommodation (A+I–P) remains less than £75,000.

The reimbursement of the company is not a transfer of value for IHT purposes if the individual is (or is treated as) the beneficial owner of the company. For the same reason the reimbursement is not a disposal by way of gift and so is outside the scope of section 102 FA 1986 (gifts with reservation).

The effect of the gift (the reimbursement) is to increase the value of the shares of the company without any corresponding rise in the CGT base cost. So the gift increases the chargeable gain on the disposal. This should not matter so long as the law remains in its current form.

31.20 Co-ownership defence to living accommodation charge

The proposal here is that the individual owns a share in the property jointly with the company. It is argued that he occupies the property as co-owner and the company does not "provide" accommodation. Co-ownership raises similar but not identical issues for other provisions which charge tax on benefits, such as s.87 TCGA 1992, s.740 ICTA 1988, s.203 ITEPA 2003, and IHT gifts with reservation rules. The discussion here is limited to the case where an individual and a company are co-owners. Similar but not identical issues arise with the other taxes where an individual and a trust are co-owners.

31.20.1 *The land law position*

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 held on trust, and the position is governed by the Trusts of Land and Appointment of Trustees Act 1996.[18] Section 12(1) TLATA provides:

18 Further consideration is needed for (1) land in other jurisdictions (2) English land before the TLATA took effect and (3) jointly owned chattels.

> 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.

I refer to a person who is so entitled as having a "statutory occupation right".

The individual will obviously have a statutory occupation right under section 12.[19]

Whether the company will also have a statutory occupation right is important. I am inclined to think (normally) not. The company will not meet the conditions of section 12.

The trustees[20] have various powers, but they do not have power to override the individual's occupation right or to require the individual to pay an occupation rent. This is fundamental so I set out the provisions in detail.

Section 13(1) provides:

> Where two or more beneficiaries are (or apart from this subsection would be) entitled under section 12 to occupy land, the trustees of land may exclude or restrict the entitlement of any one or more (but not all) of them.

The trustees cannot under section 13(1) override the individual's statutory occupation right if (as I suggest is normally the case) the individual has a statutory occupation right and the company does not.[21]

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19 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.

20 The trustees are those who have the legal title to the land. This may be or include the company; it makes little practical difference for tax purposes. (If the company is not a trustee it can apply to Court to require the trustees to exercise their powers.) The shares in the company may also be held on trust but that trust is not relevant here.

21 It is a reasonably plain inference that co-ownership gives no right of occupation unless the conditions of s.12 are met. But Barnsley, "Co-Owner Rights to Occupy Land" [1998] CLJ 123 takes the opposite view. Megarry & Wade, *Law of Real*

Section 13(6) provides:

> Where the entitlement of any beneficiary to occupy land under section 12 has been excluded or restricted, the conditions which may be imposed on any other beneficiary under subsection (3) include, in particular, conditions requiring him to—
> (a) make payments by way of compensation to the beneficiary whose entitlement has been excluded or restricted, or
> (b) forgo any payment or other benefit to which he would otherwise be entitled under the trust so as to benefit that beneficiary.

The trustees cannot require the individual to pay compensation (an occupation rent) to the company under section 13(6) because the company has no statutory occupation right: section 13(6) assumes that compensation can only be required in a case where a co-owner has such rights and they are overridden by s.13(1).

Section 13(3) provides another power:

> (3) The trustees of land may from time to time impose reasonable conditions on any beneficiary in relation to his occupation of land by reason of his entitlement under section 12.
> …
> (5) The conditions which may be imposed on a beneficiary under subsection (3) include, in particular, conditions requiring him—
> (a) to pay any outgoings or expenses in respect of the land, or
> (b) to assume any other obligation in relation to the land or to any activity which is or is proposed to be conducted there.

The trustees can do little under section 13(3) except to require the individual to pay outgoings.[22]

It is reasonably clear that sections 12–14 are a comprehensive code and there is no common law right to an exclusion rent except in a case of

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Property, 6th edition, suggests a co-owner has a right of occupation where he is also a legal owner, but that ignores the fact that the rights of the legal owner are held as trustees. It makes no difference for present purposes whether this is so or not, as what matters is whether the company has a right of occupation under s.12.

22 In particular the trustees cannot use this power to require an exclusion rent, as that must be done under s.13(6) or not at all. There is a further restriction in s.13(7) but that is not so important here.

ouster.[23]

The trustees also have power to sell the land but the Court has discretion to prevent a sale.[24] The important question here is whether a Court would allow or require a sale. It is considered that a Court would not do so so long as the individual remains in occupation, unless the company had a good reason for a sale, e.g.

(1) if the company is insolvent; or

(2) if the individual has only a tiny interest in the land (say, less than 10%) though even that is questionable.[25]

In short, the company as co-owner is normally in a miserable position: it can do almost nothing while the individual remains in occupation, except require the individual to pay the outgoings.

31.20.2 *Benefit of providing living accommodation*

If that is the case then the company co-owner which does nothing and leaves the individual in occupation does not "provide accommodation" in any year by its inaction because the individual has the right of occupation independently of anything the company does or can do. Accordingly there is no living accommodation charge.

The matter is made more complicated by *Christensen v Vasili* [2004] EWHC 476. This concerned a co-owned car. The question was whether there was a tax charge under (what is now) section 144 ITEPA 2003 which applies where a car is "made available" to an employee. The Special Commissioner held that the car was not made available:

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23 The implications of the TLATA were wholly overlooked in *Re Byford* [2003] EWHC 1267. This case concerned periods before and after TLATA but was decided on the basis of pre-TLATA law only. The analysis of the pre-TLATA law is also doubtful: [2003] *The Conveyancer* 533.

24 Sections 6, 14 TLATA 1996.

25 This is perhaps supported by the approach of s.13(7), though that only applies to powers conferred on the trustees by s.13, whereas the power of sale is conferred by section 6. The individual's position is stronger if he has more than a 50% share as then s.11 TLATA 1996 gives him further support, but it is not likely that anything will turn on that.

> 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.

Unfortunately this conclusion, which was with respect plainly right, was flatly if unconvincingly rejected in the High Court:

> In their ordinary sense, the question "who made the car available to Mr. Vasili?" must be answered in the sense that his employer did so, and has not been paid for it.

It is suggested that *Vasili* can 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.

31.20.3 *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.[26]

If the company incurs costs of maintenance, that is an employment related benefit.

31.20.4 *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. Could this benefit be taxable? [27]

In *IRC v Eversden* 75 TC 340 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 now.

Subsequently the property originally given was sold and a new (smaller) property purchased in the same proportions. This also took place before the TLATA 1996, but the settlor continued to live there after the 1996 Act took effect, dying in 1998. 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 [the second house] 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*.[28]
> (Emphasis added)

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

26 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 section 205 ITEPA 2003.

27 This issue does not arise where the company receives its share of the land gratuitously.

28 [2002] STC at p.1129. The point was rightly not appealed. The position would be different if the sale of the first property had been conditional on the purchase of the new one, that is, if the individual only agreed to join in the sale of the first if the trustee agreed to join in the purchase of the second.

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 section 87 TCGA or 740 ICTA. Where 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. I suggest that:

(1) The benefit is not the provision of living accommodation.

(2) The value of the benefit for IT purposes is nil because:

  (a) The company incurs no expense in connection with its provision. (The purchase price is not such an expense, since it is a capital expense reflected in the company's ownership of its share.)

  (b) The special valuation rules of sections 205, 206 ITEPA 2003 do not apply.

31.20.5 *The Revenue view*

The Employment Income Manual provides at 11414:

> **Living accommodation: Avoidance area: Co-ownership cases**
> 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 2003 in these cases and the strength of those arguments will depend on the facts of the case.

It is interesting to note that the Revenue 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.

31.21 Some other defences

31.21.1 *The caretaker's defence*

Section 99 ITEPA 2003 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 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 Employment Income Manual rightly provides:

> **11342. Living accommodation exemption: Necessary for proper performance of the duties: Types of employee**
> Part 3 Chapter 5 ITEPA 2003 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 EIM11341).

The following types of employee may be accepted as being within the exemption:
...
Caretakers living on the premises. This only covers those with a genuine full time caretaking job. ...

31.21.2 *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.[29]

31.21.3 *Lease premium scheme*

The Revenue Manual provides:

> **11415. Living accommodation: Avoidance area: Lease premium cases**
> Section 105 ITEPA 2003
> In these cases the employer takes a short lease on living accommodation from a third party. Instead of just paying the market rent for the property the employer pays a large premium and a small annual rent. It is argued that none of the premium can be treated as rent for the purpose of measuring the cash equivalent of this benefit.
> An example will illustrate the point. A London flat owned by a third party has a market rental value of £25,000 per annum and gross rateable value under the old rating system of £800. An employer enters into a 3 year lease with the third party paying a premium of £75,000 and a rent of £100 per annum. The employer then provides the flat rent free to an employee. The cash equivalent of the benefit is the higher of:
> - the gross rateable value and
> - the al rent payable.
>
> It is argued that the cash equivalent of the living accommodation benefit is £800 gross rateable value because none of the £75,000 can be treated as rent.

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29 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.

In some circumstances we might wish to argue that the premium should be treated as rent. Please submit your papers to Personal Tax, (Technical), Solihull in any case on which you wish to argue the point.

31.22 Non-UK situate accommodation

Some practitioners argued that the old legislation did not apply to property outside the UK. The argument does not arise (or at least has been weakened) under the ITEPA 2003.

31.23 Benefit in kind remittance basis

This section deals with the position of a UK resident and ordinarily resident but foreign domiciled individual who is an employee, director or shadow director and receives the benefit in kind of living accommodation.

A specified amount (the cash equivalent) "is treated as earnings from the employment". I refer to this as "BIK earnings".

31.23.1 *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 United Kingdom.[30] Thus one has to ascertain:

(1) what are the duties;

(2) where they are performed.

To ascertain the duties of an employee or properly appointed director is straightforward. To ascertain the duties of a shadow director is problematic. A shadow director has no positive "duties" in the normal sense of the word.

It might be argued that a shadow director has no "duties" within the meaning of section 23 ITEPA 2003. The consequence would be

30 See 8.3 (Chargeable overseas earnings) and 8.5 (Meaning of "Duties performed wholly outside the UK").

anomalous.[31] I think a Court is not likely to accept this. If a shadow director is deemed to have an employment, it follows that he can be deemed to have some "duties".

The harder question is, exactly what are the (deemed) "duties" of the "employment" of a shadow director? The duties may be regarded as the instructions or directions which he gives to the properly appointed directors.

Another possible view is that everything that the shadow director does for the company (or its assets) is regarded as part of his (deemed) "duties"; or alternatively everything he does if:

(1) he acts with the consent of the properly appointed directors; or

(2) his actions concern matters which would (apart from him) be the responsibility of the actual directors.

Whichever of these is correct, where a company holds a 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 United Kingdom. However, it should be possible in other cases, e.g. where a company only holds non-UK situate accommodation. It may help to have a contract of employment which sets out the duties which are to be performed abroad.

31.23.2 *Are BIK earnings remitted to the UK?*

If BIK earnings are "chargeable overseas earnings", they are taxable only if remitted to the UK. The meaning of "remitted to the UK" is discussed in 8.12 (Meaning of "remitted to the UK"). They are treated as remitted if they are:

(a) paid, used, or enjoyed in the United Kingdom, or
(b) transmitted or brought to the United Kingdom in any manner or form

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31 (1) Benefits in kind of a UK resident foreign domiciled shadow director would never qualify as chargeable overseas earnings.
(2) The benefits in kind of a non-resident shadow director would never be subject to tax.

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 emoluments which do not exist cannot be remitted. The tax charge arises only if the earnings are remitted. The property (or the benefit of its use) is not the same as the earnings. The Revenue do not agree. EIM provides:

> **20508 The benefit code: Expense payments to and benefits provided for a director or employee whose earnings are taxable on remittance**
> The earnings of a director or employee, except in an excluded employment (EIM20007), who is chargeable on remittances to the United Kingdom under either Section 22 or Section 26 ITEPA 2003 include
> - expenses payments remitted to the United Kingdom
> - expenses paid in the United Kingdom
> - *benefits provided or enjoyed in the United Kingdom (for example, a motorbike available for use in the United Kingdom).*
>
> **40303 Meaning of "remitted to the United Kingdom": Benefits in kind and UK-linked debts**
> *Benefit in kind*
> The definition of "remitted to the United Kingdom" in Section 33 (*see* EIM40302) includes general earnings used, enjoyed or brought to 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.*

31.23.3 *UK situate accommodation*

If the property is in the UK, the remittance basis offers no relief from the charge.

31.24 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. See para.8.8 (Non-resident employee). Thus one must ascertain:

(1) what are the duties;

(2) whether the earnings are in respect of the duties;

(3) where the duties are performed.

The question of what (if any) are the "duties" of a shadow director is discussed in the above paragraph. I conclude there are no real duties but there are deemed duties. Are the earnings "in respect of" the deemed duties? It is tentatively suggested that the answer is, no. Certainly if there were no duties there would be no earnings, but that is not enough. The benefit of living accommodation (which the earnings represent) would arise in independently of the duties. There is an 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.[32]

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 non-resident exemption to the POA charges.

In practice, so far as the author is aware, the Revenue do not pursue this tax charge on non-resident individuals. Of course, in many cases, collection of tax would be problematic. But it is significant that EIM para 11413 refers only to UK residents.

31.25 Other planning possibilities using companies

More complex possibilities involve:

(1) acquiring a property,

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32 See *R v. Dimsey & Allen* [2002] 1 AC para. 19.

(2) granting (say) a ten year lease to trustees, and

(3) transferring the freehold reversion to a company. Watch SDLT.

The living accommodation charge would not apply, because the company would not be providing living accommodation. Similar arrangements can be carried out with options. In practice, arrangements of this complexity would not often be needed.

31.26 Dealing with company structures at risk of IT charge

Many company structures have been set up in the past. The risk of a living accommodation charge depends on the facts of every case, but in practice it is often a serious concern. What can be done?

31.26.1 *Planning involving winding up of the company structure*

If practical, the safest course is to extract the property from the company so as to put an end to the charge (or risk of a charge) under the benefit in kind rules. One way to do this would be:

(1) to procure that the trust has an interest in possession for the occupier; and

(2) to liquidate the company.

The liquidation may give rise to a capital gain but this should not be a problem for a non-UK domiciled beneficiary. The property will be in the estate of the life tenant for IHT purposes but in practice that may not be too much of a problem: see 31.1 (Ownership by foreign domiciliary). Another company structure may be entered into later, as set out above.

Another possibility might be for a company to sell the property to the trust, the purchase price remaining outstanding as a loan. In principle the loan is deductible from the value of the property, thus substantially reducing any IHT exposure. See paragraph 27.9 (Deduction for debts of trustees). Watch SDLT.

Another possibility may be to reimburse the company for the cost of providing the accommodation. Watch the CGT implications.

31.26.2 *Planning not involving winding up the structure*

If the individual is UK domiciled then CGT may make it impractical to wind up the structure. In that case take stringent steps to ensure that the individual is not a shadow director.

31.27 Dealing with living accommodation enquiries in practice

In practice, as *Fayed v Advocate General* frankly reports,[33] 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, the Revenue will at least be able to exact a sum equal to the cost of litigating the issue before the Special Commissioners or beyond.

31.28 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 very unfair. The following reforms would solve these problems:

(1) Abolish the s.105 charge and extend s.106 to cover the first £75,000 of acquisition cost. All the concessions would then drop away.

(2) It would be fair to charge a little less than ORI rates, since residential market rents are less than the official rate of interest.

(3) The application of the charge to shadow directors who do no real work for the company is a nonsense. 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

33 [2002] STC 910 para. 44.

> director (whose connection with the company may be tenuous). That would strike the right balance.

The present IT rules are being used by the Revenue as a weapon to attack or discourage IHT planning (placing homes in companies for IHT reasons). This is a purpose for which the IT rules were not designed, and it is not surprising that they do not do this job well.

31.29 Section 740 charge

One should arrange, if possible, that any trust or company holding the home and chattels has no relevant income within s.740 ICTA 1988. Otherwise the use of the property would be a benefit giving rise to an income tax charge on the occupier; see 13.4.2 (Enjoyment of assets in kind). This only applies if the benefit is not otherwise chargeable to income tax. If there is a shadow director charge, there is no charge under s.740. One possibility is to arrange that the amount of the shadow director charge is a small one (e.g. by a reimbursement of the company's expenditure). Whatever the charge is, it will avoid a taxable benefit under s.740.

31.30 Transfer pricing and non-resident company holding family home

The transfer pricing provisions of Schedule 28AA ICTA 1988 impose (in short) an obligation for arm's length prices to be charged on transactions between persons under common control where one of the parties is a company. Where a non-resident company controlled by foreign trustees provides a property in the UK for the use of a beneficiary rent free, it is arguable that a charge to tax could arise on the offshore company on an amount equal to the market rent of the property. A detailed analysis of this point may be found in an article by Robert Venables QC in the *Offshore Taxation Review*, Volume 8, Issue 3. The point need not be discussed here because the Revenue do not take the point. 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.

31.31 SDLT on living accommodation charge

FA 2003 Sch. 4 para.12 provides:

> (1) Where a land transaction is entered into by reason of the purchaser's employment, or that of a person connected with him, then—
> (a) if the transaction gives rise to a charge to tax under Chapter 5 of Part 3 of the Income Tax (Earnings and Pensions) Act 2003 (c 1) (taxable benefits: living accommodation) and—
> (i) no rent is payable by the purchaser, or
> (ii) the rent payable by the purchaser is less than the cash equivalent of the benefit calculated under section 105 or 106 of that Act,
> there shall be taken to be payable by the purchaser as rent an amount equal to the cash equivalent chargeable under those sections;
> (b) if the transaction would give rise to a charge under that Chapter but for section 99 of that Act (accommodation provided for performance of duties), the consideration for the transaction is the actual consideration (if any);
> (c) if neither paragraph (a) nor paragraph (b) applies, the consideration for the transaction shall be taken to be not less than the market value of the subject-matter of the transaction as at the effective date of the transaction.

This charge may be very considerable. A licence (as opposed to a lease) is not within the charge to SDLT but the distinction between lease and licence is very fraught.

31.32 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.

31.32.1 *The charge*

The charge is in s.203(1) ITEPA 2003:

> **Cash equivalent of benefit treated as earnings**
> 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".

31.32.2 *Employment-related benefit*

This is defined in section 201(2) ITEPA 2003:

> In this Chapter—
> "benefit" means a benefit or facility of any kind;
> "employment-related benefit" means a benefit, other than an excluded benefit,[34] 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.

There is no benefit – and so no charge – if a full commercial fee is paid for the use of chattels (even if that fee is less than the "cash equivalent".

31.32.3 *"Cash equivalent" etc*

This is defined in section 203(2) ITEPA 2003:

> The cash equivalent of an employment-related benefit is the cost of the benefit less any part of that cost made good by the employee to the persons providing the benefit.

This takes us to the elaborate definition of "cost of the benefit". The starting point is section 204:

34 "Excluded benefit" is defined in s.202.

> **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 2003:

> **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;
> (b) in any other case, 20% of the market value of the asset at the time when those providing the taxable benefit first applied the asset in the provision of an employment-related benefit (whether or not the person provided with that benefit is also the person

provided with the taxable benefit).[35]

(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.

31.33 Employment-related loans

Section 175(1) ITEPA 2003 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 may of course apply to a foreign domiciled employee (including a shadow director). A full discussion is outside the scope of this book. The BIK earnings of an employment-related loan may be chargeable overseas earnings. If so, it is considered that they cannot be remitted. See 31.23 (BIK remittance basis). If that is wrong, imponderable questions arise as to what happens if the funds lent are remitted here and spent. Contrast 13.28.3 (Interest free loan and s.740 foreign domicile defence).

31.34 "Person providing benefit"

This is defined in s.209:

> **Meaning of "persons providing benefit"**
> For the purposes of this Chapter the persons providing a benefit are the person or persons at whose cost the benefit is provided.

35 There is transitional relief where those providing the taxable benefit first applied the asset in the provision of an employment-related benefit before 6th April 1980.

CHAPTER THIRTY TWO

PRE-OWNED ASSETS

32.1 Introduction

This chapter considers the provisions in Schedule 15 FA 2004 ("POA rules"). References in this chapter to "paragraphs" are to paragraphs of that Schedule. The title "pre-owned assets" is derived from the Revenue press releases announcing the provisions. This label is convenient but inaccurate since the charge may apply to property not previously owned by the taxpayer.

The provisions impose three charges to income tax which I shall call:

(1) The POA land charge.

(2) The POA chattel charge.

(3) The POA intangible property charge.

Land, chattel and intangible property are given fairly routine definitions: para. 1.

The provisions take effect from 2005/6, giving taxpayers one year to put their affairs in order to avoid a charge.

The Parliamentary joint committee on human rights concluded that the provisions are in principle compatible with the ECHR except in relation to the spouse exemptions (which fail to give relief to unmarried partners).[1] Of course this may not be the last word on the subject but (with that exception) the prospect of a successful appeal on human rights grounds seems slender.

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1 *www.parliament.the-stationery-office.co.uk/pa/jt200304/jtselect/jtrights/93/9305.htm*

32.2 The POA land charge

Paragraph 3(1) provides:

> This paragraph applies where—
> (a) an individual ("the chargeable person") occupies any land ("the relevant land"), whether alone or together with other persons, and
> (b) the disposal condition or the contribution condition is met as respects the land.

In the discussion below the "chargeable person" is called "T" and the land he occupies is called "land occupied by T" (rather than "the relevant land").

"Occupation" is a legal concept extensively discussed in rating cases.

32.3 The contribution conditions

Paragraph 3(3) provides:

> The contribution condition is that at any time after 17th 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 condition (a) and (b). Only one of them need be satisfied for the "contribution condition" to be met.

32.3.1 *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.

This will apply to traditional IHT planning where an offshore company is used to hold a foreign domiciliary's residence. It will apply:

(1) where the foreign domiciliary lends funds interest free to a company which acquires the home;

(2) where he gifts funds to a trust which finances by interest-free loan the company which acquires the home.[2]

Is it necessary that T provides consideration for the purposes of the acquisition of the land? Suppose:

(1) In 1987 T created a trust. At the time he had no plans to move to the United Kingdom.

(2) In 2005 the trustees finance by interest-free loan a company which purchases a property which T occupies.

The foreign domiciled individual has directly provided the property for the purposes of the trust. He is probably to be regarded as having indirectly provided the consideration given for the acquisition of the land; cf. *Muir v Muir* [1943] AC 468. So contribution condition (a) is satisfied.

32.3.2 *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.

---

2 It would also apply if the trust purchases the home (without a company) but in this situation one of the exemptions is likely to apply.

This applies where:

(1) "Another person" ("A") acquires "other property" for consideration.

(2) T has provided that consideration directly or indirectly.

(3) A disposes of the other property.

(4) The proceeds are (directly or indirectly) applied by "another person" (presumably either A himself or another person, "B") towards the acquisition of the land occupied by T.

The drafter may be considering a situation where:

(a) T transfers funds to A who purchases a property; and

(b) A sells that property and uses the proceeds to buy another property occupied by T.

or

(a) T transfers funds to A (e.g. trustees)

(b) A transfers the funds to B (e.g. a company held by A)

(c) B uses the funds to purchase a property occupied by T.

In both those cases I would have said that T had indirectly provided consideration given for the land and contribution condition (a) was already satisfied. I cannot think of a situation which falls within condition (b) and which does not fall within condition (a). But it does not much matter.

32.3.3 *Secondhand company*

The contribution condition will not be satisfied where:

(1) One individual has provided funds to a company to purchase a house.

(2) He sold the company to a second individual who occupies the house.

The second individual has not provided the funds for the purchase (unless the two steps form a single arrangement): see 11.8.1 (Purchase of secondhand company).

32.3.4 *"Provide"*

"Providing" is the fundamental concept in the contribution conditions and it is not an easy one.[3] It is suggested that "provide" implies an element of bounty. So if T lends funds on arm's length terms to A, who buys the property, T has not "provided" the funds and the contribution condition is not satisfied.

What if T subscribes for shares on arm's length terms? Presumably that is included in the concept of "providing" funds.

Para 17 provides:

> **Guarantees**
> Where a person ("A") acts as guarantor in respect of a loan made to another person ("B") by a third party in connection with B's acquisition of any property, the mere giving of the guarantee is not to be regarded as the provision by A of consideration for B's acquisition of the property.

What if B borrows to purchase property (perhaps with a guarantee by T) and T later gives funds to B who repays? Subject to *Furniss v Dawson,* it is suggested that T has not provided the consideration.

32.4 The disposal conditions

Paragraph 3(2) provides:

> The disposal condition is that—
> (a) at any time after 17th March 1986 the chargeable person owned an interest—
> (i) in the relevant land, or

3 Some guidance ought to be found from comparable wording in the context of 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.

(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[4] of all, or part of, his interest in the relevant land or the other property, otherwise than by an excluded transaction.

This is also 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.

32.4.1 *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 directed at IHT avoidance arrangements (*Eversden, Ingram* and double trust schemes) which would not normally be carried out by foreign domiciled individuals. It might of course apply in many other situations, e.g. if a foreign domiciliary transferred his house to a trust or company. It applies to a disposal of land for full consideration. However, in such case the exclusion for arm's length transactions will usually apply.

32.4.2 *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:

4 "Disposal" is further defined in paragraph 3(4).

(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 property (not land) to A; and

(2) A uses that property to purchase land occupied by T.

This overlaps with the contribution condition. The overlap matters because the excluded transaction defences to the contribution and disposal conditions are not the same.

32.5 The POA chattel charge

Paragraph 6 provides:

> (1) This paragraph applies where—
> (a) an individual ("the chargeable person") is in possession of, or has the use of, a chattel, whether alone or together with other persons, and
> (b) the disposal condition or the contribution condition is met as respects the chattel.
>
> (2) The disposal condition is that—
> (a) at any time after 17 March 1986 the chargeable person had (whether alone or jointly with others) owned—
> (i) the chattel, or
> (ii) any other property the proceeds of the disposal of which were (directly or indirectly) applied by another person towards the acquisition of the chattel, and
> (b) the chargeable person disposed[5] of all or part of his interest in the chattel or other property otherwise than by an excluded transaction.
>
> (3) The contribution condition is that at any time after 17 March 1986 the chargeable person had directly or indirectly provided, otherwise than by an excluded transaction, any of the consideration given by another

5 "Disposal" is further defined in paragraph 6(4).

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.

32.6 The POA intangible property charge

Paragraph 8 provides:

(1) This paragraph applies where—
- (a) the terms of a settlement,[6] 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 660A ICTA 1988 (income arising under settlement where settlor retains an interest) as income of a person ("the chargeable person") who is for the purposes of Part 15 of that Act the settlor,
- (b) any such income would be so treated even if subsection (2) of that section did not include any reference to the spouse of the settlor, and
- (c) that property includes any property as respects which the condition in sub-paragraph (2) is met ("the relevant property").

(2) The condition mentioned in sub-paragraph (1)(c) is that the property is intangible property which is or represents property which the chargeable person settled, or added to the settlement, after 17th March 1986.

(3) Where this paragraph applies in respect of the whole or part of a year of assessment, an amount equal to the chargeable amount determined under paragraph 9 is to be treated as income of the chargeable person chargeable to income tax.

In practice the GWR or estate exemptions will usually be available here, so the POA intangible property charge will not usually affect foreign domiciliaries. The charge does not apply to intangible property received by a company held by a trust, since that is not property comprised in a

6 "Settlement" here has the IHT meaning and not the IT meaning: paraagraph 1.

settlement, and not caught by s.660A but the shares in the company will be intangible property (except perhaps bearer shares). It is intended to catch *Eversden* schemes marketed by life insurance companies (which will not normally have been carried out by foreign domiciliaries) but for those schemes its effect may be avoidable.

32.7 Excluded transactions

A disposal of property by an excluded transaction is ignored for the disposal conditions; and the provision of property by an excluded transaction is ignored for the contribution conditions. Paragraph 10(1) defines "excluded transaction" for the disposal conditions and paragraph 10(2) defines the phrase for the contribution conditions. Each sub-paragraph contains five categories of excluded transaction, making 10 in all. Simplicity was evidently not an important consideration to the drafter of the POA rules.

Excluded transactions are not a defence to the POA intangible property charge.

32.8 Excluded transactions: disposal conditions

32.8.1 *Arm's length exclusion*

Paragraph 10(1) provides:

> For the purposes of ... the disposal condition, the disposal of any property is an "excluded transaction" in relation to any person ("the chargeable person") if—
> (a) it was a disposal of his whole interest in the property, except for any right expressly reserved by him over the property, either—
> (i) by a transaction made at arm's length with a person not connected with him, or
> (ii) by a transaction such as might be expected to be made at arm's length between persons not connected with each other.

There is no equivalent of this category of excluded transaction for the purposes of the contribution conditions. The reason is that a disposal at arm's length is not likely to amount to "providing" consideration.

32.8.2 *Spouse exclusions*

The second and third categories of excluded transaction are in paragraph 10(1)(b) and (c):

> (b) the property was transferred to his spouse (or where the transfer has been ordered by a court, to his former spouse);
> (c) it was a disposal by way of gift (or, where the transfer is for the benefit of his former spouse, in accordance with a court order), by virtue of which the property became settled property in which his spouse or former spouse is beneficially entitled to an interest in possession.[7]

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 variants of the double trust scheme (which involves a sale of a house to an interest in possession trust for consideration).

32.8.3 *Disposition for maintenance of family*

The fourth category of excluded transaction is in para 10(1)(d):

> the disposal was a disposition falling within section 11 of IHTA 1984 (dispositions for maintenance of family).

32.8.4 *Annual exemption and small gifts*

The fifth category of excluded transaction is in para 10(1)(e):

> the disposal is an outright gift to an individual and is for the purposes of IHTA 1984 a transfer of value that is wholly exempt by virtue of section 19 (annual exemption) or section 20 (small gifts).

---

7 This is restricted by paragraph 10(3):
A disposal is not an excluded transaction by virtue of sub-paragraph (1)(c) or (2)(b), if the interest in possession of the spouse or former spouse has come to an end otherwise than on the death of the spouse or former spouse."

This will include substantial gifts which qualify for 100% BPR or APR.

32.9 Excluded transactions: contribution conditions

Para 10(2) provides:

> For the purposes of ... the contribution condition the provision by a person ("the chargeable person") of consideration for another's acquisition of any property is an "excluded transaction" in relation to the chargeable person if—
> (a) the other person was his spouse (or, where the transfer has been ordered by the court, his former spouse),
> (b) on its acquisition the property became settled property in which his spouse or former spouse is beneficially entitled to an interest in possession.

These are the equivalent of 32.8.2 (spouse exclusions). The spouse trust exclusion here is wider than the spouse trust exclusion for the disposal condition, as the words "by way of gift" do not appear. The last two exclusions in para 10(2) are:

> (d) the provision of the consideration is a disposition falling within section 11 of IHTA 1984 (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 1984 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 32.7.3 and 32.7.4 (family maintenance, annual exemption and small gifts).

32.9.1 *Outright gifts*

The remaining exclusion is where:

> (c) the provision of the consideration constituted an outright gift of money (in sterling or any other currency) by the chargeable person to the other person and was made at least seven years before the earliest date on which the chargeable person met the condition in paragraph 3(1)(a) or, as the case may be, 6(1)(a).

Para (c) applies only to the contribution conditions. It is extremely narrow; it only applies to outright gifts.[8]

It is suggested that a gift to a trust from which the settlor is excluded is in principle an outright gift. In practice foreign domiciliaries more often make gifts to trusts under which they can benefit, and whether these are "outright gifts" is debatable. Absurdly, the exemption only applies to gifts of money. I am unable to see any reason for that.

32.10 Exemptions from charge

32.10.1 *"Relevant property"*

Paragraph 11 provides five exemptions from the POA charges. It uses the concept "relevant property" defined in para 11(9). The expression has three possible meanings. In relation to the POA land and chattel charges, "relevant property" carries one of two meanings:

> (i) where the disposal condition ... is met, the property disposed of,
> (ii) where the contribution condition ... is met, the property representing the consideration directly or indirectly provided.

In relation to the POA intangible property charge, "relevant property" has the meaning given in paragraph 8.

32.10.2 *Exemption for property in estate; "derived property"*

Paragraph 11(1) provides what I shall call "the estate exemption". This exemption is that the POA land, chattel and intangible property charges:

> do not apply to a person at a time when his estate for the purposes of IHTA 1984 includes—

---

8 Independent Taxation Manual discusses "outright gift" (in the context of s.660A ICTA 1988):

> "**202. Outright gifts**
> A gift is not an outright gift if it is subject to conditions or if it could revert to the donor in any circumstances whatsoever.
> 'In any circumstances whatsoever' would not include an independent decision by the recipient spouse to return it to the donor."

(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.

It is useful to have a label for property within 11(1)(b). I shall call it "derived property".[9] The condition for the estate exemption may be satisfied by the relevant property or derived property. This has important consequences for a property held by companies. If a company (without debt) held a residence (the actual relevant property) then the company shares are derived property since:

(1) the shares derive their property from the residence (the relevant property); and

(2) the value of the shares is, in principle, not substantially less than the value of the relevant property.

Example 1

F subscribes for share capital in a company which purchases the house, occupied by F.

The contribution condition is satisfied: however, the estate exemption applies.

Example 2

F gifts half the shares to his wife. The estate exemption does not apply and POA land charge is due.

32.10.3 *Company funded by loan*

Suppose F *lends* property to the company, rather than subscribing for share capital. The shares are not derived property because their value is substantially less than the relevant property. However, the *loan* is itself derived property if the company has no assets apart from the land. So the

9 I adopt the label from the expression with a similar definition in s.660A ICTA 1988.

estate exemption may still apply. Alternatively the shares and debt together constitute derived property. If I am wrong on that, it is an interesting question whether the partial estate exemption applies or if the company has assets apart from the home.

32.10.4 *Partial estate exemption*

Paragraph 11(2) provides:

> Where the estate for the purposes of IHTA 1984 of a person to whom paragraph 3, 6 or 8 applies includes property—
> (a) which derives its value from the relevant property, and
> (b) whose value, so far as attributable to the relevant property, is substantially less than the value of the relevant property,
>
> the appropriate rental value in paragraph 4, the appropriate amount in paragraph 7 or the chargeable amount in paragraph 9 (as the case may be) is to be reduced by such proportion as is reasonable to take account of the inclusion of the property in his estate.

I refer to this as the partial estate exemption.

I find the concluding words "such proportion as is reasonable to take into account of the inclusion of the property in his estate" somewhat ungrammatical. Presumably it means: "such proportion as is reasonable to take into account having regard to the inclusion of the property in his estate".

32.10.5 *Excluded liability rule*

Paragraph 11(6) provides:

> Where at any time the value of a person's estate for the purposes of IHTA 1984 is reduced by an excluded liability affecting any property, that property is not to be treated for the purposes of sub-paragraph (1) or (2) as comprised in his estate except to the extent that the value of the property exceeds the amount of the excluded liability.

I call this "the excluded liability rule". The rule is aimed at double trust schemes (which would not have been carried out by a foreign domiciliary) but it extends more widely. The key expression is "excluded liability" defined in paragraph 11(7):

> For the purposes of sub-paragraph (6) a liability is an excluded liability if—
> (a) the creation of the liability, and
> (b) any transaction
> [i] by virtue of which the person's estate came to include
> [A] the relevant property or
> [B] property which derives its value from the relevant property or
> [ii] by virtue of which the value of property in his estate came to be derived from the relevant property,
> were associated operations, as defined by section 268 of IHTA 1984.

Given the wide meaning of associated operation, I am unable to think of any liability affecting property which is not an excluded liability. The excluded liability rule only applies for the purposes of the estate exemption. The question of to what extent debts may limit the GWR exemption is one which would merit further consideration.

The rule only applies to a liability which "affects" property. So it does not apply to a loan to an individual or company unless secured. E.g. if F lends to a company which purchases his property, the company's liability is an excluded liability but (in the absence of a charge) it does not affect the property, so the excluded liability rule does not apply.

32.11 GWR exemption

Paragraph 11(3) and (5)(a) provide what I shall call "the GWR exemption". The three POA charges do not apply to a person at a time when the relevant property or derived property—

> (a) would fall to be treated by virtue of any provision of Part 5 [FA 1986] as property which in relation to him is property subject to a reservation.

The question of whether property is subject to a reservation is considered at 25.3 (Property subject to a reservation). For this purpose para 11(8) tinkers with the GWR tracing rules:

> In determining whether any property falls within sub-paragraph (5)(b), (c) or (d) in a case where the contribution condition in paragraph 3(3) or 6(3) is met, paragraph 2(2)(b) of Schedule 20 [FA 1986] (exclusion

of gifts of money) is to be disregarded.

Note that property may be subject to a reservation even though it is excluded property.

32.11.1 *Partial GWR exemption*

Paragraph 11(4) provides:

> Where any property which falls within sub-paragraph (3B) 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 paragraph 4, the appropriate amount in paragraph 7 or the chargeable amount in paragraph 9 (as the case may be) is to be reduced by such proportion as is reasonable to take account of that fact.

I refer to this as 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).

32.11.2 *Occupation/enjoyment for full consideration*

The next two exemptions in paragraph 11(5)(b), (c) are not of much importance to foreign domiciliaries and I do not discuss them here. This leaves the fifth exemption in paragraph 11(5)(d) which applies where the relevant property or derived property:

> would fall to be treated as property subject to a reservation but for s.102C(3) and Schedule 20 paragraph 6 FA 1986.

There are two exemptions here:[10]

10 Another possible reading is that the exemption only applies if s.102C(3) and Schedule 20 para 6 both apply, i.e., it is not enough that Schedule 20 para 6 applies if s.102C(3) does not. But *Hansard* confirms (if necessary) that this is not the correct construction: HC 7 July 2004 col.881, 900.

(1) where the GWR rule would apply but for s.102C(3); and

(2) where the GWR rule would apply but for Sch. 20 para.6.

Of these two exemptions, the important one is para.6(1) Schedule 20 FA 1986 which in turn provides two exemptions to the GWR rule:

> 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 ...

The exemption for full consideration 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 18th May 1987.

The second exemption in para.6(1)(b) Schedule 20 is less likely to be important in practice.

32.12 Non-resident taxpayer

Paragraph 12(1) provides:

> This Schedule does not apply in relation to any person for any year of assessment during which he is not resident in the United Kingdom.

This is straightforward.

32.13 UK resident foreign domiciliary

Paragraph 12(2) provides:

> Where in any year of assessment a person is resident in the United Kingdom but is domiciled[11] outside the United Kingdom, this Schedule does not apply to him unless the property falling within paragraph 3(1)(a), 6(1)(a) or 8(1)(c) is situated in the United Kingdom.

This provides an exemption where:

(1) T occupies non-UK situate land;

(2) T uses non-UK situate chattels; or

(3) intangible property is not UK situate.

It does not provide exemption where a non-UK company holds UK land.

32.14 Former foreign domiciliary

Paragraph 12(3) provides:

> In the application of this Schedule to a person who was at any time domiciled[12] outside the United Kingdom, no regard is to be had to any property which is for the purposes of IHTA 1984 excluded property in relation to him by virtue of section 48(3)(a) of that Act.

32.15 Quantum of charge: land

I only consider the quantum of charge for land and even then not in full detail. We find the usual cascade of definitions. Paragraph 3(5) provides:

> Where this paragraph applies to a person in respect of the whole or part of a year of assessment, an amount equal to the chargeable amount determined under paragraph 4 is to be treated as income of his chargeable to income tax.

---

11 "Domiciled" is defined in paragraph 12(4):

> " For the purposes of this paragraph, a person is to be treated as domiciled in the United Kingdom at any time only if he would be so treated for the purposes of IHTA 1984."

12 See above footnote.

32.15.1 *"The chargeable amount"*

One therefore turns to paragraph 4 to find the quantum of the charge. Para. 4(1) provides:

> For any taxable period the chargeable amount in relation to the relevant land is the appropriate rental value (as determined under sub-paragraph (2)), 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 relevant land in respect of the occupation of the land by the chargeable person.

32.15.2 *"The appropriate rental value"*

This is defined in para. 4(2). So far as relevant to a case where the contribution condition is satisfied, this provides:

> (2) The appropriate rental value is R x (DV ÷ V)
> where—
> R is the rental value of the relevant land for the taxable period,
> DV is—
> ...
> (c) in a case falling within paragraph 3(3), 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.[13]

This takes us to the definition of "rental value". That is defined in the same manner as the income tax benefit in kind rule: it means the "annual value". The "annual value" is in turn defined in paragraph 5. That is copied from s.110 ITEPA 2003, except that s.110(3), (4) are omitted. The annual value is more than an open market rent because it assumes that (contrary to market value) that the landlord will pay costs of repairs and insurance.

The reader will recall that by concession the annual value for benefit in

13 The valuation date is to be determined by regulations not available at the time of going to print.

kind purposes is deemed to be the rateable value.[14] There is no reason to think that this concession will be applied to the POA land charge. The charge is (in short) slightly above market rental value.

32.16 Interaction with benefit in kind charge

Paragraph 19 provides:

> Where, in any year of assessment, a person is (apart from this paragraph) chargeable, in respect of his occupation of any land or his possession or use of any chattel, to income tax both—
> (a) under this Schedule, and
> (b) under Part 3 of ITEPA 2003,
> 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.

32.17 *De minimis* exemption

The Press Release announcing the POA charges promised "a substantial *de minimis* exemption" (*sic*). This turns out to be £5,000 per annum: paragraph 13. This is significant only if annual value is (contrary to my expectation) construed by concession to mean rateable value.

32.18 Election out of pre-owned assets regime

One can elect out of the POA charges into the IHT regime. Paragraph 21 deals with the POA land and chattels charges. Paragraph 22 deals with intangible property. There are no significant differences.

32.19 Unwinding existing structures

What is to be done when a foreign domiciliary resides in a home owned by a company and falls within the POA land charge? The choice lies between electing out of the POA regime, unwinding, or reorganising so as to fall within the estate exemption.

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14 See 31.12.1 (Rental value of the accommodation).

It may be sensible to elect and retain the structure where:

(1) IHT is not a problem (e.g. insurance is inexpensive);

(2) Shadow directorship is not a problem (expect an investigation to follow the election); and

(3) A sale of the company is envisaged in the short or medium term. See paragraph 32.2.4 (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. But re-organisation to avoid the POA problem will usually be possible: see 32.10 (Exemption for property in estate).

32.20 Commentary

Of course the provisions are shot through with anomalies, but not markedly more so than much anti-avoidance legislation. (If it seems worse, it is because new unfairnesses rank more sorely than those to which we have become enured by the passage of time.)

It might be objected that the provisions impose an income tax charge on income which does not exist. Once it is accepted that income tax should not be charged on an individual who occupies his own property[15] 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, there is apparent double income taxation. But if the POA charge is seen for what I suggest it is, which is an erratic *ersatz* annual IHT charge, this objection falls away. The quantum of the charge is penal (compared to IHT rates) but 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.[16] The POA rules take the clothes or label of a tax, but – looked at this way – they are not a tax as that word is normally understood.

The controversial aspect of the new provisions is that they are retrospective in nature even if cleverly designed to be retroactive in

15 See Kay and King, *The British Tax System*, 5th ed., 1990, p.80.

16 And to stop similar arrangements being made in the future.

method. (One should avoid semantic – indeed Orwellian – debate about the meaning of "retrospective" and look at the effect.) The POA rules are unashamedly targeted at taxpayers who have made the following arrangements since 1986:

(1) *Eversden*[17] schemes;

(2) *Ingram*[18] and similar shearing schemes;

(3) "double trust" schemes.

This is unprecedented in the UK tax system, which has traditionally allowed taxpayers to plan their affairs more securely on the basis of the law of the day. One may approve of this as an attack on tax avoidance, or disapprove as offensive to the rule of law. Views may divide on party political lines. What should not be controversial is that those who have done *Ingram* schemes have been particularly unfairly treated. They entered into a package with an IHT advantage at a CCT cost. The Government have removed the benefit and left them with the cost.
Foreign domiciliary IHT planning using companies to avoid IHT on UK land or chattels were not a target of the POA rules; and in practice they will only occasionally and accidentally be caught.

Of course, the arrangements will bring some revenue for the Government, though how much is a matter of speculation. Set against the tax raised (whatever it is) and the blow against tax avoidance (however one values or regards that) there are some entries to make on the debit side: the POA rules will impose significant costs of compliance and tax planning (for they require taxpayers to incur professional fees in order to rearrange their affairs). They will 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 asset, but it is essential to successful tax administration. But there it is.

17 *Eversden v IRC* 75 TC 340.
18 *Ingram v IRC* [1999] STC 37.

CHAPTER THIRTY THREE

ESTATES OF DECEASED PERSONS[1]

33.1 Introduction

On the death of a person domiciled in England and Wales, or in another common law jurisdiction operating similar rules, all his property passes to his personal representatives ("PRs") who are under a duty to pay the debts of the estate, including taxes. Provided that there are sufficient assets available, they pay pecuniary legacies and transfer property which the deceased has specifically gifted. Finally, they distribute the residue of the estate amongst the residuary legatees. These transfers are normally done by means of an "assent".

Special taxation rules apply during this period of administration. The interplay of the rules can produce some curious results where a foreign domiciliary is a beneficiary or testator. There can sometimes be considerable scope for tax planning. I shall discuss the position where a foreign domiciliary is:

(1) a testator,

(2) a pecuniary legatee (entitled to a cash legacy),

(3) a specific legatee (entitled to specific assets), and

(4) a residuary legatee.

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1 Many of the problems discussed here arise in a similar way where charities are beneficiaries of estates. This chapter draws on Chapter 28, *Venables and Kessler on the Taxation of Charities* (4th ed., 2003).

I first consider CGT and then income tax.

33.2 Residence and domicile of PRs for CGT

Section 62(3) TCGA 1992 provides:

> In relation to property forming part of the estate of a deceased person
> [a] the PRs shall for the purposes of this Act be treated as being a single and continuing body of persons (distinct from the persons who may from time to time be the PRs), and
> [b] that body shall be treated as having the deceased's residence, ordinary residence, and domicile at the date of death.
>
> (Paragraphing added)

The residence and domicile of the PRs in their private capacity is irrelevant.

33.3 Deceased not UK resident

If the deceased was not UK resident at the time of his death (regardless of domicile) the PRs are in principle outside the scope of CGT.

33.3.1 *Section 87 TCGA and estates*

Could gains accruing to the PRs be "trust gains" within the scope of s.87 TCGA 1992; see 18.6 (The s.87 charge)? That could only be the case if the deceased's estate was a "settlement" for the purposes of s.87. Section 97(7) provides:

> In sections 86A to 96 and Schedule 4C and in the preceding provisions of this section—
> "settlement" and
> "settlor" have the meaning given by section 660G(1) and (2) of the Taxes Act and "settlor" includes, in the case of a settlement arising under a will or intestacy, the testator or intestate...

It is considered that a deceased's estate is not itself a "settlement" within s.87, and this is supported by the reference to "settlement arising under a will or intestacy". Section 87(9) also assumes that this is correct.

Moreover it is hard to see how PRs can make capital payments.

33.4 Deceased UK resident and domiciled

If the deceased was UK resident and domiciled, the PRs are liable to CGT on all chargeable gains (less losses). They pay CGT at the same rate as trusts. In the case of assets which were owned by the deceased, the PRs' acquisition cost is normally the market value at the date of the death.[2] If PRs sell assets in the course of administration, then any gain will be subject to CGT, even though the net proceeds of sale will in due course pass to a foreign domiciliary. If, by contrast, PRs transfer an asset *in specie* to a legatee to whom it has been bequeathed, whether specifically or as part of residue, then the PRs will not realise any chargeable gain but the base cost of the recipient beneficiary will be that of the PRs.[3] Where the legatee is a foreign domiciliary (or a non-UK resident, or a charity), he will often be able to dispose of the asset in due course free of CGT.

It is thus a fundamental principle of CGT planning that PRs should generally avoid, wherever possible, making disposals of assets which are devised or bequeathed to foreign domiciliaries, non-residents or charities.

33.5 Deceased UK resident not UK domiciled

Suppose at the time of his death the deceased was UK resident but foreign domiciled. The PRs are treated as UK resident but not UK domiciled. The CG Manual para. 30660 says:

> **Remittance basis not in administration period**
> Published 7/94
> If the deceased was resident and/or ordinarily resident but not domiciled in the UK before his or her death, then on disposing of assets outside the UK he or she would have benefited from the application of the remittance basis in Section 12 TCGA 1992 ... . Although the personal representatives have the same residence and domicile status as the deceased had, if they realise chargeable gains from disposals of assets situated outside the United Kingdom but do not remit those gains to the United Kingdom immediately they cannot benefit from this treatment. This is because the remittance basis applies only to individuals but

2 s.62(1) TCGA 1992.

3 s.62(4) TCGA 1992.

Section 65(2) says that the body of personal representatives is not to be treated as an individual.

At first sight this seems surprising, but on reflection, it is not absurd to draw a distinction between:

(1) a UK resident foreign domiciled individual, taxed on the remittance basis, and

(2) the PRs of that individual, taxed on an arising basis.

A remittance basis makes less sense for PRs whose role is generally short term.

It has been argued that the Revenue view is wrong. This would, however, require the word "individual" in s.12(1) TCGA 1992 to be construed so as to include PRs, which is quite contrary to general statutory usage. It has been suggested that the reference to domicile in s.62(3)[b] is otiose on the Revenue view, because (if the remittance basis is inapplicable) the domicile of the PRs is irrelevant for CGT. However, domicile of PRs could be relevant for the purposes of s.87 TCGA 1992 if PRs receive a capital payment from an offshore trust. Where the PRs are not UK domiciled, they will not pay CGT on capital payments from a non-resident settlement (because those charges only arise on a payment to a UK domiciled person).

It seems plain on (almost) any view that gains of non-resident companies may be attribute to PRs who are resident but not UK domiciled; see s.13 TCGA 1992. This is consistent with the Revenue view that the remittance basis does not apply in these cases.

For these reasons it is considered that the Revenue view is correct. Of course, if the PRs are actually outside the UK, especially if they are outside the EU, the Revenue may not, in practice, be able to recover the tax.

In what follows it is assumed that the PRs are UK resident for CGT.

33.6 Gift of pecuniary legacy to foreign domiciliary: CGT planning

Suppose that a foreign domiciliary is entitled to a pecuniary legacy of £1,000,000 under a will. The estate holds a foreign situate asset which had a value of £600,000 at the date of the death of the deceased and which is now worth £1,000,000. If the PRs sell the asset in order to pay the legacy, they will be liable to CGT. Can this liability be avoided by the PRs agreeing to transfer the property to the foreign domiciliary in satisfaction of his pecuniary legacy?

The strategy is viable provided the foreign domiciliary acquired the asset "as legatee", so that s.62(4) TCGA would prevent the PRs realising any chargeable gain. This provides:

> On a person acquiring any asset as legatee (as defined in section 64)—
> (a) no chargeable gain shall accrue to the personal representatives, and
> (b) the legatee shall be treated as if the personal representatives' acquisition of the asset had been his acquisition of it.

"Legatee" is defined by s.64(2) to include "any person taking under a testamentary disposition...". Section 64(3) provides:

> For the purposes of the definition of "legatee" above, and of any reference in this Act to a person acquiring an asset "as legatee", property taken under a testamentary disposition or on an intestacy or partial intestacy includes any asset appropriated by the personal representatives in or towards satisfaction of a pecuniary legacy or any other interest or share in the property devolving under the disposition or intestacy.

Thus, provided that the PRs had the power of appropriating the asset in satisfaction of the legacy, then the foreign domiciliary could properly be said to take as legatee.

Suppose, however, the PRs had such power only with the consent of the foreign domiciliary? The wording of s.64(3) is in the author's view wide enough to cover this case too.[4]

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4 Although, for stamp duty purposes, it was held that the transfer of the asset to a legatee amounts to a conveyance on sale where the consent of the legatee is required: *Jopling v IRC* [1940] 2 KB 282. Revenue Practice CCAB Statement of June 1967 provided:

> "The Revenue stated that in their view [TCGA 1992 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

If, however, the PRs had no power of appropriation, then the "appropriation" could be authorised only on the basis that it was in fact a sale of the asset to the foreign domiciliary for £1,000,000 coupled with a payment of the pecuniary legacy of £1,000,000 by way of set-off. In that case, the foreign domiciliary would acquire as purchaser and not as legatee. Fortunately, PRs will generally have this power: see s.41 Administration of Estates Act 1925.

33.7 Gift of specific legacy to foreign domiciliary: CGT planning

33.7.1 *Succession law background*

This section considers the position where a testator by his will gives assets specifically to a foreign domiciliary. In the first instance, the PRs will acquire the assets and in due course they will receive the income arising from them. If they do not need to resort to the assets or income for the purpose of paying debts, taxes, etc., they will in due course assent to the vesting of the assets and income in the foreign domiciliary.

33.7.2 *Capital gains tax*

In the first instance the PRs are deemed to own the asset and, if they dispose of it, are liable to CGT. If, however, they do not dispose of the asset to a third party but assent to it vesting in a legatee, then the PRs, as it were, retrospectively pass out of the picture and the legatee is deemed to have acquired the asset at the same time as the PRs acquired it. This would normally be at the time of the death of the deceased.

Suppose the PRs inherit an asset belonging to the deceased which is the subject matter of a specific gift in his will; that they then sell the asset, the sale giving rise to a charge to CGT, and that they subsequently transfer the

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> 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 1992 s 62(4)]."

This was written, however, before the enactment of what is now s.64(3) TCGA 1992 (in the FA 1969). This has brought the law into line with what was formerly the Revenue's practice.

whole or part of the proceeds of sale to the specific legatee. Does the doctrine of relation back have any scope? In my opinion, it does not. In the first instance, the common law doctrine would appear to operate only where an asset owned by the deceased is subsequently vested in the legatee. Even if this difficulty could be overcome, however, the express provisions of the statutory code deals so comprehensively with the situation that any application of the doctrine of relation back to CGT is by necessary implication excluded. So if there is such a sale, the PRs bear the CGT and transferring the proceeds of sale to the foreign domiciliary does not confer any exemption.

33.8 Gift of residue to foreign domiciliary: CGT planning

33.8.1 *Succession law background*

This section considers the position where a testator gives the whole or part of his residuary estate to a foreign domiciliary absolutely. During the period of administration, the PRs alone are said to be entitled to the assets which are comprised in the residue of the estate. While it is true that the residuary legatees have legal rights to compel due performance of the administration of the estate, it has been repeatedly held by courts of the highest authority that the PRs do not stand in the same relationship to their residuary legatees as do trustees to their beneficiaries. See *Lord Sudeley v Attorney-General*.[5] Upon completion of the administration, the residuary legatee becomes entitled to the assets which at that time form part of the estate, and any net income which the PRs have not expended in the course of administration. It is possible for PRs to assent specific assets before completion of administration.

33.8.2 *When is administration of estate completed?*

How long does the administration period last? This question has arisen in a number of contexts, including income tax, CGT, estate duty and general succession law, and has given rise to a voluminous case law. In all these contexts the test is the same. In *IRC v Aubrey Smith* 15 TC 661 Lord Hanworth MR, said at p.672:

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5 [1897] AC 11; this (rather odd) principle was re-affirmed in *CSD v Livingston* [1965] AC 694.

> In Lord Sudeley's case, [1897] A.C. at page 15, Lord Halsbury, then Lord Chancellor, says this:
>
> > "The thing that the legatee was entitled to was one-fourth share of a residuary estate, consisting, it may be, of many things; and I think it was fallacious on the part of Mr. Channel to say that the residue was very nearly ascertained, because the question is not only of amount – although I think that of itself would not be sufficient if it were only of amount – but it is a question of substance as well as a question of amount. It is uncertain until the residuary estate has been ascertained of what it will consist:"
>
> –and on a further page he says this:
>
> > Until the thing has been ascertained, until the trust fund has been constituted, the thing of which the trustees are the trustees has not been ascertained. Whether you treat them, therefore, as trustees or executors, the same consideration arises. Now, if the only thing that the legatee is entitled to is the fourth share of an ascertained residuary estate, I say that to my mind it is impossible to maintain that the character of any part of that estate can be ascertained so as to make it possess a specific locality until that has happened; it is a condition precedent to know what the residuary estate is, and until that has been ascertained you cannot tell of what it will "consist."
>
> .... I read all those passages because they appear quite clearly to lay down that until the fact is ascertained, or can or ought to be inferred, that the residue has become defined so that the aliquot portion passing to the beneficiary can also be defined, the beneficiary has not, until that time, a definite interest in the sum which will ultimately fall to him. Whatever be the contentions of the Respondent, it appears to me as Lord Haldane said in the case I first cited that it is largely a question of fact.... What has to be determined here ... is: Is it clear that the portion of each of the sons is ascertained, or has been ascertained, or is capable of ascertainment, and that ascertainment has been assented to by the executor-trustees?

The important points which emerge from the case law are that PRs continue to hold an asset as PRs until:

(1) they "assent" an asset to a beneficiary; or

(2) the administration of the estate is complete (at which point there is an implied assent). For this purpose:

   (a) The estate must be completely ascertained and 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 Commissioners.

33.8.3 *The Revenue view*

The Revenue view is set out in the CG Manual and the relevant passage (published 7/94)is here set out in full:

> **30700. Period of administration**
> The period during which the PRs are settling the estate is called a period of administration. The period starts with the death of the deceased person. The date on which it ends is a question of fact which is often difficult to resolve. During this period the liability for Capital Gains Tax on sales of assets from the estate falls on the personal representatives unless they have taken specific steps to vest the ownership of the assets involved in legatees in advance of the sale, see CG30910.
>
> **30701. Attitude of the courts**
> On questions of when administration is complete the Courts look for a construction of the law that leads to an early conclusion of administration. The leading case in this respect is *CIR v Sir Aubrey Smith* 15 TC 661.
>
> **30702.**
> In his judgement Lord Hanworth MR set out a principle of general application when he said, at the bottom of page 675, top of page 676
>
> > 'The question is, in all cases: has the administration of the Estate reached a point of ripeness at which you can infer an assent, at which you can infer that the residuary estate has been ascertained and that it is outstanding and not handed over merely for some other reason'.

30703.
On this basis we would normally argue that the period of administration ends when residue has been ascertained, see CG30780+.

30710. Extended period of administration
There are some exceptional cases where all the figures are apparently available to enable residue to be ascertained but it has to be accepted that the period of administration is continuing.

30711. Difficulty in distributing assets
One example is where distributing shares in accordance with legatees fractional entitlements to residue would result in one legatee receiving a majority shareholding whilst the other legatees would only receive minority holdings. Because of the disparity in values between majority and minority holdings it may be necessary for the personal representatives to apply the rule from *Lloyd's Bank v Duker* [1987] 3 All ER 193. This would require them to sell these shares rather than distributing them in specie.
The period of administration would continue in such a case until the shares were sold and the Capital Gains Tax liability arising to the personal representatives was quantified.
The rule referred to above is of fairly limited application. The fact that a majority shareholding would be broken into minority holdings on distribution should not be accepted as preventing distribution of shares and thus the ending of the period of administration. Nor should minor valuation differences between minority shareholdings passing to the legatees be accepted as covered by the rule in the *Duker* case.

30712. Litigation
The period of administration may also be extended where the distribution of the estate is being challenged. The personal representatives may be unable to distribute the estate pending the outcome of litigation.

30720. Confusion over terminology
Even where ascertainment of residue marks the end of the administration period for Capital Gains Tax purposes, assets may remain in the hands of the personal representatives after that date. They may have to carry out administrative acts regarding transfer of assets to legatees. In some cases they may sell assets. If so they will be doing this as bare trustees for the legatees. Personal representatives and their agents sometimes regard these acts as forming part of the period of

administration. This may lead to confusion when references are made to the period of administration.

30721.
Because of the possible confusion it is important to establish precisely what is meant when a reference is made to a period of administration. From the Inland Revenue's side we can try to avoid this confusion for the majority of cases by referring to events as falling before or after residue has been ascertained rather than simply referring to the period of administration.

33.9 CGT planning

The general aim must be to avoid realising assets in respect of which the PRs would be obliged to pay capital gains tax.

It may be necessary to sell some assets to pay liabilities of the PRs, and it may be that the assets available for sale will give rise to a chargeable gain.

One solution is as follows:

(1) The PRs assent the asset to the foreign domiciliary subject to a charge for their liabilities under s.36(10) Administration of Estates Act 1925.

(2) The foreign domiciliary sells the asset: any gain on the sale accrues to the foreign domiciliary: s.26(2) TCGA 1992.

(3) Under the charge the proceeds are used to pay the PRs' liability.

33.9.1 *Importance of assents*

PRs transfer assets to beneficiaries by means of an "assent". The assent is fundamental, since a sale after an assent to a foreign domiciliary may in broad terms be free of CGT and a sale before assent will not.

An assent of land in England and Wales must be in writing. An assent of other property may be oral or implied by conduct. No formal written assent is required if (say) shares are simply transferred to the name of a beneficiary by stock transfer form. If a portfolio of shares is registered in the names of PRs (or their nominees), and the foreign domiciliary wants them to be sold, it may be administratively convenient if an assent is made under which the PRs (or their nominees) become nominees for the foreign domiciliary. Then the shares can be sold without CGT and without the formality of a transfer of legal title to the foreign domiciliary.

33.10 Appointment to beneficiary by executors under overriding powers

Section 62(4) TCGA 1992 provides:

> On a person acquiring any asset as legatee (as defined in section 64)—
> (a) no chargeable gain shall accrue to the personal representatives, and
> (b) the legatee shall be treated as if the personal representatives' acquisition of the asset had been his acquisition of it.

Where executors exercise a power to appoint trust property to a beneficiary, that beneficiary takes under the appointment "as legatee" and s.62(4) will apply.

The starting point is the rule of trust law that, for the purposes of the rules relating to perpetuities, where trustees exercise a power of appointment, the deed of appointment is read back into the original trust instrument. It is treated as coming into operation at the date of the instrument that creates the power. See *Muir v Muir* [1943] AC 468; *Pilkington v IRC* 40 TC 416 at 441. This rule has been applied for tax purposes, in a different context, in *Chinn v Collins* 54 TC 311: the exercise of a power of appointment merely "fills in a blank in the original settlement which left blank how the final distribution of a trust asset was to be made"; see page 357.

Quite apart from that, the beneficiary would take as "legatee" in the general sense of the expression. The definition in s.64(2) is inclusive and not a comprehensive definition. The reason that the beneficiaries take as legatee is that they acquire under an assent. They also acquire from the PRs acting in their capacity as PRs.

This conclusion is consistent with the general scheme of the TCGA. A person who acquires under an appropriation acquires "as legatee": see s.64(3). It would be anomalous if a person who acquired under an appointment would not. (A power of appropriation is sometimes regarded as a dispositive power: *Re Freeston* [1978] Ch 741, though I would not regard that as an essential point.)

In CG Manual 31432–3 (although one might quibble with the language used) it seems clear that the Revenue accept that an appointee acquires as legatee.

33.11 CGT planning by instrument of variation

Where there is more than one residuary legatee and some are foreign domiciliaries, non-residents or charities, it would often make sense for assets pregnant with capital gain to be transferred to them rather than to United Kingdom 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 pregnant with capital gain to the foreign domiciliary. UK resident and domiciled beneficiaries would instead receive cash or assets not pregnant with capital gain. The foreign domiciliary might in due course realise the gains free of tax. There would be an overall tax saving, which could be shared between the foreign domiciliary and the other beneficiaries by negotiation, or which could be allowed to accrue entirely to the foreign domiciliary if the other beneficiaries were so minded.

33.12 Residence of PRs for income tax purposes

PRs are regarded as UK resident for income tax if they are all actually UK resident. They are regarded as non-UK resident if they are all actually non-UK resident. The position where an estate has some resident and some non-UK resident PRs is governed by s.111 FA 1989:

> (1) Where the personal representatives of a deceased person include at least one who is not resident in the United Kingdom as well as at least one who is, then for all the purposes of the Income Tax Acts—
>
> (a) if the condition in subsection (2) below is satisfied, the personal representative or representatives not resident in the United Kingdom shall be treated as resident there, and
>
> (b) otherwise, the personal representative or representatives resident in the United Kingdom shall be treated as not resident there (but as resident outside the United Kingdom).
>
> (2) The condition referred to in subsection (1) above is that the deceased person is at his death—
>
> (a) resident in the United Kingdom,

(b) ordinarily resident there, or
(c) domiciled there.

Thus it is possible to arrange that personal representatives 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).

In the first instance, the PRs pay tax at the ordinary rate (i.e. basic or lower or Schedule F rate) on any income arising from the assets if:

(1) the PRs are UK resident, or

(2) the income has a UK source.

33.13 Specific legacy to foreign domiciliary: income tax

If they assent to the asset and its income vesting in the beneficiary, something rather peculiar happens. Under the common law doctrine of relation back, the beneficiary is deemed to have been the owner of the asset since the death. The doctrine of relation back operates for income tax purposes: see *IRC v Hawley* 13 TC 327. Thus, the beneficiary will, retrospectively, be treated as having received the income year by year as it arose. The PRs may have paid UK tax. This will retrospectively be treated as being paid by the PRs in a representative capacity on behalf of the beneficiary. Thus, a foreign domiciled beneficiary should be able to reclaim tax paid by UK resident PRs on unremitted foreign income.

33.14 Gift of residue to foreign domiciliary: income tax

It is not possible to appreciate the existing income tax law without understanding the history. In *R v Special Commissioners for Income Tax Purposes, ex p. Dr Barnado's Homes* 7 TC 646, the residuary legatee was a charity which was seeking to reclaim income tax paid by the PRs in the course of administration. The residuary legatee was not in equity entitled to the income of the residuary estate as it arose during the course of administration, so it could not at that time reclaim income tax paid. Instead it sought to recover on completion of administration. It was held by the House of Lords that the completion of administration did not confer any retrospective title on the residuary legatee to such income as income. In effect, all that the residuary legatee took (including accumulated income of the estate) it took as capital. So on completion of administration, income tax paid by the PRs still could not be recovered by the charity. The doctrine of relation back was not extended to gifts of residue.

That was a victory for the Inland Revenue, with the immorality of which they did not seem at all concerned. It was only when, predictably, individual residuary legatees successfully contended that they could not be made liable to super-tax or surtax on the income of the residuary estate arising during the course of administration[6] that the Revenue realised they had made a rod for their own backs. Legislation was therefore brought in which is now to be found in ICTA 1988 Part XVI.

The legislation is extremely complicated and technical. It is to be questioned whether it always hits its mark, especially where the residue is held on discretionary trusts. The legislation distinguishes between

(1) an absolute interest in residue, e.g. to a beneficiary absolutely, and

(2) limited interest in residue, e.g. upon trust to pay the income to A for life, and subject thereto upon trust for B.

The legislation also draws a distinction between a "United Kingdom estate" and a "foreign estate". These terms are defined as follows:

> (9) "United Kingdom estate" means, as regards any year of assessment, an estate the income of which comprises only income which either—
> (a) has borne United Kingdom income tax by deduction, or
> (b) in respect of which the personal representatives are directly assessable to United Kingdom income tax,
> not being an estate any part of the income of which is income in respect of which the personal representatives are entitled to claim exemption from United Kingdom income tax by reference to the fact that they are not resident, or not ordinarily resident, in the United Kingdom.
> (10) "Foreign estate" means, as regards any year of assessment, an estate which is not a United Kingdom estate.
> (10A) Amounts to which section 699A(1)(a) and (b) applies shall be disregarded in determining whether an estate is a United Kingdom

6 e.g. *Corbett v IRC* 21 TC 449. There is a raft of super-tax cases on the issue of whether administration was completed.

estate or a foreign estate, except that any estate the aggregate income of which comprises only such amounts shall be a United Kingdom estate.

(Section 701 ICTA 1988)

It is possible to procure that an estate with non-resident PRs qualifies as a "foreign estate" by arranging that there is income which does not satisfy the conditions of s.701(9), i.e.:

(1) Income which has not borne UK income tax by deduction; and

(2) on which the PRs are not assessable to income tax.

33.15 Position where foreign domiciliary has absolute interest in residue; UK estate

We consider first of all absolute gifts of residue. We assume that the same foreign domiciliary was absolutely interested in residue throughout the administration period, as would normally be the case.

Firstly, one must compute the "residuary income" of the estate for each year of assessment during which the administration period was current.[7] This is then the "residuary income" of the foreign domiciliary for that year.

If during the administration period any sums are paid to the foreign domiciliary on account of his interest in residue, the sums are deemed to be income of the foreign domiciliary up to a ceiling. In the case of a UK estate, the ceiling is the residuary income for each year net of income tax at the applicable rate (i.e. basic or lower or Schedule F rate: s.696(3)). Any amount deemed to have been paid to the foreign domiciliary as income for any year by virtue of this provision is deemed to be a net sum which has suffered deduction of tax at the applicable rate.

On the completion of the administration of the estate all of the residuary income of the foreign domiciliary (which has not been dealt with as above) is deemed for tax purposes to have been paid to the foreign domiciliary as income for the year that administration is completed. Again, it is deemed to be a net payment which has suffered deduction of tax at the applicable rate; s.696(5).

7 s.696(2).

In the case of income received from a UK estate, income is subject to tax on an arising basis.

33.16 Position where foreign domiciliary has absolute interest in residue; foreign estate

However, the remittance basis applies to a foreign estate. Section 696(6) provides:

> In the case of a foreign estate, any amount which is deemed to have been paid to that person as income for any year by virtue of this section shall be deemed to be income of that amount and shall be chargeable to income tax under Case IV of Schedule D as if it were income arising from securities in a place out of the United Kingdom.

Accordingly, the remittance basis applies.

It follows that it is very important to ensure that the estate is a "foreign estate" and not a "UK estate".

33.17 Limited interest in residue

In the case of a limited interest in residue, similar rules apply but the deemed income is limited to the income of the estate.

CHAPTER THIRTY FOUR

WHO IS THE SETTLOR?

34.1 Why does it matter who is the settlor?

The identity of the settlor of a settlement is relevant for many tax purposes. It is not practical to compile a full list, but the following are the most important:

(1) IHT excluded property rules[1] and reverter to settlor exemption: s.54 IHTA 1984.

(2) CGT charge where settlor has an interest in:

(a) a non-resident trust: s.86 TCGA 1992;[2]

(b) a UK resident trust: s.77 TCGA 1992.

(3) IT charge where settlor has an interest in a settlement: s.660A ICTA 1988.[3]

(4) Duties of disclosure to the Revenue.[4]

The question of the identity of the settlor therefore often arises in matters concerning foreign domiciliaries.

The identity of the settlor is relevant for trust law purposes (e.g. the rule

1 See 23.1 (Excluded property for IHT).
2 See 18.3 (The s.86 charge).
3 See 10.1 (The settlement provisions).
4 See 36.1 (Reporting requirements on creation of settlement).

against accumulations may restrict accumulation to life of settlor).

The person who is named as "the settlor" in the trust documentation is not necessarily a settlor, or the only settlor, for tax purposes.

34.2 Statutory definitions of "settlor"

34.2.1 *IHT definition of "settlor"*

Section 44 IHTA 1984 provides the IHT definition:

> In this Act "settlor", in relation to a settlement, includes[5] any person by whom the settlement was made directly or indirectly, and in particular (but without prejudice to the generality of the preceding words) includes any person who has provided funds directly or indirectly for the purpose of or in connection with the settlement or has made with any other person a reciprocal arrangement for that other person to make the settlement.

34.2.2 *CGT definitions of "settlor"*

CGT has many definitions of settlor. The most important, and the only one considered here, is the definition for purposes of s.86 TCGA 1992 ("the s.86 definition").[6] TCGA 1992 Schedule 5 paras 7, 8 provide the 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

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5 The income tax definition uses the exhaustive term "means" but the IHT definition 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 otherwise within the IHT definition. I cannot think of such a case.

6 Other very similar definitions apply for the purposes of s.286(3) and Schedule 1 TCGA 1992 (incorporating the IT definition); s.77 TCGA 1992; ss.169B and 169C TCGA 1992.

from a person are references to—

(a) property provided by that person;

(b) property representing property falling within paragraph (a) above;

(c) so much of any property representing both property falling within paragraph (a) above and other property as, on a just apportionment, can be taken to represent property so falling.

...

(3) Where a person who is a settlor in relation to a settlement makes reciprocal arrangements with another person for the provision of property or income, for the purposes of this paragraph—

(a) property or income provided by the other person in pursuance of the arrangements shall be treated as provided by the settlor, but

(b) property or income provided by the settlor in pursuance of the arrangements shall be treated as provided by the other person (and not by the settlor).

...

(6) For the purposes of this paragraph references to property representing other property include references to property representing accumulated income from that other property.

(7) For the purposes of this paragraph property or income is provided by a person if it is provided directly or indirectly by the person.

(There are further provisions relating to property provided by a company, not discussed here.)

34.2.3 *Income tax definitions of "settlor"*

Section 660G ICTA 1988 provides the definition for the purposes of the income tax "settlement provisions":

(1) In this Chapter:

...

"settlor", in relation to a settlement, means any person by whom the settlement was made.

(2) A person shall be deemed for the purposes of this Chapter to have made a settlement if he has made or entered into the settlement directly or indirectly, and, in particular, but without prejudice to the generality of the preceding words, if he has provided or undertaken to provide funds directly or indirectly for the purpose of the settlement, or has made with any other person a reciprocal arrangement for that other

person to make or enter into the settlement.

I call this "the income tax definition".[7] One can identify five parts of the definition. A person is a settlor if he has:

(1) made the settlement directly or indirectly;

(2) "entered into"[8] the settlement directly or indirectly;

(3) provided funds directly or indirectly for the purposes of the settlement;

(4) undertaken to provide funds directly or indirectly for the purposes of the settlement;[9]

(5) made a reciprocal arrangement with another person to make or enter into the settlement.

34.2.4 *Settlor "in general sense" and other meanings of "settlor"*

In keeping with the patchwork nature of UK tax law, these definitions are based on a common framework but they all have slight differences from each other.

The IT definition of "settlor" dates back to 1936 and is the ancestor of the other definitions. It is considered, however, that there is little significant difference in meaning. In IHT there has been a little tidying up of the verbose IT definition; the CGT s.86 definition is an attempt to extract its essence. Cases on one statutory provision may generally be taken as good authority on the meaning of the word "settlor" in the others.

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7 Though there are other definitions, e.g. in s.110(4) FA 1989.

8 The words "entered into" are not found in the other definitions of "settlor". The reason is that in this context only the word "settlement" has an extended meaning and includes an agreement or arrangement. One is said to "enter into" an agreement or arrangement even though it is perhaps not normal usage to say that one "enters into" a settlement in the narrower trust sense.

9 The reference to "undertaking" to provide funds is not found in the IHT or CGT s.86 definitions. Undertakings to provide funds are not found in practice so this has no practical relevance. The drafter of the IHT and CGT definitions presumably decided to omit it as unnecessary.

The concept behind the definitions is here referred to as a settlor "in the general sense" or "for general tax purposes".

There are further specific IHT provisions which may affect the identity of the settlor for IHT. So sometimes a person who is the settlor in the general sense is not regarded as the settlor for IHT. This chapter considers the general tax sense of settlor; for the IHT provisions see 24.1 (Transfers between trusts).

34.3 Two settlors

One trust may have two or more settlors. The consequences are discussed in 24.4 (Two settlors for IHT); 18.5 (Two settlors for CGT s.86 charge).

34.4 Gift to B followed by gift to trust by B

In *Hatton v IRC*[10] the facts were as follows:

(1) Mrs Cole ("the mother") made a settlement ("the first settlement") conferring on her daughter Mrs Hatton a valuable equitable interest;

(2) The daughter transferred her interest to a new settlement ("the second settlement").

So this was in essence a case of a gift to B followed by gift to trust by B. The question was who was the settlor of the second settlement: the mother or the daughter or both. The Special Commissioners explained the background facts (67 TC at 771):

> Once the first settlement had been executed in the evening of 10 August it was a virtual certainty that the second would be made on the following day provided that [the mother] was then still living. We accept that [the daughter] did not know that Mr Lawson [attorney for the mother] had made the first settlement until after he had done so but she knew:
> (a) that her mother had instructed Mr Lawson to make dispositions of property to reduce the value of her mother's estate; and
> (b) that one such disposition in contemplation on 10 August affected

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10 67 TC 759. For another aspect of this decision see 34.13 (Provision for "purpose" of a settlement).

> the flat, with some of its contents, and other items of silver and jewellery
>
> and she [the daughter] was content to leave the details to him. There was no real likelihood that she would reject the suggestion that she should make the second settlement when Mr Willcox [her advisor] put it to her.

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.

This does not enunciate any clear test to decide when funds are provided indirectly. The comment is certainly consistent with the "at least a conscious association" test set out in *Fitzwilliam*, discussed below.

It follows that if there is an arrangement under which:

(1) A makes a gift[11] of property to B, and

(2) B gives the same[12] property to a trust,

A will in principle be a "settlor" as he has provided property indirectly. B will also be a settlor as he provided property directly. For the tax consequences, see 34.3 (Two settlors). Note, however, that although A is a "settlor" of the discretionary trust, he has not made a chargeable transfer and no IHT is payable by A on the gift to the trust by B.

Of course, this formulation will not solve all problems, since the question may arise as to what is an "arrangement".

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11 It is assumed that the "gift" from A to B is not made on terms which require B to transfer the property to the trust. It is also assumed that *Furniss v Dawson* does not apply. If that were not the case:
(1) A would obviously be the settlor,
(2) B would not be a settlor.

12 The same may apply if B creates a settlement with other property (not the property given) if this is part of the arrangement between A and B.

If A is a beneficiary of the trust, his gift to B may also become a gift with reservation: see 25.6.2 (Gift from A to B followed by gift to trust by B).

34.5 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.*
>
> *(Mills v IRC* 49 TC at 387 (Buckley LJ))

This *obiter* comment is probably going too far; if it is correct, it can only be right if (as Buckley LJ assumes) the payer regards himself as under an obligation (albeit not legally binding) to make the payment to the friend. The friend has absolute *de facto* (though not *de jure*) power of disposition of the funds. So the situation is different if a father proposed to make a gift to his son, and the latter *asks* that the sum be paid to trustees of a settlement for the son and/or 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 it is the father (not the son) who is the settlor. The son has not provided funds even indirectly.

34.6 Appointment from old trust to B followed by gift to new trust by B

Fitzwilliam v IRC 67 TC 614 concerned a discretionary will trust. There was an arrangement under which:

(1) The trustees 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 settlement a few days later ("step 5").

So this was a relatively simple case of an appointment from an old trust to B followed by a gift to a new trust by B. The question was who was the settlor of the new settlement: Lady Hastings or the testator of the will trust or both. Lord Keith said:

> The argument for the Crown is that, by virtue of the appointment contained in step 3, property was provided to Lady Hastings directly or indirectly for the purpose of or in connection with the settlement which Lady Hastings later made under step 5. The person who provided that property is said to be Earl Fitzwilliam [the testator], because the appointment by the trustees falls to be read back into his will, under the principle of *Muir v Muir* [1943] AC 468 and *Pilkington v IRC* [1964] AC 612. These cases decided that for the purposes of the Scottish rule against successive life-rents and the English rule against perpetuities the exercise of a power of appointment must be written into the instrument creating the power. Earl Fitzwilliam is, therefore, to be treated as the settlor so far as concerns the trust purposes contained in the appointment made by his trustees under step 3, but he cannot reasonably be regarded as having provided property directly or indirectly for the purpose of or in connection with the settlement made by Lady Hastings under step 5.
>
> The words "for the purpose of or in connection with" connote that there must *at least be a conscious association of the provider of the funds* with the settlement in question. It is clearly not sufficient that the settled funds should historically have been derived from the provider of them. If it were otherwise anyone who gave funds unconditionally to another which that other later settled would fall to be treated as the settlor or as a settlor of the funds. It is clear that in the present situation there cannot possibly have been any conscious association of Earl Fitzwilliam with Lady Hastings' settlement.
>
> (*Fitzwilliam v IRC* 67 TC at 732, emphasis added)

It seems therefore that if:

(1) a trust ("trust A") exists and A is its settlor;

(2) There is an arrangement under which:

 (a) the trustees of trust A appoint trust property to B;

(b) B gives the property to a separate trust ("trust B");

B will be the settlor of trust B, and A will not be a settlor, unless the creation of trust B is envisaged by A at the time that trust A is made.

The "conscious association" test is an understandable and generally helpful paraphrase of the statutory words (though of course it does not solve much as the question may arise as to what is a "conscious association". Further, Lord Keith said there must *at least* be a conscious association, suggesting that it is a necessary, but may not be a sufficient, condition). The application of the conscious association test in the case of an appointment followed by a gift really is surprising, but the House of Lords have spoken. The matter is for most practical purposes ended – at least until the House of Lords speak again. For implications for tax planning, see 34.18 (Tax planning to create settlement with foreign domiciled settlor).

34.7 Transfer from trust A to trust B by exercise of trustees' power

This section considers the general tax sense of settlor. Special rules apply for IHT: see 24.1 (Transfers between trusts).

34.7.1 *Transfer from trust A to new trust created by trustees*

Suppose:

(1) Trustees of a trust made by A ("Trust A") have power to transfer to a new trust.

(2) The trustees transfer the trust funds to new trustees to hold on the terms of a newly created trust, Trust B. All the funds of Trust B are derived from Trust A.

Who is the settlor (in the general tax 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.[13]

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13 If at the time of the creation of Trust A, the transfer to Trust B is already in contemplation, then A is plainly the settlor of Trust B. It is here assumed that the transfer was not in contemplation at the time of the creation of Trust A.

The answer is that A is the settlor of Trust B. In *Eilbeck v Rawling* 54 TC 101:

(1) a Gibraltar settlement ("Trust A") made by the taxpayer ("A") held £600,000;

(2) a Jersey settlement ("Trust B") made by the taxpayer's brother ("B") held £100;

(3) £315,000 was transferred from Trust A to Trust B by exercise of the trustees' powers.

Buckley LJ said at p.161:

> It has long been firmly established law that the donee of a special power of appointment is charged with the exercise of a personal discretion which he cannot delegate. When he exercises that discretion in making an appointment, he acts as the delegate of the settlor. What the donee does in exercise of a special power of appointment is done vicariously by the settlor. It is also settled law of long standing that, for the purposes of the rule against perpetuities, when a special power is exercised, the limitations created under it are to be written into the instrument which created the power. This association of the interests arising under an appointment in the exercise of a special power with the settlement conferring that power is not, in my opinion, confined to the rule against perpetuities. If one asks who was the settlor of the £315,000 appointed by the appointment of 27 March 1975, the only possible answer is [A] the settlor of the £600,000 comprised in the Gibraltar settlement. The taxpayer's brother [B] did not settle the £315,000; he settled only £100. The Gibraltar trustee [the trustees of Trust A] did not settle the £315,000; it was not the Gibraltar trustee's to settle, and making the appointment the Gibraltar trustee was only exercising a fiduciary power conferred on him by the Gibraltar settlor, whose delegate he was as donee of the power. The exercise of the power had, in my opinion, precisely the same effect as if the Gibraltar trustee had appointed the £315,000 in favour of the Jersey trustee to be held upon trusts identical with the trusts of the 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. It may be objected that this reasoning was rejected in *Fitzwilliam v IRC*: see 34.6 (Appointment from old trust to B followed by gift to new trust by B). There is no "conscious association" between A and Trust B. However, *Fitzwilliam* was a case where the Court found that an individual beneficiary who assigned an asset to the new trust was the "settlor". The beneficiary displaced the testator from being a settlor by his independent act. There is no equivalent here.

The alternative conclusion that Trust B has no settlor for general tax purposes would have the result, attractive to taxpayers but unpalatable to the Court, that A might escape CGT on trust gains under s.86 TCGA 1992 (and IT under s.660A ICTA 1988). The property in Trust B could be excluded property, as one could not say that "the settlor was domiciled in the United Kingdom at the time that the settlement was made"! That can hardly be right. The Revenue agree. CG Manual 33241:

> **33241 Settlor [June 2003]**
> Where trustees exercise a special power of appointment, or power of advancement, in such a way as to create a new settlement, see CG33800+, the settlor of the new settlement is the person who was the settlor of the old one. See, for example, *Pilkington v CIR*, 40 TC 416, page 442, and *Chinn v Collins*, 54 TC 311, page 351H.

The same point is made again at 34802.

34.7.2 *Transfer from trust A to existing trust made by B*

Suppose:

(1) A transfers property ("A's fund") to a trust ("Trust A"). This confers on the trustees the standard power to transfer property to another settlement.

(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.

34.8 Provision of property for company owned by trust

The Revenue take the view that provision of property to a company wholly owned by a trust is in principle provision of property for the purposes of the trust, and therefore makes the provider a settlor. SP 5/92 paras 16, 17 provides:

> 16 The condition in TCGA 1992 Sch 5 para 9(3) may be satisfied where property or income is provided to a company in which the trustees are participators. 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.

This is supported by commonsense, and by *obiter* in *Crossland v Hawkins* 39 TC at p 506 followed by Goulding J in *IRC v Mills* 49 TC at p 337. It should be taken to represent the law.

It is submitted that the property is provided for the purposes of the settlement at the time when it is provided to the company, not at the later date (if at all) when the trust receives any asset from the company.

34.9 Provision of services[14]

In two well known cases:

(1) a third party created a trust which held a company; and
(2) actors (Jack Hawkins, Hayley Mills) provided services to the company

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14 See *Taxation*, 13 March 2003, p.572 (Malcolm Gunn). This section will need review after *Arctic Systems* (a forthcoming test case).

at a substantial undervalue. The company made profits transferred as dividends to the trustees.

In each case it was held that the actor was the settlor.[15]

Viscount Dilhorne in *IRC v Mills* 49 TC 367 at 408 considered two situations:

(1) The employees of a company, some shares in which were held by trustees, contribute by their labour to the profits of the company, and so increase the shareholders' dividends and so increase the income of the settlement.
(2) A stockbroker might, if the advice he gave to the trustees of a settlement proved well founded, be said to be contributing to the settlement.

One might have said that these were not settlors because they provided no bounty. That was not the way that Viscount Dilhorne put it. He said:

> The difference between those cases, on the one hand, and *Crossland v Hawkins* and this case [*IRC v Mills*], on the other, is that in *Crossland v Hawkins* and in this case funds which ordinarily would have been received by Mr. Hawkins and by Miss Mills for their acting were diverted to companies which were channels for their transmission to trustees. It is not the provision of services but of funds which comes within the section.

The distinction is not between provision of services and provision of funds, because the actors did provide services; the distinction is between:

(1) the provision of services which yields funds; and

(2) the provision of services which does not yield funds.

When does the provision of services yield funds? The test is whether one can identify funds which:

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15 More accurately, the actor was one of the settlors but the contribution by the third party who made the trust was ignored as insignificant.

(1) would ordinarily (in the absence of the settlement) have been received by the individual, but

(2) were diverted to the trust.

In the case of Viscount Dilhorne's examples of employees and stockbrokers, these conditions are plainly not met.

Suppose:

(1) an individual has an opportunity of purchasing land, or shares in a private company;
(2) he allows the trust to take up the offer by advising the trust and not pursuing the opportunity himself;
(3) had the trust not taken up the offer he would have done so.

In this case the individual is a settlor if one can distinguish the return from the trust's investment from the profit from the advice. A clear case being where the trust only invested a nominal amount in the project. But if the trust provides substantial funds for the development, there is nothing one can identify as coming from the advisor. One should not apportion the profits between the advisor's contribution (advice) and the settlement's contribution (finance). It is impractical to do so as there is no sufficiently clear answer to how the apportionment should be made. If that is right, the *Mills* and *Hawkins* line of cases is effectively restricted to "one-man companies" with no capital base (as was the case in both *Mills* and *Hawkins*). Tax Bulletin 64 Example 9 suggests that the Revenue accept this. The example (slightly re-phrased) is as follows:

> Mr. J owns 60 of the 100 issued £1 shares in J Limited. Mr. J is a 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.) The Revenue say:

> Section 660B applies and attributes the dividends received by the children to Mr J for tax purposes. Since Mr. J is the person

> [1] responsible for making the company's profits and
> [2] decides on the level of dividends paid,[16]
> it is Mr J who is the settlor rather than the children's grandmother.
> The legislation could apply in a similar way if the children had subscribed for shares themselves with money received from a third party or even from bank accounts in their own names.

Suppose a stockbroker who is well disposed to the trust (perhaps a beneficiary) gives free investment advice to trustees to invest in quoted (easily obtainable) investments, and the trust profits from acting on his advice. There is an element of "bounty" but the stockbroker has not provided funds and is not the settlor. One cannot identify funds which would ordinarily have been received by the stockbroker. On the contrary, the stockbroker was free (if he had the resources) to make the same investments as those he recommended to the trustees. This is a clear case.

Suppose a property developer who is well disposed to the trust gives free property market advice to trustees, and the trustees invest in land successfully because of the advice. The developer has not provided property and is not the settlor. One cannot identify funds which would ordinarily have been received by him.

Another view?

In *Mills* in the Court of Appeal, Buckley LJ noted other circumstances why a person who provides services to a trust or company may not be providing property:

(1) A person does not provide funds for a settlement if:

   (a) he is entirely ignorant of the settlement (which would in all probability be the case for the employees of a company held by a trust), or

   (b) he does not have the view of advancing the interests of the trust.

(2) A person does not provide funds for a settlement if he does so for reward in the ordinary course of his professional business.

16 It is hard to see the relevance of [2].

These are obvious examples of circumstances in which a person providing services to a trust should not be regarded as a settlor because there is no element of "bounty".

34.10 Provision of interest free loan or bank guarantee

A person who lends interest free is in principle a settlor. In *IRC v Wachtel* 46 TC 543 (1) the trustees borrowed from a bank, and (2) a person 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 person was rightly held to be a settlor: see 46 TC at p.555.

34.11 Consent to exercise of trustees' powers

A trust sometimes provides that the trustees can only exercise a power of appointment with the consent of a particular beneficiary (typically the life tenant). If the power of consent is a wholly personal one,[17] this raises some intriguing tax 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 possession in the trust probably makes the consentor the "settlor" of a "settlement", for the purposes of the income tax[18] settlement provisions. The consentor has provided income for the purpose of the "settlement" because he has effectively given up his interest in the income by virtue of his consent.[19]

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17 On this terminology and power of consent generally see *Drafting Trusts and Will Trusts*, James Kessler QC (6th ed., 2002) para. 6.33 (Nature of powers of consent).

18 Not for the purposes of CGT, as the Revenue accept: CG Manual 33241. Nor for the purposes of IHT.

19 The position is analogous to a person who assigns or surrenders his life interest. An assignor is a settlor of a settlement for income tax purposes: *IRC v Buchanan* 37 TC 362. The analogy is not exact. In one case the "arrangement" consists of the assignment alone. In the other case the "arrangement" consist of the consent and the exercise of the trustees' power of appointment. So in a sense there is an arrangement with two settlors: (i) the consentor and (ii) the (actual) settlor of the settlement (in the strict sense) who conferred the power of appointment on the trustees. But the Revenue (or the actual settlor) may plausibly argue that the consentor (not the actual settlor) is taxable under the Settlement Provisions in these

(2) 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[20].

In these cases the consentor has not provided any property by his consent.

(3) The giving of a consent is probably not a disposal for CGT[21] 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).

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circumstances. They may take support from *Braybrooke v Att-Gen* 9 HLC 149 at 165, accessible on *www.kessler.co.uk*. (A case on the Succession Duty Act 1853 whose provisions are analogous to s.660G ICTA 1988. Since Succession Duty was only abolished in 1949, the drafter of the predecessor to s.660G 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.

20 This is fairly clear from first principles, but some support can be found in two cases. In *Braybrooke* (see the above fn) a tenant in tail exercised his power to dispose of the lands entailed, with the consent of the protector. The protector was not the creator of the disposition: "It cannot be argued that a person whose consent is apparently necessary to a disposition, makes that disposition." In *Mills v IRC* the father's consent was apparently thought to be necessary for Hayley Mills to enter into the arrangements: see 49 TC 367 at 403. This did not prevent Hayley being a settlor.

21 Under general principles or by virtue of s.24 TCGA 1992 (extinction of an asset constituting a disposal).

The contrary is arguable but it would not normally matter.[22]

(4) The giving of the consent is probably not a "disposal" for the purposes of the gift with reservation rule[23] and indeed it is likely that the power of consent is a "settlement power" and so not property for IHT: see IHTA 1984 s.272.

The Revenue 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).

34.12 Sale of assets at undervalue

A sale at a conscious undervalue is the provision of funds and makes the seller a "settlor". A sale at market value is not the provision of funds. A sale which is a bargain at arm's length (at a price regarded by both sides as market value) is not in my view the provision of funds even if the parties have mistaken the value and the property is sold at an undervalue. This is consistent with the general principle that a "settlement" must have an element of "bounty": see 10.3 ("Settlement").

34.13 Provision for "purpose" of a settlement

A person is a settlor if he provides funds for the *purpose* of a settlement.[24]

In *Mills v IRC* 49 TC 367, the funds of the settlement were derived from the acting work of young Hayley Mills, then aged 14. She was

22 It will matter if the usual CGT exemption on the disposal of an equitable interest does not apply (e.g. offshore trusts). It could matter if the conditions of TCGA 1992 Sch. 4A are satisfied, but that would be unusual.

23 The Revenue agree; see the CTO Advanced Instruction Manual E.91:

> "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 statement makes it less likely that the Revenue will argue there is a disposal for CGT.

24 In the IHT definition, the wording is "for the purpose of or in connection with" the settlement, but it is suggested that this makes no difference.

supposedly[25] 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. This is not a point of direct importance to foreign domiciliaries but I cannot resist dealing with it here. Viscount Dilhorne said in the House of Lords:

> [1] I do not agree with Lord Denning M.R. that the word "purpose" in this section connotes a mental element or with Buckley L.J. that there must be a motivating intention. I do not myself think that it assists to consider whether the question he posed is to be answered objectively or subjectively. I do not consider it incumbent, in order to establish that a person is a settlor as having provided funds for the purpose of a settlement, to show that there was any element of mens rea.
>
> [2] Where it is shown that funds have been provided for a settlement a very strong inference is to be drawn that they were provided for that purpose, an inference which will be rebutted if it is established that they were provided for another purpose.

This is not right. It is not even wrong. The sentence at [2] cannot sensibly be reconciled with the sentiment at [1]. At [2] Lord Dilhorne apparently distinguished between:

(1) providing funds "for" a settlement; and

(2) providing funds "for the purpose of" a settlement.

It is submitted that "purpose" inescapably connotes a mental element. However, 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. The usual principles of agency may be applied. In *Mills*, the intention of the father, acting for the daughter, was plainly that funds should be provided for the purpose of the settlement. Likewise in *Hatton* (see 34.4 (Gift to B

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25 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 difficulty the Courts faced was caused by the fact that the case was argued on an incorrect and implausible factual assumption.

followed by gift to trust by B)) the intention of Mrs. Cole's attorney was that funds should be provided for the settlement, and this intention may be regarded as the intention of Mrs. Cole. Once this point is understood all the apparent difficulties in this area fall away.

34.14 Trust made by instrument of variation

Suppose:

(1) S inherits property absolutely from the estate of a testator, T.

(2) S varies the will so as to create a settlement of that property.

S is obviously the settlor in the general tax sense; see 34.4 (Gift to B followed by gift to trust by B). For income tax purposes, there is nothing more to be said: S is the settlor.

For inheritance tax purposes, the effect of s.142 IHTA 1984 is probably to override the general tax sense, and the settlor is T and not S. The Revenue accept this view. (The contrary view is arguable but it will not usually be in the taxpayer's interest to argue it.) CTO Advanced Instruction Manual P.81 provides:

> **Effect of coming within s.142(1)**
> When a variation or disclaimer satisfies the requirements of IHTA 1984, s 142(1) (and, for variations only, there is a valid election):[26]
> - the variation or disclaimer is not a transfer of value (IHTA 1984, s 17(a))
>   and
> - the IHTA applies as if (IHTA 1984, s 142(1))
>
> – the deceased had effected the variation
>   or
> – the disclaimed benefit had never been conferred.
>
> Consequently, for example
> - if the extent to which the death estate is exempt is increased or decreased, you may need to adjust the tax on the whole of the death estate, including property taxable at a separate title, such as settled property in which the deceased had a life interest

26 This paragraph has not been revised since the abolition of elections in 2002, but this does not affect the point being made.

- if a variation sets up a non-interest in possession trust, the deceased is treated as the settlor
  and
- the GWR rules in FA 1986, s 102 cannot apply to a disposition which is accepted as a variation within IHTA 1984, s 142(1). This is because the effect of IHTA 1984, s 142(1) is that the deceased is treated as the donor. For an example see Chapter D, Gifts with Reservation at D.23.

The identity of the settlor for CGT is an unresolved question. The issue is whether s.62 TCGA 1992 overrides the general tax sense of settlor so that for CGT the settlor is S and not T. 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 suggests that the position would be different if:

(1) the instrument of variation was made after administration of the estate had been completed; or

(2) if the will or intestacy had been 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) if the disposition varied was a joint tenancy (because, as in (2), there is no administration period).

The position may also have been affected by the enactment of (what is now) TCGA 1992, s.62(9): this subsection was not in force in the tax years relevant to *Marshall v Kerr*.[27]

It appears to be the Revenue view that the beneficiary is the settlor. CG Manual 37888 (June 2003) provides:

> The Revenue 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*, preferred slightly different reasoning in holding that a residuary legatee, who had

27 See "*Marshall v Kerr* Revisited", *Taxation*, 3 May 2001 (Christopher Sokol).

> 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). This decision should be applied for the purposes of Sections 77 & 86 TCGA 1992 (charge on settlors of certain settlements) and Schedule 1 TCGA (annual exempt amount for trustees).

The author has been expecting further litigation on this aspect since 1994 but it has not happened yet and the question may remain forever unresolved.

34.15 Trust made by exercise of power of advancement

Where trustees have a power of advancement (that is, a power to pay or apply trust property to or for the benefit of a beneficiary) they may use that power to transfer trust property to a new trust.[28] The consent of the beneficiary is not needed and therefore the beneficiary is not the settlor of the trusts so created.

34.16 Trust with no element of bounty

34.16.1 *Is a trust without bounty a "settlement"?*

It is possible (albeit unusual) that a trust is made with no element of bounty. An example may be an employee trust made by the employer for his own benefit. Such a trust:

(1) is not a "settlement" for IT purposes: see 10.3 ("A settlement").

(2) is a settlement in the ordinary trust law sense, and in the usual CGT and IHT definitions of the term.

The Revenue accept this. CG Manual 34804:

> Companies frequently create settlements. These are generally settlements for employees, see CG35020, or other commercial

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28 See *Drafting Trusts and Will Trusts*, 6th ed., paragraph 10.11 (Power of advancement used to create new trusts).

arrangements, see CG35023. Such settlements are usually excluded from TCGA 1992 Section 77 because of the bounty test. Exceptionally it may be appropriate to argue that TCGA 1992 Section 77 applies to the particular settlement. Although there is no specific provision comparable to TCGA 1992 Schedule 5 Paragraph 8(4), nevertheless it may be appropriate in such a case to consider whether the property entering the settlement has been provided indirectly by the shareholders, both for the purposes of TCGA 1992 Section 77 and for the purposes of ICTA 1988 Section 660A.

34.16.2 *Who is the settlor of a trust with no element of bounty?*

CG Manual 33240 says:

> Because a person who has 'made' or 'entered into' a settlement is within the definition of settlor it is not considered necessary for 'bounty' to have been provided. Therefore employee trusts have a settlor. See CG33580 and CG35020+.

The argument is considered valid for the IHT definition of "settlor" which uses the words "made" or "entered into". The argument does not run for the CGT s.86 or s.79 definitions.[29]

34.17 Trust made by company

It is suggested that the IT and CGT settlement provisions do not (by implication) apply to settlements made by companies even if there is an

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29 The CG Manual accepts this:

> "**35020. Trusts for employees**
> There is nothing in Section 77 itself to prevent it being applied to a company. In particular, where a company has set up a settlement for its employees, the deed may provide that if all the trusts fail, the property may revert to the company. The most common cases are share option schemes and unapproved pension schemes. 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 Part XV Taxes Act and FA 1988, SCH 10 [TCGA 1992, S 77–TCGA 1992, S 79] can apply to top-up pension schemes. But this is not likely to be the case where the structure and operation of a scheme are broadly similar to an approved pension scheme.'"

element of bounty and so a settlement.[30] Where a company is a settlor, however, the controlling shareholder(s) will often also be settlor(s) because they provide property indirectly.[31]

34.18 Tax planning to create settlement with foreign domiciled settlor

The "who is the settlor" question may arise in a tax planning context.

Example 1

(1) H (UK domiciled) gives property to his wife W (not UK domiciled); and

(2) W gives it to a settlement.

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. It is suggested that the test is: does W have a genuine and wholly independent role? See 34.4 (Gift to B followed by gift to trust by B). As a practical matter 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[32] 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 settlement.

The settlor of the new trust will be B, not the settlor of the old trust: see

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30 See Venables and Kessler on the *Taxation of Charities*, 4th ed., paragraph 16.3.2.

31 Contrast 12.4.2 (Transfers by companies).

32 While W also needs tax advice, what matters here is that W has independent advice on the property law aspects of the gift.

34.6 (Appointment from old trust to B followed by gift to new trust by B). Of course, care must be taken in carrying out such schemes. 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 a botched execution of this scheme, see *Anker-Petersen v Christensen* [2002] WTLR 313.

CHAPTER THIRTY FIVE

SITUS OF ASSETS

35.1 Introduction

Situs[1] of assets is relevant for many tax purposes of which the most important for the foreign domiciliary are:

(1) IHT excluded property status; and

(2) the CGT remittance basis.

Situs (like domicile) is in origin a concept of private international law which has been adopted for tax purposes. The rules of private international law are laid down by the common law.[2] The common law rules apply for tax, except so far as modified by specific rules in the CGT and IHT legislation. The reader will not be surprised to find that different rules have emerged for the two taxes, leading to some unnecessary complexity. As a third tier of complexity, a number of old IHT double tax treaties override the usual IHT situs rules. These are not considered here. The income tax rules are different again: see 3.1 (Situs of source).

The reader who wants to research the common law rules in more detail is advised to turn to Dicey & Morris, *Conflict of Laws*, 13th ed., 2000. It is important to know the Revenue's view and the relevant extracts from the Revenue Manuals are set out in full, drawing together the comments

1 A note on terminology. IHT legislation generally refers to the "situs" or "situation" of assets. The TCGA refers to "location". One sometimes sees "local situation". The concept in each case is the same. "Situs" has become adopted into the English language and should not be written in italics.

2 The common law rules derive from ecclesiastical law: see *New York Life Insurance Co v Public Trustee* [1924] 2 Ch 101 at 119.

on IHT and CGT which are spread across the Manuals.

The starting point is that every asset is situate in one, and only one, jurisdiction.

The situs of tangible property, such as land and chattels, seems obvious (but occasionally the law does not adopt the obvious solution).

In relation to intangible assets (shares, debts, etc.), the law must somehow choose connecting factors to link the asset to a jurisdiction. In principle, it would not matter much what the rule was, as long as there is some rule and its application is clear. There is usually a large choice of possible connecting factors, and the selection of the determining factor must be arbitrary.[3] The consequence is an area of law with many anomalies. The situs concept is not well suited to serve as a territorial limitation for IHT and CGT. It is not surprising that situs no longer has the role it once had in private international law.

35.2 Registered shares and securities: situs for IHT

The CTO Advanced Instruction Manual provides:

> **S.16 Inscribed[4] and registered securities[5]**
> **S.16.1 General rule**
> The locality, for Inheritance Tax purposes, of inscribed and registered securities is governed by the situation of the register, entry upon which is necessary to complete the title of the owner of the security: see *Att Gen v Higgins* (1857) 2 H and N 339. See, however, CTO Manual S.17[6]

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3 In *R v Williams* [1942] AC 549 the Privy Council said:

> Shares in a company are "things in action" which have in a sense no real situs, but it is now settled law that for the purposes of taxation ... they must be treated as having a situs which may be merely of a fictional nature.

In *New York Life Insurance* (*supra*) the situs rules were described as "legal fictions". A better analysis is to say that "situs" (of a chose in action) is metaphorical language describing an abstract concept. The situs of a chose in action is not "fictional", but perfectly "real" (or at least as much so as concepts such as "residence" or "domicile" or indeed "chose in action") though the concept may be described as "technical" or even "artificial". Lawyers are entitled to use ordinary words in special senses and to call a situs a "fiction" is pedantic and inappropriate. See J.H. Baker, *The Law's Two Bodies*, OUP, 2001 lecture 2 ("Legal Fictions").

4 "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".

5 "Securities" here includes shares as well as "debt securities".

6 See 35.5 (Securities issued by international organisations).

below as respects certain international securities.

It is immaterial, for this purpose, that the business of the company may be wholly administered outside the country in which the register is kept: see *Baelz v Public Trustee* [1926] Ch 863.

S.16.2 Branch registers

When a company has more than one register, any stocks and shares registered on a branch register and transferable only by a change therein, 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 – see *Brassard v Smith* [1925] AC 371. "The true test", per Lord Dunedin, at p 376, is "where could the shares be effectively dealt with?": the last three words were explained by Viscount Maughan in *R v Williams* [1942] AC 541 at p 558 as meaning "effectively dealt with as between the shareholder and the company, so that the transferee will be legally entitled to all the rights of a member".

S.16.3 Effectiveness of register

When, therefore, shares are entered on a list (described as a register) maintained by the company, but a transfer cannot legally be effected thereon, the local situation of the list does not determine the locality of the holding – see *Erie Beach Co Ltd v Att Gen for Ontario* [1930] AC 161, where 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* (see CTO Manual S.16.2), that the *Erie Beach* case 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 – see CTO Manual S.16.8.

S.16.4 Exceptions governed by the "speciality" rule

The foregoing rules apply to inscribed and registered stocks, including debenture stocks, and to registered shares.

Debentures, however, if under seal, are specialty debts, locally situated where the document is found (see S.22).[7] 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 (see CTO Manual S.16.5).

S.16.5 UK government securities

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 – see *Royal Trust Co v Att Gen for Alberta* [1930] AC 144, a decision relating to registered bonds of the Dominion of Canada and their situation for the purpose of Alberta death duties.

Securities falling within the specialty rule include Treasury bills. British Savings Bonds stand on a similar footing. 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.

The text at this point has been withheld under the Code of Practice on Access to Government information.

National Savings Income Bonds, however, are securities registered on the National Savings Stock Register and as such are situate in the UK.

S.16.6 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 CA 1985, Sch.14 para.4, a company which maintains an overseas branch register has to keep a duplicate thereof at the place where its principal register is kept: but, subject thereto, "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 CA 1985, Sch.14 para.5.

Shares on the overseas branch register of a UK company are therefore situated, for Inheritance Tax purposes, in the country where the register

7 See 35.11 (Specialty obligations: situs for IHT)

is kept.

Under CA 1985, s 362 a company may maintain an overseas branch register. The countries and territories in which overseas branch registers may be kept are specified in CA 1985, Sch. 14. CA 1985, s 362(4) and CA 1985, s 362(5) enable the provisions as to overseas branch registers to be extended by Order in Council to countries within the jurisdiction, or under the protection, of the Crown.

S.16.7 Duplicate and multiple registers

Under certain overseas company laws, duplicate (or even multiple) share registers are permissible, and it is often open to the shareholder to use any register he pleases to record the transfer of his security.

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.

A point to be noted is that while some companies do maintain effective branch registers others do not but merely provide, as a matter of convenience, transfer offices whose function is simply to forward details of the proposed transfers to head office for entry on the register there; such transfer offices have no legal significance as respects locality.

Details of transfer arrangements given in the Stock Exchange Year Book do not always make the position clear and, if necessary, you should ask the parties to elucidate it.

In cases involving duplicate or multiple registers, and subject to the provisions of any relevant Double Taxation Convention, the locality of the holding is to be determined by selecting from the alternative available registers the one upon which the shares would normally be dealt with in the ordinary course of business – see *Treasurer of Ontario v Aberdein* [1947] AC 24. 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.

This general assumption may be refuted by the particular circumstances of the case (see *Standard Chartered Bank Ltd v IRC* [1978] 1 WLR 1160, [1978] STC 272) but if tax is offered on shares in a foreign company with transfer facilities in the UK, it may be assumed that the register here is the one on which the shares would normally be dealt with in the ordinary course of business.

...

As to cases where the share certificates are indorsed in blank, see CTO

Manual S.20.[8]

S.16.8 Canadian companies: transfer agencies

In the case of many companies incorporated under Canadian law, the register, entry upon which is necessary to complete title to the company's shares, is not a register of *shareholders* as with UK companies, but a register, or branch register, of *transfers* kept by one of the company's duly appointed "transfer agents".

In applying to these companies the test of "where could the shares be effectively dealt with" (*Brassard v Smith*, see CTO Manual S.16.2), the vital consideration is in what place or places the company has established transfer agents to operate a register, or branch register, of transfers. There may be, and generally 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 (see CTO Manual S.16.7).

The foregoing applies to shares registered in the name of the transferor or his nominee (including marking names), and whether or not the share certificates are indorsed in blank (*Treasurer of Ontario v Aberdein* [1947] AC 24. It may be taken as applying also whether the company in question was incorporated under Canadian dominion or provincial law.

S.16.9 Branch registers of British Columbian and Newfoundland companies

It is understood that the legislation of these provinces permits companies to keep branch registers outside the provinces so that 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. It is not considered that this restriction affects locality for Inheritance Tax purposes on the deceased's death.

S.16.10 Branch registers of Nova Scotia companies

It is understood that every company incorporated under the laws of Nova Scotia must keep at its registered office in the province a duplicate

8 See 35.9 (Share certificates indorsed in blank: IHT).

of any branch register kept outside the province. As regards transfers inter vivos, a distinction is understood to arise between:

(a) 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 should be treated as situated in the UK

(b) 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.

The instruction at CTO Manual S.16.9, concerning the situation on death, applies also to Nova Scotia companies. However, any case where implementation of this principle in relation to a company governed by the legislation of these Canadian provinces would deny a full credit for any Canadian provincial death taxes charged on the basis of a situs there on the death, should be referred to Pre-grant (Foreign) if difficulties arise, or to your Team Leader, in Scotland.

It is necessary for completeness to mention *Macmillan v Bishopsgate Trust (No. 3)* [1996] 1 WLR 387. This concerned a company incorporated and with a share register in New York. Auld LJ adopted the view set out above: see p.411e. Alarmingly, Aldous LJ states without discussion that the situs is the place of incorporation: see p.423f. Staughton LJ inclines to the same view but expresses himself more cautiously: see p.405e. However, this was a case where the Court did not have to decide between place of the share register and the place of incorporation as rival connecting factors for situs. 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 Revenue Manual tactfully ignores this case. It is a pity that the majority of the Court of Appeal did not express themselves more carefully or more cautiously; they have introduced into the law if not an uncertainty at least an inconsistency which needs to be explained away. But there it is.

35.3 Shares and securities issued by municipal or governmental authority: situs for CGT

Section 275 TCGA 1992 provides:

(d) shares or securities issued by any municipal or governmental authority, or by any body created by such an authority, are situated in the country of that authority.

The CG Manual provides:

12450. Shares and securities
(Published 7/94)
Shares or securities issued by any municipal or governmental authority or by any body created by such an authority are situated in the country of that authority, Section 275(d) TCGA 1992. This applies to shares and securities issued by such bodies whether they are in registered form or in bearer form (see below).

35.4 Registered shares and securities: situs for CGT

Section 275 TCGA 1992 provides:

(e) subject to paragraph (d) above, registered shares or securities are situated where they are registered and, if registered in more than one register, where the principal register is situated.

The CG Manual provides:

12451.
(Published 7/94)
Registered shares and securities other than those dealt with in the previous paragraph are situated where they are registered. This will normally be in the country where the company was incorporated. If they are registered on more than one register then they are located where the principal register is located, Section 275(e) TCGA 1992. Which register is the principal register is a question of fact.

It follows that there is an important distinction for CGT situs between:

(1) securities (if registered) whose situs is the place of the register, and
(2) debts which are not "securities" whose situs is the residence of the creditor.

"Security" is not defined. For a discussion of its meaning, see *Gore-Browne on Companies* paragraph 17.3; *Interests in Securities*, Benjamin, 1st ed., 2000, paragraphs 1.02 and 1.20. In practice a debt which is registered is likely to be a "security".

35.5 Securities issued by international organisations

The CTO Advanced Instruction Manual provides:

> **S.17 Securities issued by international organisations**
>
> **S.17.1 Designated international organisations**
>
> FA 1984, s 126 as extended by FA 1985, s 96 (now ICTA 1988, s 324) provides that any security issued by an international organisation designated by the Treasury for the purposes of the section by statutory instrument shall be treated for IHT as situated outside the UK. The following organisations have been so designated.
>
> (a) The Asian Development Bank: The International Organisations (Tax Exempt Securities) Order 1984 (SI 1984 No 1215) made on 2 August 1984
>
> (b) The African Development Bank: The International Organisations (Tax Exempt Securities)(No 2) Order 1984 (SI 1984 No 1634) made on 22 October 1984
>
> (c) (i) The European Community
>
> (ii) The European Coal and Steel Community
>
> (iii) The European Atomic Energy Community
>
> (iv) The European Investment Bank: The European Communities (Tax Exempt Securities) Order 1985 (SI 1985 No 1172) made on 25 July 1985 in respect of c(i)–c(iv)
>
> (d) The European Bank for Reconstruction and Development: The International Organisations (Tax Exempt Securities) Order 1991 (SI 1991 No 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.
>
> **S.17.2 OECD support fund and Inter-American Development Bank**
>
> Under s.4(1) OECD Support Fund Act 1975 and FA 1976, s 131(2) respectively, any security issued by the OECD support fund or the Inter-American Development Bank is treated as situated outside the UK for IHT purposes.
>
> **S.17.3 Other international securities**
>
> Unless in bearer form and situated physically in the UK securities issued

by the following organisations are effectively outside the charge to IHT where:

(a) they form part of the estate of a person domiciled outside the UK or

(b) they are comprised in a settlement and the settlor was not domiciled in the UK at the time the settlement was made, namely:
   - (i) the International Monetary Fund: The Bretton Woods Agreement Order in Council, 1946 (SR & O) 1946 No 36)
   - (ii) the International Bank for Reconstruction and Development: The Bretton Woods Agreement, as above
   - (iii) the International Finance Corporation: The International Finance Corporation Order, 1955 (SI 1955 No 1954)
   - (iv) the International Development Association: The International Development Association Order, 1960 (SI 1960 No 1383).

The CG Manual provides:

12470. Securities of International/European Organisations
(Published 7/94)
Special rules are provided for dealing with securities issued by International and European Organisations.

12471.
(Published 7/94)
Section 265 TCGA 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

12472.
(Published 7/94)

Section 266 TCGA 1992 also provides that any security issued by the Inter-American Development Bank shall be treated as located outside the UK for Capital Gains purposes.

35.6 Bearer shares and securities

The CTO Advanced Instruction Manual provides:

S.18 Bearer securities
A security which is represented by a document of title, the property in which passes by delivery, is locally situated, for Inheritance Tax purposes, in the place where that document is found at the material time – see *Att Gen v Bouwens* (1838) 4 M & W 171, *Winans v Att Gen* [1910] AC 27. (See, however, S.17 above as to certain international securities.)

This is correct and applies to shares as well as debt securities. As a precaution in a contentious case (such as tax avoidance) the bearer instruments should ideally be placed in a territory where there is a market for them; see *Young v Phillips* 58 TC 232.

The CG Manual provides:

12452. Shares and securities
(Published 7/94)
The Companies Acts allow companies to issue 'share warrants to bearer' or 'stock warrants to bearer' provided the company's Articles of Association allow it. These are commonly called bearer shares and securities. The name of the owner of such bearer securities is not recorded in the register of the company. They can be sold without any necessity to notify the company. The holder of the warrant is entitled to receive payment of dividends and, provided certain conditions are complied with, to vote at general meetings.

12453.
(Published 7/96)
The location of bearer securities issued by any body other than those referred to in CG12450 is not covered by a specific capital gains rule. Therefore it has to be decided in accordance with general law, *see* CG12420–12421. General law provides that such securities are located where the certificate is located. As for chattels, the location can change

if the certificate is moved in or out of the UK.

This is correct in relation to shares. It does not apply to debts, where a specific CGT rule does apply, overruling the common law rule: see 35.13 (Debt situs for CGT). But in the common arrangement of debentures, where a company owes a single debt to trustees, and investors hold merely an equitable interest in that debt, it is arguable that their right is not a "debt" and therefore dealt with by the common law principles of bearer securities not by the statutory CGT debt rule.

35.7 Letters of allotment

The CG Manual provides:

> **12460. Letters of allotment** [March 2003]
> Letters of allotment should be treated as located in the country where the company issuing the letters is registered. In the case of *Young v Phillips* 58 TC 232 bonus shares were issued in respect of registered shares located in the UK. The issue was made in letter of allotment form. The letters were then taken to the Channel Islands and disposed of there. It was held that the letters of allotment were located in the UK because they evidenced rights which were properly enforceable only in the UK.

The same rule must apply for IHT.

35.8 Eurobonds and depository receipts

There are no relevant statutory provisions, so the common law rules apply for IHT and CGT. But what is the rule? The CTO Advanced Instruction Manual deals with the matter very briefly:

> **S.19 Eurobonds and American depository receipts**
> The situs of securities dealt with through computerised clearing systems (e.g. Euroclear; CEDEL) is regarded as determined by the terms of issue of the particular security. ...

However, a published statement is more helpful:

> ... where a financial institution or other intermediary has purchased Eurobonds or similar fungibles through Euroclear or Cedel on behalf of a client-investor, the Revenue will treat the financial institution or intermediary as the nominee or agent of the client-investor, unless the terms of the particular issue prescribed otherwise. So, save in the excepted circumstances, the Revenue will look through the intermediary and treat the beneficiary-investor as owning the underlying Eurobonds or similar fungibles.
>
> We have also explained that, in the Revenue's view, the *situs* for IHT purposes of Eurobonds and similar fungibles in any issue depends on the terms of that issue and, in particular, where under those terms the bondholder's rights to or rights of action for property exist. Those rights will be determined by reference to general, not Revenue, law principles. So where title to the rights under an issue passes by delivery, the *situs* for IHT purposes of such rights is where the instrument of title is physically.
>
> There is little we can add to the foregoing guidance. In particular we cannot offer any undertaking about the likely future IHT liability which may arise in respect of rights to particular Eurobond issues currently extant or which may be issued in future.
>
> However, in order to be as helpful as possible, we can say that where a Eurobond issue satisfies the terms and conditions of section 124 of the Income and Corporation Taxes Act 1988, the Revenue will treat for IHT purposes the rights and interests of the beneficiary-investors in such issues as rights to and interests in a bearer security.
>
> ([1994] PCB 139)

The CG Manual discusses the nature of depository receipts in more detail:

> **50240. Depository receipts: general**
>
> You may come across assets referred to as Depository Receipts (DRs). The commonest are American Depository Receipts (ADRs).
>
> DRs are used as substitute instruments indicating ownership of securities such as shares. Although DRs may be owned by anyone, they are designed primarily to enable investors to hold and deal in shares of companies located in countries other than their own. Such activities might otherwise be inhibited by difficulties in transferring original share certificates from one country to another. The investors hold or trade the DRs rather than the share certificates themselves.
>
> A person holding shares for which DRs are available can convert them into DR form by depositing the share certificates with a local branch of

a depository (a financial institution such as a bank). The depository issues a DR. This document certifies that the depository, or an appointed custodian in the country of the underlying shares, holds the share certificates and that the owner of the DR is entitled to the share certificates on surrender of the DR. The precise detail of the arrangements may vary, but the holder of a DR will generally retain the rights attaching to ownership of shares, such as voting rights, and will receive via the depository any dividends on the shares, converted into the investors' local currency, or US Dollars for an ADR.
The holder of shares in DR form may at any time cancel the arrangement by asking for delivery of the share certificates in respect of their underlying shares, and surrendering the DRs at a local branch of the depository.

50241. Tax analysis
For capital gains purposes the holder of the DR has two separate chargeable assets, namely
- ♦ a beneficial interest in the underlying shares, and
- ♦ the DR (being the document evidencing title, and comprising a number of rights as against the depository).

A disposal of shares in DR form is therefore in strictness a disposal of two separate assets. In general, however, the value of a DR may be expected to track closely that of the underlying shares. So the consideration on any disposal may relate entirely, or almost entirely, to the shares themselves. In practice therefore you may not need to make any apportionment of base cost, or consideration received, on a disposal of shares in DR form.

50242. Tax analysis
If a person 'converts' shares into DR form, there is no change in their ownership of the underlying shares, but they have acquired a second asset, the DR itself. If a person 'converts' their DR back into the underlying shares, there is again no change in their ownership of the shares, but there will have been a disposal of the separate DR asset. Normal TCGA principles would apply to this disposal. Normally there will be no chargeable gain on such an event.

50243. Tax analysis – situation of assets
Although the DR itself may be issued outside the UK, you should not accept any suggestion that a disposal of shares in a UK registered company held in DR form by a non-domiciled person should give rise to chargeable gains only on a remittance basis, see CG25300+. It is to

> be expected that the great majority, or all, of any consideration on such a disposal will be attributable to the disposal of the beneficial interest in the shares themselves. The shares are, under Section 275(e) TCGA 1992, assets located in the UK, see CG12451, so the remittance basis will not apply.

Now, the general common law rule is that a bare trust is transparent for situs; that is, the situs of the interest of the beneficial owner is that of the underlying asset.[9] But a DR is unlike an ordinary bare trust in that it can readily be dealt with (i.e. transferred) in the jurisdiction of the depository. That is the jurisdiction where litigation over the transfer of a DR is likely to take place, and the better view is that that is the situs of the DR; the situs of the underlying shares is irrelevant. The 13th edition of 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.[10]

It must be frustrating for the Revenue to see a significant part of the economy taken out of the scope of UK tax by means of depository receipts. But in practice IHT at least on such assets is largely uncollectable. It is likely that the Revenue will back down on this point if pressed.

35.9 Share certificates indorsed in blank

The CTO Advanced Instruction Manual provides:

> **S.20 Share certificates indorsed in blank**
> Certificates of many American and Canadian railroads and of certain

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9 See 35.23 (Bare trust or nomineeship).

10 This view is enthusiastically supported by Joanne Benjamin's *Interests in Securities*, OUP, 2000, Chap 7. See too an interesting posting to the Trusts Discussion Forum V2 # 74 (Peter Cushen).

other companies have a printed form of transfer and/or power of attorney indorsed, 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 "indorsed in blank", i.e. for the indorsement 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. In order to guarantee that the purchaser will in fact receive his dividends with a minimum of trouble and risk, it is usual for the shares to be 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" (a list of good Marking Names recognised by the London Stock Exchange is printed in the Stock Exchange Official Year Book) though the beneficial owner may, if he wishes, have them registered in his own name, or in the name of some nominee other than a good Marking Name.

The local situation of shares for Inheritance Tax purposes is determined (subject, for the purposes of relief from double taxation, to the provisions of any relative Double Taxation Convention) according to the following rules:

(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. 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 should be referred to the Divisional Manager (B1)/your Team Leader, in Scotland.

(b) If the registered owner is
   - [i] the beneficial owner himself, or
   - [ii] a nominee of the beneficial owner, or
   - [iii] in the case of settled property, the trustees of the settlement or their nominees,

   the rules are as at (a) above. 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.
>
> [Paragraphing added]

This is consistent with the Revenue's view on DRs. It is arguable that if the good Marking Name is in the UK, the interest of the nominee is UK situate. The view taken in the Manual is favourable to the taxpayer so is unlikely to be challenged directly.

> (c) 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 (c) can apply: the registered owner will always be one of the persons named at (b) (in practice, almost always, 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.

35.10 Simple debt situs for IHT

By "simple" debt I mean a debt which is not a specialty. The CTO Advanced Instruction Manual provides:

> **S.22 Debts**
> **S.22.1 General principles: English law**
> A **simple contract** debt is situated, by English law, where the debtor resides: *Att Gen v Bouwens* (1838) 4 M & W 171; *English, Scottish and Australian Bank Ltd v IRC* [1932] AC 238.

In *Raiffeisen Zentralbank v Five Star Trading* [2001] QB 825 at 842, the Court of Appeal confirmed this test while admitting its arbitrary nature:

> In the case of intangible property, English law has, for various purposes (e.g. inheritance), traditionally allocated to it a situs at the place of the debtor's residence. This is on the basis that the debtor is there directly subject to the coercive power of the courts to enforce the obligation. The location of a right of action in this or any way is, however,

> evidently artificial. Parenthetically, I add that "coercive power" would itself appear to be an unstable international concept, capable of widely differing interpretation ...
>
> Modern conditions underline the artificiality of selecting supposed control at the debtor's residence as an appropriate basis for characterisation or choice of the relevant law to determine questions regarding the validity or effect as against the debtor of an assignment. Jurisdiction may be grounded on consent and various other bases apart from residence. Obligations are commonly enforced today not against the person, but against assets. Debtors often trade or hold some or even all of their assets overseas. Proceedings are as a result often begun and enforced against debtors in countries other than that of their residence, as in this case. The move towards single legal markets, like those involving countries party to the Brussels and Lugano Conventions, makes judgments readily exportable between countries.

Although the reason for the rule no longer holds, the rule still survives and is as good as any other. Well established precedents are not overturned merely because the historic reason has become unsound. So it is submitted that the law is settled.

35.10.1 *Debt under letter of credit*

The CTO Advanced Instruction Manual S.22.1 continues:

> 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 Ltd v National Bank of Kuwait* [1981] 3 All ER 607).

35.11 Specialty obligation: situs for IHT

35.11.1 *Meaning of "specialty"*

"Specialty" is an opaque word 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.[11] It follows that life policies, contracts for deferred annuities, and capital redemption policies and the like may be specialties if made by deed.

(3) The term also includes a debt incurred under a statute, whether or not it is a debt under a deed: *Royal Trust Co v AG for Alberta* [1930] AC 144. The specialty in that case was securities issued by Canada under the authority of local legislation.

(4) Certain debts are by statute given the nature of a "specialty" debt.[12]

The requirements for a document to be a "deed" in English law were formerly that the document must be "signed, sealed and delivered". 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". It is clear that this alteration governs the meaning of "specialty". So a seal is not now required for an English law document to be a "specialty". The Law Commission took this view in the relevant Working Paper (no. 85, 1985) and in their Report no. 253, para. 2.12ff. No particular form is necessary to be a "specialty" beyond the formalities of a deed.

As a shorthand, a deed was often referred to as a document "under seal". (The other requirements all being assumed to be satisfied.) This usage is now out of date. When the Revenue Manuals refer to a document "under seal" the reference is to a document which satisfies the current requirements of a deed.

35.11.2 *Documents governed by foreign law*

Authority is scant, but it is suggested that the position depends on whether the local law has a concept of a "deed" (and a "specialty").

A document governed by foreign law which recognises "deeds" is a

11 In *Aiken v Steward Wrightson Agency* [1995] 1 WLR 1281 the term was applied to a contract under a deed to provide services (and an action for breach of that contract was held to be an action "upon a specialty" so as to qualify for a twelve year limitation period).

12 e.g. s.14(2) Companies Act 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."

specialty if it is executed in accordance with the local law requirements of a "deed". In the Isle of Man, for instance, no seal was ever required to constitute a written document a deed, though the parties must intend the document to be a deed: see *Aall Trust & Banking Corporation Ltd v Samuel McCormick* 2 OFLR 85, Butterworths Offshore Service Cases, Vol 2, page 479.

A document governed by a foreign law which does not recognise deeds will be a specialty if it is executed in accordance with the English law requirements of a deed, even though the local jurisdiction does not recognise deeds: *The Alliance Bank of Simla v Carey* (1880) 5 CPD 429.

35.11.3 *Situs of specialty*

The rule is that a specialty is situate in the country where the deed itself is situate. 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 Revenue accept this. The CTO Advanced Instruction Manual s.22.1 provides:

> **S.22 Debts**
> **S.22.1 General principles: English law**
> ...
> A **specialty** debt is situated, by English law, where the instrument happens to be at the material time: *Att Gen v Bouwens Commr of Stamps (New South Wales) v Hope* [1891] AC 476. (See also CTO Manual S.16.4.)
> 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 rule that registered securities are situate where registered. The Revenue accept this: see CTO Manual 16.4, 16.5 set out at 35.2 (Registered shares and securities: situs for IHT).

35.11.4 *Scottish specialties*

The CTO Advanced Instruction Manual continues:

S.22.2 General principles: Scottish law
In Scotland, the rule that a debt is situated where the debtor resides applies alike to specialty 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 the case should be referred (to your Team Leader (Sco)).

S.22.3. Scottish specialities found abroad
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 IHTA 1984, s 159 is admissible should be referred to the Divisional Manager (B1)/Team Leader (Sco) 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, to the extent explained in CTO Manual S.16.4.[13]

(Paragraphing added)

I find the comments relating to Scotland somewhat surprising.

35.11.5 *Reason for the specialty situs rule and future developments*

What is the reason for this rule? In *R v Williams* [1942] AC at 555 the Privy Council offer this explanation:

> Such an obligation [a specialty debt] was for centuries treated as very different from an ordinary debt. Indeed, the act of creating a specialty by deed was at one time possible only to men of the highest rank. Unlike debt, it was enforced by an action of covenant[14]: 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[15]; and,

13 See 35.2 (Registered shares and securities: situs for IHT).
14 This ceased to be the case with the Civil Procedure Act 1833.
15 This rule was abolished by the Administration of Estates Act 1869.

> unlike such debts,[16] were enforceable against the real estate. 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 situs rule has no valid reason but *Commissioner of Stamps v Hope* [1891] AC 476 offers a different reason:

> ... the distinction drawn and well settled has been and is whether it is a debt by contract or a debt by specialty. In the former case, the debt being merely a chose in action – money to be recovered from the debtor and nothing more – could have no other local existence than the personal residence of the debtor, where the assets to satisfy it would presumably be, and it was held therefore to be bona notabilia [i.e. assets situate] within the area of the local jurisdiction within which he resided; but this residence is of course of a changeable and fleeting nature, and depending upon the movements of the debtor, and inasmuch as a debt under seal or specialty had a species of corporeal existence by which its locality might be reduced to a certainty ... it was settled in very early days that such a debt was bona notabilia where it was "conspicuous," i.e. within the jurisdiction within which the specialty was found at the time of death: see Wentworth on the Office of Executors, ed. 1763, pp. 45, 47, 60(1).

The reason for the rule is not that the specialty has a "species of corporeal existence".[17] The reason is that the situs rule for a specialty is certain and easier to apply than that for a simple contract. There is a little sense in that.

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16 This rule was abolished by the Administration of Estates Act 1833.

17 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.

A bold House of Lords might one day sweep these dusty cobwebs away.[18] But the issue of situs scarcely arises nowadays outside tax cases. The Revenue are not likely to argue the point against their own Manuals. It will not normally be in the interest of a taxpayer to argue against the specialty rule, as a well advised taxpayer will keep his specialties outside the UK. So the Courts are not likely to have that opportunity to examine the issue (except perhaps in litigation relating to Scotland or in the Privy Council). The House of Lords has shown itself prepared to amend long established common law rules, such as the rule that there is no recovery for payments made under an error of law. But it has generally done so when the old law not only lacks a logical basis but is also conducive to injustice. That is not the case here. Well established precedents are not overturned merely because the underlying principle is logically precarious. So it is submitted that the law will remain as it is even if challenged in the Lords.

35.12 Debt secured on land

In the case of a debt charged on land and made by deed, the choice lies between:

(1) The location of the land.

(2) The specialty rule (situs is location of deed).

Let us look at the matter as one of principle. Is the rule that situs depends on location of the land a sensible or workable rule? It is not, for the following reasons:

(1) The 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

18 It is interesting to note that the specialty rule was reversed by statute for probate duty: Revenue Act 1862.

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 document 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 explanation of this case is probably that it did not concern the common law situs rule. A different rule was implied by implication for the purpose of the relevant statute (the Queensland Dividend Duty Act of 1890). This explains why the earlier case of *Commissioner of Stamps v Hope* was not referred to in the judgement of the Privy Council.

Toronto General Trust Corporation v The King [1919] AC 679 is an exceptional case that proves the existence of the general rule. Here a mortgage debt was represented by two duplicate deeds, one in Ottawa and one in Alberta. In such a case one cannot apply the rule that the debt is situate where the deed is situate, so it is sensible to fall back on the simple contract rule. But had there been only one deed, it is plain that the debt would have been situate where the deed was.

Dicey states:

> A mortgage debt is normally a specialty. A mortgage of land confers an

> interest in land and will be held situate where the land is situate,[19] 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.[20] … 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.[21]

With respect, this overlooks *Commissioner of Stamps v Hope*. The case cited, *Re Hoyles*, 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 necessarily 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 CTO Manual's passage cited above[22] suggests that this is the Revenue view: situs is determined by the location of the specialty, not the location of the 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 the simple debt rule prevails. This conclusion is also supported by the passage from *Raiffeisen* cited in 35.10 (Simple debt situs for IHT). This conclusion is consistent with the position for specialty debts secured on land.

19 [Dicey's footnote] *Re Hoyles* [1911] 1 Ch 179.

20 [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.

21 Dicey's footnote refers to: *Re Hoyles* [1911] 1 Ch 179; *Dicey* para. 22–012; Falconbridge, *Selected Essays on the Conflict of Laws*, 2nd ed. 1954 pp.573–580.

22 35.11.3 (Situs of specialty); note the two references to mortgages in the quotation at 22.1 and 22.3 [1].

35.13 Debt situs for CGT

A debt is in some cases a chargeable asset for CGT, so its situs may be relevant for CGT. Section 275 TCGA provides:

> (c) subject to the following provisions of this subsection, a debt, secured or unsecured, is situated in the United Kingdom if and only if the creditor is resident in the United Kingdom,
>
> ...
>
> (k) a judgment debt is situated where the judgment is recorded.

The CG Manual explains:

> **12440. Debts**
> Judgment debts, that is, debts created by the judgments, decrees, etc, of courts of record, are located where the judgment is recorded, Section 275(k) TCGA 1992.
>
> **12441.**
> The general rule for other debts is that the debt is situated in the UK if and only if the creditor is situated in the UK. This applies whether the debt is secured or unsecured, Section 275(c) TCGA 1992.

The rules relating to municipal securities, government securities and registered securities take precedence over this provision; see 35.3 (Shares and securities issued by municipal or governmental authority: situs for CGT) and 35.4 (Registered shares and securities: situs for CGT). This provision does override the specialty rule (which applies for IHT) and the rule for bearer securities.

35.14 Situs of bank account for IHT

The CTO Advanced Instruction Manual provides:

> **S.23 Bank accounts**
> A bank account is a debt, and under general law is situated at the branch of the bank where the account is kept: *R v Lovitt* [1912] AC 212. ...
> This general law rule may be modified for IHT purposes by a Double Taxation Convention ...

Note, however, that UK bank accounts may qualify as excluded property;

see s.157 IHTA 1984.

35.15 Situs of bank account for CGT

A foreign currency bank account is normally a chargeable asset for CGT; s.252 TCGA 1992.[23] The question therefore arises as to the situs of the account for CGT. Section 275(l) TCGA 1992 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 United Kingdom,
>
> is situated in the United Kingdom if and only if that individual is resident in the United Kingdom and the branch or other place of business of the bank at which the account is maintained is itself situated in the United Kingdom.

The moral is that a foreign domiciled UK resident individual should keep chargeable foreign currency in non-UK bank accounts. In cases where the conditions (i), (ii) and (iii) are not all satisfied, the usual CGT debt rule applies.

35.16 Insurance policies

The CTO Advanced Instruction Manual provides:

> **S.24 Policy monies**
>
> **S.24.1 Policies under hand**
>
> The general rule as to the locality of sums due under a policy of life assurance, when the policy is under hand, is that they are situated where the debtor is resident (generally the head office of the company). Where, however, 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).

23 To this there is one exception, relating to personal expenditure: s.252(2).

S.24.2 Policies issued through foreign branch offices of UK companies

A further type of case is one in which the 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. In such cases the 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:

(a) that the policy is issued to a resident in that country from the branch in that country
(b) that the holder of the policy remains resident and retains the policy there, pays the premiums to the branch there, and dies there
(c) that representation to his estate is taken there and the money collected there.

With regard to condition (b), if in any case the assured has assigned the policy to the assurance company as security for a loan and the policy has been sent to the head office in the UK and is in the UK at the date of the assured's death, the policy is not on that account only to be regarded as situated in the UK.

Divergence in detail (for example, discontinuous residence) would not necessarily lead to a different conclusion, but when any of the conditions is not fulfilled, or where the locality of the policy has to be determined before the policy holder's death, the question will fall to be considered by reference to the particular facts of the case. Any such case should be referred to Pre-grant (Foreign) for consideration.

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.

S.24.3 Policies under seal

The locality, for Inheritance Tax purposes, of policies under seal[24] is governed in all respects by the rules relating to specialty debts – see S.22.[25] Most Lloyds policies are embossed with a seal but they are not specialties unless additionally they bear the witnessed personal signature

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24 "Under seal" should be read to mean "made by deed" in the light of the changes to deeds: see 35.11.1 (Meaning of "specialty").

25 See 35.11 (Specialty obligation: situs for IHT).

of the General Manager of Lloyds Policy Signing Office.

The situs of policies and bonds rarely arises for CGT, because of the relief for policies, see 19.11 (CGT), but the same (common law) principles would apply.

35.17 Land

The CTO Advanced Instruction Manual provides:

> **S.26 Land/interest in land**
> Immovable property is situated where it is actually located, but you should 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.

For CGT, s.275(a) TCGA 1992 provides:

> (a) the situation of rights or interests (otherwise than by way of security) in or over immovable property is that of the immovable property.

The CG Manual provides:

> **12430. Land and buildings**
> (Published 7/94)
> Land and buildings are located in the country where they are found. This applies to all rights and interests in the land and buildings. It will therefore apply to leases of land, tenancies etc, Section 275(a) TCGA 1992.

35.18 Chattels

The rule is what one would expect. The CTO Advanced Instruction Manual provides:

> **S.27 Chattels**

Chattels are situated where they happen to be at the relevant time.

For CGT, s.275(b) TCGA 1992 provides:

subject to the following provisions of this subsection, the situation of rights or interests (otherwise than by way of security) in or over tangible movable property is that of the tangible movable property.

The CG Manual provides:

12435. Chattels
(Published 7/94)
Items of tangible moveable property (chattels) are located where they are found at any point in time. This applies to all rights and interests over such assets also. Therefore a lease of a chattel can change from being located in the UK to being located elsewhere if the chattel is removed from the UK to another country, Section 275(b) TCGA 1992.

35.19 Works of art

There is an extra-statutory concession for works of art:

F7 Foreign owned works of art
Where a work of art normally kept overseas becomes liable to inheritance tax on the owner's death solely because it is physically situated in the United Kingdom at the relevant date, the liability will—by concession—be waived if the work was brought into the United Kingdom solely for public exhibition, cleaning or restoration. If the work of art is held by a discretionary trust (or is otherwise comprised in settled property in which there is no interest in possession), the charge to tax arising under IHTA 1984 s64 will, similarly, be waived.

In other respects the usual chattel rules apply.

35.20 Ships and aircraft

The CTO Advanced Instruction Manual provides:

S.25 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.

For CGT, s.275(f) TCGA provides:

> a ship or aircraft is situated in the United Kingdom if and only if the owner is then resident in the United Kingdom, and an interest or right in or over a ship or aircraft is situated in the United Kingdom if and only if the person entitled to the interest or right is resident in the United Kingdom.

The CG Manual provides:

> **12480. Ships and aircraft**
> (Published 7/94)
> Contrary to the general rules of international law, for capital gains purposes the location of a ship or aircraft does not depend on its country of registration. Instead the ship or aircraft is located in the UK if and only if the owner is resident in the UK. Similarly any interest or right in or over the ship or aircraft is located in the UK if and only if the owner of the interest or right is resident in the UK, Section 275(f) TCGA 1992.

35.21 Goodwill

For CGT, s.275(g) TCGA provides:

> the situation of good-will as a trade, business or professional asset is at the place where the trade, business or profession is carried on.

The CG Manual provides:

> **12490. Goodwill**
> (Published 7/94)
> Goodwill which is an asset of a trade, profession or vocation is located where the trade, profession or vocation is carried on, Section 275(g) TCGA 1992. 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.

It is considered that the same applies for IHT, though because of Business

Property Relief, the issue will not often arise.

35.22 Intellectual property

Section 275 TCGA 1992 provides:

> (h) patents, trade marks, and registered designs are situated where they are registered, and if registered in more than one register, where each register is situated, and rights or licences to use a patent, trade mark, or registered design are situated in the United Kingdom if they or any right derived from them are exercisable in the United Kingdom,
>
> (j) copyright, design right and franchises, and rights or licences to use any copyright work or design in which design rights subsists, are situated in the United Kingdom if they or any right derived from them are exercisable in the United Kingdom.

35.23 Situs of equitable interest under a bare trust or nomineeship[26]

The interest of a beneficial owner in property held by a nominee or bare trustee is situate where the underlying asset is situate: a nomineeship or bare trust is "transparent" for situs. See *Re Clore IRC v Stype Investments* [1982] STC 62 at 633–4 (where land in England was held by a Jersey nominee). The practice of the Revenue is to look through nomineeship of all kinds.[27] Thus it is quite safe for a foreign domiciled individual (or trust with a foreign domiciled settlor) to hold foreign securities through a UK stockbroker's nominee.

What happens in practice if an individual with no connection to the UK dies holding a portfolio of securities including UK situate securities held by a nominee? I suspect that it is not the practice of the nominee to require a grant of probate in every jurisdiction in which the securities are situate, though it has been suggested that this would be desirable.[28] Otherwise it may be necessary to seek grants in many jurisdictions and the administration of estates would be made considerably more difficult. If it is correct that a nominee for an individual unconnected with the UK,

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26 For present purposes the terms "bare trust" and "nomineeship" are identical.

27 See 35.8 (Depository receipts) and 35.9 (Share certificates indorsed in blank).

28 See the thread in the Trusts Discussion Forum, September 2002, under the heading "Onshore/Offshore" accessible on *www.trustsdiscussionforum.co.uk*.

holding UK situate assets, does not require probate then the IHT strictly payable on the death of the individual in respect of the UK situate securities held by the nominee is uncollectable. This brings into question the proposition that securities situate in country A held by nominees in country B should be regarded as situate in country A and not in country B. The rule that one looks through nominees holding securities (as opposed to land) makes little sense in current market conditions. But the opposite rule would have disastrous consequences for the situs as no foreign domiciled individual (or trust with a foreign domiciled settlor) could use UK stockbroker nominee services. The status quo is better than the alternative. Underlying the problem is the fundamental unsuitability of a situs rule to determine territorial limitations for tax purposes, at least in relation to intangible assets such as securities.

35.24 Situs of equitable interest under a substantive[29] trust

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.[30]

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

29 By "substantive" I mean a trust other than a bare trust (nomineeship) or unit trust.

30 For a contrary view see Jonathan Harris, *The Hague Trusts Convention*, 1st ed., 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.

This conclusion has few significant tax planning implications because the situs of an equitable interest under a substantive trust is only rarely relevant for UK tax purposes: examples would include situations where a reversionary interest is not "excluded property" for IHT, or where an equitable interest is within the scope of CGT.

35.25 Situs of unit in a unit trust

The situs of a unit is not normally relevant for IHT[31] but it matters for CGT. A unit is quite unlike an equitable interest under a conventional trust. A unit trust is based on contract, as well as trust, and is governed to some extent by company law principles. One should not apply rules governing other kinds of equitable interests without considering this.

It is suggested that share/security situs rules should normally be applied, so that the place of the register is normally the determining factor. The Revenue accept this.[32]

Another possible view is that situs depends on the residence of the trustees. In practice a situation where the place of residence of the trustees is different from the place of the register would be so rare that the priority between the two tests may never need to be decided. The residence of the trustees determines whether the unit trust is an "offshore fund" for the purpose of the offshore funds provisions: see 20.2 (Meaning of "offshore fund"). It might therefore be said to be consistent with the CGT legislation if situs of a unit depends upon the residence of the trustees. However, situs is not a CGT concept but a general law one so the relevance of the CGT position 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

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31 See 23.4 (Authorised unit trusts and OEICs).

32 Press Release 16th October 2002 (OEICs and AUTs) para.9 stated (before the introduction of s.6(1A) and s. 48(3A) IHTA 1984):

> "[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.

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.[33]

(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 bought and sold constantly by the trustees of the unit trust. The holder of a unit normally has no further rights 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.

The reader interested in this topic should study Kam Fan Sin, *The Legal Nature of the Unit Trust* (1997), Clarendon Press.

35.26 Unadministered estate of deceased person

The CTO Advanced Instruction Manual provides:

> **S.21 Unadministered estates or shares therein**
> **S.21.1 Position under general law**
> A person who takes an absolute interest as a residuary legatee, under English law and many other legal systems,[34] is entitled, not to the assets **in specie** of the testator, but to a **chose in action**, enforceable against the executors, requiring them to administer the estate and to transfer the clear residue, or a share thereof, as the case may be. The same rule

33 A similar argument applies in relation to the situs of an equitable interest under a substantive trust.

34 Author's note: Further consideration will be required for jurisdictions other than England and Wales, especially civil law jurisdictions.

applies in the case of an intestacy.
A similar rule applies to the *ius crediti* which a Scots beneficiary has.

The "chose in action" is situate where it is enforced, i.e. where the executors are. The situs of the assets of the estate is not relevant. See *CSD v Livingston* [1965] AC 694. This will apply for CGT. The CTO Advanced Instruction Manual continues:

S.21.2 Treatment for IHT
IHTA 1984, s 91 contains special rules for IHT purposes, under which 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.
Consequently you should, in such a case, consider separately the situs of each of the underlying assets.
For example, the excluded property provisions in IHTA 1984, s 6(2) may apply to qualifying securities included in the unadministered estate.

CHAPTER THIRTY SIX

DUTIES OF DISCLOSURE

36.1 Reporting requirements on creation of settlement

There is in principle no obligation to report to the Inland Revenue the creation of a trust made by a foreign domiciliary unless that trust receives income or gains subject to UK tax. The position with regard to settlements with a UK domiciled (or deemed domiciled) settlor is governed by s.218(1) IHTA 1984:

> Where any person, in the course of a trade or profession carried on by him, other than the profession of a barrister, has been concerned with the making of a settlement and knows or has reason to believe—
> (a) that the settlor was domiciled in the United Kingdom, and
> (b) that the trustees of the settlement are not or will not be resident in the United Kingdom,
>
> he shall, within three months of the making of the settlement, make a return to the Board stating the names and addresses of the settlor and of the trustees of the settlement.

Several conditions must be satisfied for the duty to apply to a person:

(1) The person must be acting in the course of a trade or profession carried on by him.

Barristers are exempt from this duty. The reason must be that they will usually be instructed by others who are subject to the duty. The duty rests on the firm or company acting and not directly on its employees.

(2) The practitioner must be concerned with the making of a settlement.

This would include not only solicitors who might draft the settlement but other advisors who advise in relation to the creation of a settlement, even if the actual execution of the settlement were delegated to foreign advisors.

The practitioner might advise on the matter generally, leaving the client to take whatever action he wishes in light of the advice, perhaps in conjunction with the trustees; in such circumstances he is probably not "concerned with the making of a settlement"; this presupposes the settlement had been established. What if the client had decided against a non-resident settlement after all or wanted to think about it? The practitioner may not know what the client eventually decided to do. The obligation under s.218 must obviously be restricted to those who are able to provide the relevant information.

(3) The practitioner must know or have reason to believe that the settlor is domiciled in the UK.

"Settlor" for this purpose has the usual IHT meaning: see 34.1 (Who is the settlor?). A settlement may have more than one settlor. Supposing one settlor is domiciled in the UK but the other is not. Does the reporting requirement arise? On a literal construction one could not say "the settlor" is UK domiciled and the reporting requirement would not arise. The answer may be that there are deemed to be two separate settlements for IHT. In any event, a purposive construction suggests that the duty does arise, and that is the better view. A practitioner should err on the side of caution.

A question also arises about the time when the settlor's domicile is relevant. Section 218 merely says that it applies if the settlor *was* domiciled in the UK. Does this mean domiciled in the UK at the time the settlement was made? Or does it mean that the settlor had at any time been domiciled in the UK. Context and common sense dictate that the provision should be interpreted as referring to the domicile of the settlor at the time the settlement was made because that is the date that matters for IHT.

(4) The person must know or have reason to believe that the trustees of the settlement are not or will not be resident in the United Kingdom

TCGA 1992 Schedule 5A imposes overlapping reporting requirements relating to non-resident settlements made by UK domiciled settlors. But s.218 IHTA is wider in three respects. First, it applies to a deemed domiciliary. Second, it applies to settlements which are not necessarily non-resident under the CGT rule.[1] Third, the CGT duty is imposed on the settlor. The duty here is on the professional advisors.

In marginal cases the practitioner may be placed in difficulty. It may be necessary in some cases to disclose the creation of the settlement to the Inland Revenue out of caution.

There is no requirement under s.218 to notify the amount or nature of the settled property. This is unlikely to impede the Inland Revenue because they have power in s.219 to require information to be provided by "any person" and they would know from the notification to whom further enquiries could profitably be directed.

36.1.1 *Non-resident practitioner*

It is arguable that no duty will arise on foreign practitioners who have no UK connection; the usual territorial limitation must apply: see *Clark v. Oceanic* 56 TC 183. However, the author is inclined to think that the requirement that the settlor is domiciled in the United Kingdom is sufficient to meet the territorial requirements so that no further territorial limitations should be implied.

36.1.2 *Penalty for failure to disclose*

Failure to make the return can give rise to a nominal penalty.

More seriously, the practitioner faces criminal liability for fraud on the

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1 The test of non-residence for the purpose of s.218 is set out in by s.218(3):

> "For the purposes of this section trustees of a settlement shall be regarded as not resident in the United Kingdom unless
>
> [1] the general administration of the settlement is ordinarily carried on in the United Kingdom and
>
> [2] the trustees or a majority of them... are for the time being resident in the United Kingdom."
>
> (Paragraphing added)

A quick reading of this provision may give the impression that the test is the same as that which applies for CGT. See 4.4 (Trust residence for CGT). However, although the wording is similar the effect is significantly different. A trust is non-resident for CGT only if neither conditions [1] nor [2] are not satisfied. A trust is non-resident for s.218 if only one of these conditions is not satisfied.

Revenue or conspiracy to defraud if:

(1) the practitioner dishonestly fails to disclose when a duty lies on him to do so; or

(2) any person agreed with another practitioner or a client that there shall be no disclosure.

36.2 IHT account on death of foreign domiciled individual

Section 216 IHTA 1984 provides that, with certain exceptions, the personal representatives of a deceased person must deliver to the Board an account specifying to the best of their knowledge and belief all "appropriate property" and the value of that property. "Appropriate property" (in short) means all property which forms part of the deceased's estate immediately before his death, so excluded property need not be returned.

The IHT (Delivery of Accounts) (Excepted Estates) Regulations 2002 provide relief for "excepted estates". The regulations distinguish between those who die domiciled in the UK and those who do not. In relation to those dying domiciled outside the UK, there is no duty to put in an account if the following conditions are satisfied:

> (a) the person died on or after 6th April 2002;
> (b) he was never domiciled in the United Kingdom or treated as domiciled in the United Kingdom by section 267 of the 1984 Act; and
> (c) the value of that person's estate situated in the United Kingdom is wholly attributable to cash or quoted shares or securities passing under his will or intestacy or by survivorship in a beneficial joint tenancy or, in Scotland, by survivorship, the gross value of which does not exceed £100,000.

See regulation 3(3).

Curiously, this is the case even if the individual has made prior chargeable transfers so there is a tax charge on death (though there may be a separate duty to put in an account of the earlier transfers).

It follows that an Inland Revenue account (Form IHT 200) is strictly required in every case where any deceased person dies domiciled outside the United Kingdom leaving any property in the United Kingdom other than cash, quoted shares or securities . It does not matter that no tax is payable on the death (e.g. because the property falls within the nil rate band). How well observed this requirement is in practice is another matter. However, if an individual wishes to ensure that his personal representatives are under no duty to put in returns to the United Kingdom on his death, he must not have any United Kingdom situate property at the time of his death (apart from up to £100,000 value of cash, or quoted shares or securities). Then there is no duty to put in an account.

36.3 Proceeds of Crime Act 2002 and disclosure of tax avoidance schemes

A discussion of these topics is outside the scope of this book.