# 2 Tax avoidance and the courts

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## I INTRODUCTION

### 1 The problem of tax avoidance

> 'Aggressive tax avoidance is unacceptable, The majority of hardworking people in this country pay the right amount of tax and they quite rightly expect everyone else to do the same. But the behaviour of a small minority – both those who seek to avoid and those who devise and promote tax avoidance schemes – undermines the honesty of the majority.
>
> As a key part of our long term economic plan, this government has taken significant strides to make the UK's tax system one of the most modern and competitive in the world. To maintain the integrity of this tax system, it must apply fairly and consistently to everyone.' ((The Exchequer Secretary to the Treasury, David Gauke MP, *Raising the stakes on tax avoidance: summary of responses and draft legislation*, January 2014)

The desire to escape the payment of tax need scarcely occasion surprise. In some cases, this may be achieved either by non-declaration or by the making of a fraudulent return (eg by deliberately under-declaring), both of which are examples of tax evasion, that is, illegal acts, subject to criminal sanctions. However, the greater number of situations concern attempts to avoid or minimise the payment of tax. Although there is currently an ongoing debate on questions of tax justice and tax morality, highlighted by the activities of pressure groups such as the Tax Justice Network and UK Uncut, tax avoidance remains something a taxpayer is legally entitled to do. As Lord Templeman said in *Ensign Tankers (Leasing) Ltd v Stokes* (1992), 'there is no morality in a tax and no illegality or immorality in a tax avoidance scheme'.

The policy of the former Labour Government had been to equate tax evasion *and* tax avoidance with non-compliance with a view to prosecuting both; although optimism was expressed by some that the Coalition Government (2010–2015) was likely to be more ready to maintain the historical clear focal divide between tax avoidance and tax evasion, this has not been the case. With the introduction of the general anti abuse rule (GAAR – see **[3.74]**), bringing with it a shift of emphasis from 'tax avoidance' *simpliciter* to 'abusive tax avoidance', the distinction between tax evasion and tax avoidance has become an even finer one. In light of cases such as *Moyles v R & C Comrs* (2014) (see **[2.38]**), this would seem justifiable despite the criticism by one commentator that this approach amounts to an 'abuse of rights' on the part of the authorities. Accordingly, the distinction is now between on the one hand, 'tax planning', referring to the sensible use of the available exemptions and reliefs which Parliament intended and, on the other hand, aggressive tax avoidance where, often, the sums involved are greater, the methods adopted by the 'tax planning industry' to escape the fiscal net may take on a complexity that is beyond the comprehension of most individuals and may involve schemes which are divorced from reality (although this distinction too may now have become blurred following the Chancellor of the Exchequer's July 2015 Budget Speech when he referred to the need to combat tax evasion, avoidance *and* 'aggressive tax planning'). Indeed, in one Supreme Court case Lord Walker spoke of 'the unremitting ingenuity of tax consultants and investment bankers determined to test the limits of the capital allowances legislation' (*R & C Comrs v Tower MCashback LLP 1 and another* (2011), and the sentiment is not restricted to the capital allowances legislation but extends to most other tax legislation. Categorised now by HMRC as 'aggressive tax avoidance', this latter situation is clearly the one envisaged by the OECD, which suggests that such avoidance is 'the arrangement of a taxpayer's affairs that is intended to reduce his tax liability and … although the arrangement could be strictly legal it is usually in contradiction with the intent of the law it purports to follow.' Various Government publications for over a decade confirm that it is losing considerable amounts of revenue through tax avoidance practices such as these, as well as through tax evasion. In *Protecting Tax Revenues* (HMRC, March 2008) the Revenue explained why protecting tax revenues mattered:

> '… a strong and growing economy based on opportunity for all and a fair society in which everyone shares in rising national prosperity … requires a modern tax system that encourages work and savings, keeps pace with business developments and globalisation and supports the provision of public services.
>
> For such a system to be effective, it needs to operate fairly and effectively. Those who attempt to pay less than their fair share through fraud or by undertaking artificial avoidance schemes undermine the ability of the tax system to deliver these objectives …'

The effect of the behaviour of those who do not pay the tax they should (either through lack of care or understanding on the taxpayer's part or through the use of highly artificial avoidance schemes or through evasion or fraudulently obtaining tax repayments) results in a shortfall in tax revenues, requiring tax rates to be higher for other individuals and businesses in



order to fund public services, thereby eroding the principle of fairness that underpins the tax system. The tax gap, the difference between the amount of tax that should in theory be collected by HMRC against that which is actually collected, and the tax gap as a percentage of tax liabilities is shown in the table below.

*Tax gap and percentage of liabilities 2005–06–2013–14*

| *Year* | *Tax Gap (bn)* | *Percentage of Liabilities* |
|---|---|---|
| 05–06 | 37 | 8.4 |
| 06–07 | 35 | 7.6 |
| 07–08 | 37 | 7.5 |
| 08–09 | 36 | 7.5 |
| 09–10 | 33 | 7.3 |
| 10–11 | 34 | 7.0 |
| 11–12 | 33 | 6.6 |
| 12–13 | 34 | 6.6 |
| 13–14 | 34 | 6.4 |

According to HMRC, the largest percentage gap reductions between 2005–06 and 2013–14 are to be found in corporation tax (by just over half) and excise duties (by just over one-third). The largest part of the overall gap for 2013–14 (just under half) is attributable to small and medium-sized enterprises, followed by large businesses (just over a quarter).

Of this tax gap, for 2013–14, tax avoidance is estimated to account for 8% of the overall tax gap (amounting to £2.7 billion); this barely differs from the gap of £2.8bn or 8% in 2012–13. These figures are an estimate of what HMRC believes to be the tax gap; others have suggested that both the overall tax gap and the amount attributable to avoidance are much higher.

Over its five years in office, the Coalition Government described itself as being 'relentless in its crackdown on tax avoidance and evasion' and in its determination to reduce the incentives, and increase the penalties, for engaging in that kind of behaviour. It started by setting out its new anti-avoidance strategy (*Tackling Tax Avoidance*, HM Treasury and HM Revenue & Customs, March 2011), which comprised three elements: *first*, the prevention of avoidance at the outset where possible, including developing strategic defences against avoidance, such as principles-based legislation where appropriate (see **[3.73]**); *secondly*, detecting avoidance early where it persists, achievable through, amongst other things, maintaining the effectiveness of the rules on disclosure of tax avoidance schemes (DOTAS – see **Chapter 5**); and *thirdly*, countering avoidance effectively through legislative change and challenge through litigation. Building upon that base, the Coalition Government made more than 40 changes, closing loopholes and introducing major reforms to the UK tax system. It is estimated that between 2010 and 2015 the measures taken to tackle avoidance should raise more than £12bn. Most notable of these measures is the general anti-abuse rule (GAAR – see **[3.74]** ff), which seeks to tackle the most egregious of tax avoidance arrangements and to deter those who may be tempted to use them. Other measures

include the introduction of the accelerated payment regime (see **[5.26]**), under which certain taxpayers involved in marketed avoidance schemes are required to pay up front the tax they are disputing. As at 13 September 2015, more than 25,000 accelerated payment notices (APNs) to pay disputed tax had been issued since August 2014. By the end of 2016, HMRC expect to have completed issuing around 64,000, bringing forward £5.5 billion in payments for the Exchequer by March 2020.The APN scheme was extended to NICs with effect from 12 April 2015 by the National Insurance Contributions Act 2015. In addition, HMRC:

- legislated for follower notices to encourage users of tax avoidance schemes to settle with HMRC after a relevant judicial ruling or risk facing a penalty if they lose (see **[5.27]**) (HMRC issued 379 'follower notices' to tax avoidance users with a collective value of more than £170m in 2014–15);
- set up a rigorous regime of penalties and monitoring requirements for high risk promoters of tax avoidance schemes, thereby tackling the supply as well as the use of marketed tax avoidance (see **[5.28]**) (HMRC has identified and issued with conduct notices the first risky promoters under the regime, requiring them to change their ways. If they fail to comply with these notices, they can be labelled as high-risk promoters, named and fined up to £1m);
- expanded and strengthened the DOTAS regime to ensure that it remains robust and to ensure that more promoters and users of avoidance schemes have to tell HMRC about their avoidance activities (the fact that the number of schemes being disclosed has declined significantly suggests that DOTAS is working successfully and that the market for tax avoidance schemes is in decline);
- increased HMRC's specialist transfer pricing team to better ensure that multinational enterprises (MNEs) pay the tax due and to prevent them from shifting profits outside of the UK; and
- introduced measures in FA 2016 to improve large business compliance, including a requirement that large businesses publish their tax strategies, a special measures regime for businesses that persistently engage in aggressive tax planning and a framework for cooperative compliance.

From an EU perspective, to ensure full tax transparency and cooperation, the Directive on Administrative Cooperation, effective from 1 January 2016, provides for the exchange of information between Member States tax administrations on all relevant financial income including interest, dividends and other similar types of income. Internationally, the UK has led efforts within the G20 group of countries to reform the international corporate tax rules through OECD Base Erosion and Profit Shifting (BEPS) project, to make it harder for companies to avoid tax by hiding profits abroad. Whilst the European Commission's recent Anti-Tax Avoidance Directive, which provides for the automatic exchange of information on country-by-country reporting of multinational companies, is said to ensure a consistent and uniform implementation of the OECD recommendations across the EU, it may be seen by some as the Commission exploiting an opportunity to push its own agenda of a unified EU tax corporate tax policy.

As well as implementing and deploying the new powers granted to it, HMRC has been steadily defeating tax avoidance schemes in court. HMRC



wins about 80% of cases that taxpayers choose to take to court, and it hopes that the publicity generated from these wins will act as a deterrent to those thinking of embarking on a tax avoidance scheme. Greater public awareness has undoubtedly contributed to changing attitudes towards avoidance over recent years.

Despite all of this, in its report on HMRC's progress in improving tax compliance and preventing tax avoidance (18 November 2014), the Public Accounts Committee (PAC) said that 'HMRC's action against tax avoiders continues to be unacceptably slow, putting tax revenues at risk'. Moreover, in its later report on the performance of HMRC for the year 2014–15 (3 November 2015), the PAC warned that HMRC's failure to gather intelligence on losses through aggressive tax avoidance is an obstacle to improving UK tax laws.

It can only be hoped that the creation in 2014 of a dedicated Counter-Avoidance Directorate within HMRC, which brings together policy, operational and technical expertise into a single directorate, will drive marketed avoidance further out of the system. This directorate, which also deals with specific issues around the GAAR and DOTAS is aimed, not at taxpayers who legitimately organise their tax affairs in the most efficient way, but rather at the people who use what HMRC calls 'specific avoidance schemes' and 'serial avoiders, and the highest risk promoters'.

This chapter analyses the way in which the courts have attempted to tackle tax avoidance; **Chapter 3** explores specific targeted legislative measures designed to neutralise avoidance; and **Chapter 5** provides an overview of the disclosure rules (DOTAS), effective from 1 August 2004, the regime against promoters of tax avoidance schemes (POTAS), accelerated payments and follower notices. **[2.1]**

## 2 Tackling tax avoidance

HMRC has three main weapons at its disposal when tackling tax avoidance. The first is legislative in the form of specific, targeted anti-avoidance measures and is considered in **Chapter 3**. The second is a group of measures that embrace the disclosure rules, rules that are aimed at promoters of tax avoidance schemes, accelerated payments and follower notices; **Chapter 5** provides an overview of all of these measures. The third weapon in HMRC's armoury, and the subject of this chapter, is to challenge in the courts the legal efficacy of avoidance schemes.

The chapter is largely historical: it charts the journey taken by the courts from a time when the Revenue was seldom successful in challenging tax avoidance (**[2.3]**) to the present day when it is winning far more cases than it loses. What happened on that journey is both interesting and instructive, and lays the foundation for the decisive HMRC victories that are being seen today. See, for example, the recent decision of the Court of Appeal in *Eclipse Film Partners No 35 LLP v R & C Comrs* (2015) (note that the Supreme Court refused leave to appeal on the substantive issue (2016) – see **[10.28]**). This case concerned some high-profile tax planning schemes, The Eclipse schemes, which purported to be trading partnerships set up to sub-license films for a commercial profit. The 287 partners borrowed large sums from Barclays Bank to buy the licensing rights for a number of films. The interest

on these loans created losses, for which they could then claim the special sideways tax relief introduced in 2005 to encourage investment in the British film industry. Each investor obtained £400,000 of tax relief for an investment of £173,000. However, HMRC challenged the £117m total of tax relief claims on the grounds that the partnership was not really a trading organisation; it claimed that the borrowed money simply earned interest which could then be returned to investors to pay the costs of their loans. The First-tier Tax Tribunal agreed with HMRC and disallowed the relief; the Upper Tax Tribunal also held that the partnerships were not trading (although Eclipse's appeal was partially allowed on technical grounds – *Eclipse Film Partners No.35 LLP v R & C Comrs* (2013)). On appeal to the Court of Appeal, Eclipse 35 advanced two arguments: *first*, the only reasonable conclusion from the facts was that it was trading; *secondly*, the activity of acquiring film rights and sub-licensing them for profit was inherently a trade as a matter of law. The Court rejected both arguments. On the first point, it decided that the activity of Eclipse 35 was of the character of a fixed-term investment, though some contingent receipts might be due later, depending on the success of the film. On the second point, the court found that there were no decided cases that justified the view that Eclipse 35's activity was inherently a trade. Following the approach taken by the House of Lords in *Barclays Mercantile Business Finance Ltd v Mawson* (2004) (*BMBF* – see **[2.38]**), a case that would appear to have offered definitive guidelines for future courts in deciding on issues of tax avoidance, the Chancellor of the High Court, Sir Terence Etherington, delivering the judgment of the whole Court, said that it was necessary to stand back and look at the whole picture and, having particular regard to what the taxpayer actually did, ask whether it constituted a trade. Having done that, the Court of Appeal concluded that there was no trade. Of the Court's decision to dismiss the appeal, Sir Terence Etherington warned that it had 'very serious fiscal consequences for the members of Eclipse 35. They will be taxed on the income from the arrangements without any relief for the interest they have already paid.' In fact, the investors never actually received the partnership income and are therefore being taxed on large profits that they never received (and see *Scotts Atlantic Management Ltd (in members voluntary liquidation) & Ors* (2015), which concerned a tax avoidance scheme that routed profits of a tax advisory business through employee benefit trusts. Taking a purposive approach to the construction of the relevant provisions, the Upper Tribunal dismissed the taxpayers appeal. See **[10.133]**; see also *Chappell v R & C Comrs* (2014), where a scheme involving a stock lending arrangement and manufactured dividend payment was held to be artificial with no commercial purpose and thus failed to achieve the income tax shelter it sought, and *Price v R & C Comrs* (2015), where, once again, following *BMBF*, the Upper Tribunal, taking a realistic view of the facts, dismissed the appellant taxpayers' claim that a payment of £6m for the acquisition of shares that were subsequently sold for £552 thereby created a £6m capital loss available for offset against taxable income. These are yet more examples of widely-marketed tax avoidance schemes to fail before the courts). **[2.2]**

## 3 Background

In the past the Revenue won few victories, in part because of the difficulty it had in putting forward the argument that transactions used to avoid tax should be viewed as shams. No matter how artificial a transaction may be, so long as it is genuine and properly implemented, it cannot be ignored as a sham (see, for example, *Hitch v Stone* (1999); *Audley v R & C Comrs* (2011)). The main reason for the Revenue's lack of success, however, was to be found in *IRC v Duke of Westminster* (1936). The object of the scheme in that case was to make servants' wages deductible in arriving at the Duke's total income by paying them by deed of covenant. Hence, although there was no binding agreement to that effect, it was accepted that so long as payments were made under the covenant they would not claim their wages. The House of Lords upheld the scheme saying that, in deciding the consequence of a transaction, the courts will look at the legal effect of the bargain that the parties have entered into and not take account of any supposed artificiality. **[2.3]**



## 4 The 'new approach' – an overview

Unsurprisingly, the *Westminster* case gave rise to what, in effect, could be called the very first 'taxpayer's charter', instilling a belief in those taxpayers that could afford to do so that the lengths to which they could go to avoid tax were limitless, provided they were not illegal, The growth in tax avoidance schemes became marked in the 1970s, and it seemed that legislative measures, which appeared to be insufficient to keep up with the problem, were met with even more ingenious schemes. In the early 1980s, however, the Revenue won some outstanding battles in the courts, most importantly before the House of Lords in the leading cases of *WT Ramsay Ltd v IRC, Eilbeck v Rawling* (1981), *IRC v Burmah Oil* (1982) and *Furniss v Dawson* (1984), from which cases there developed what became known as the *Ramsay* principle (named after the first case in the series, but which caused much confusion in later cases because many doubted the constitutional ability of the judiciary to develop such a principle). At that time, and most notably at the high point of *Furniss v Dawson*, in which case Lord Scarman commented that new law was gradually being developed and that the boundaries remained yet to be fully explored, it was felt that the new principle had sounded the death knell to artificial avoidance schemes. That feeling was given further credence by the high level of hostility shown by the Revenue to such schemes as evidenced by *IRC v Rossminster Ltd* (1980), and it was believed that potential customers would be deterred from purchasing avoidance packages. The status of the *Westminster* case was left unclear by these judgments, which showed that judicial attitudes to tax avoidance from the 1980s onwards were very different from those prevailing in the 1930s. Indeed, in *Furniss v Dawson*, Lord Roskill considered that 'the ghost of the Duke of Westminster has haunted the administration of this branch of the law for too long'.

Concern, however, was expressed that the development of the so-called *Ramsay* principle was nothing short of judicial legislation and, as such, an infringement of the Bill of Rights of 1689 (which established that there should be no taxation without representation). Not surprisingly therefore, subsequent decisions have been concerned with a close analysis of the true effect of *Ramsay* and the series of cases that followed. *Craven v White* (1989) and *Fitzwilliam v IRC* (1993), both of which were won by the taxpayer, left the precise ambit of the 'judicial associated operations rule' uncertain, with Lord Oliver in *Craven v White* seeking to explain that the *Ramsay* principle was simply an exercise in statutory construction. In *IRC v McGuckian* (1997), this view

was used to the Revenue's advantage in the promotion of purposive statutory interpretation, which certain members of the House of Lords (notably, Lords Steyn and Cooke) believed to be the basis of the *Ramsay* decision. This approach would have given the Revenue almost guaranteed success in challenging tax avoidance schemes, as is evident from Lord Steyn's comment: 'Given the reasoning underlying the new approach it is wrong to regard the decisions of the House of Lords since the *Ramsay* case as necessarily marking the limit of the law on tax avoidance schemes.' Importantly, however, there could be seen an element of retreat in the decision of *MacNiven v Westmoreland* (2001), with Lord Nicholls commenting that 'the *Ramsay* approach is no more than a useful aid ... *Ramsay* did not introduce a new legal principle. It would be wrong, therefore, to set bounds to the circumstances in which the *Ramsay* approach may be appropriate and helpful'. Lord Hoffmann in the same case went further. In rejecting the view that *Ramsay* is a principle of construction, he commented: 'There is ultimately only one principle of construction, namely to ascertain what Parliament meant by using the language of the statute.' He explained further that the formulation of *Ramsay* given in *IRC v Burmah Oil* and *Furniss v Dawson* is simply 'a statement of the consequences of giving a commercial construction to a fiscal concept'. Whilst the approach taken by Lord Hoffmann was applied by the Court of Appeal in relation to a PAYE scheme in *DTE Financial Services Ltd v Wilson* (2001), the difficulties inherent in such an approach can be seen in the conflicting decisions of the High Court and the Court of Appeal in *Barclays Mercantile Business Finance Ltd v Mawson* (2002), and in the judgments of both Peter Gibson and Carnwath LLJ in the Court of Appeal in that case. And, whilst in *The Collector of Stamp Revenue v Arrowtown Assets Ltd* (2003) Lord Millett (sitting as a non-permanent judge in the Hong Kong Court of Final Appeal) delivered a challenge to Lord Hoffmann's approach, the House of Lords in *Barclays Mercantile Business Finance Ltd v Mawson* (2004) appeared finally to have laid to rest the notion that *Ramsay* had given birth to a special principle affecting tax statutes and tax law, affirming that the case had been decided on the normal basis of statutory construction, leading to the conclusion that the decisions of the House of Lords in *IRC v Burmah Oil* and *Furniss v Dawson*, which appeared to have created a principle lying outside the meaning of the statute whereby transactions or elements in transactions that had no commercial purpose were to be disregarded, were either incorrectly decided or had been misconstrued. Indeed, in *R & C Comrs v Tower MCashback LLP 1* (2011), Lord Walker commented that 'the clarity of Lord Wilberforce's insights [in Ramsay] was rather obscured by some subsequent decisions, especially (if I may respectfully say so) the opinion of Lord Brightman in *Furniss v Dawson* ...'. However, a recent spate of cases, including *Tower MCashback*, demonstrate that the application of *Barclays Mercantile Business Finance Ltd v Mawson* (2004) is by no means straightforward. **[2.4]–[2.20]**

## II ARTIFICIAL SCHEMES AND THE *RAMSAY* 'PRINCIPLE'

### 1 The decisions in *Ramsay* and *Burmah Oil*

In both *Ramsay* and *Burmah Oil* the taxpayers sought to obtain the benefits of CGT loss relief, in the former case to wipe out large profits, in the latter



to turn a large, non-allowable loss into an allowable one. To achieve this end both adopted schemes involving a series of steps to be carried out in rapid succession according to a pre-arranged timetable. Once started, it was intended that the schemes should be carried through to their conclusion that would be that a capital loss had been incurred. In reality, a comparison of the taxpayer's position at the start and finish showed that either no real loss was suffered, or, in *Ramsay's* case, that the only loss suffered was the professional fees paid for the implementation of the scheme! The House of Lords decided that such schemes should be viewed not as a series of separate transactions, none of which was a sham, but as a whole; the position of the taxpayer in real terms being compared at the start and at the finish. Thus, the scheme involved no real loss and was self-cancelling. In *Ramsay* Lord Wilberforce expounded this new approach to avoidance schemes and sought to explain the decision in *Westminster's* case:

> 'While obliging the court to accept documents or transactions, found to be genuine, as such, it does not compel the court to look at a document or a transaction in blinkers, isolated from any context to which it properly belongs. If it can be seen that a document or transaction was intended to have effect as part of a nexus or series of transactions, or as an ingredient of a wider transaction intended as a whole, there is nothing in the doctrine to prevent it being so regarded; to do so is not to prefer form to substance, or substance to form. It is the task of the court to ascertain the legal nature of any transaction to which it is sought to attach a tax, or a tax consequence, and if that emerges from a series, or combination of transactions, intended to operate as such, it is that series or combination which may be regarded.'
>
> ([1981] STC 174 at 180)

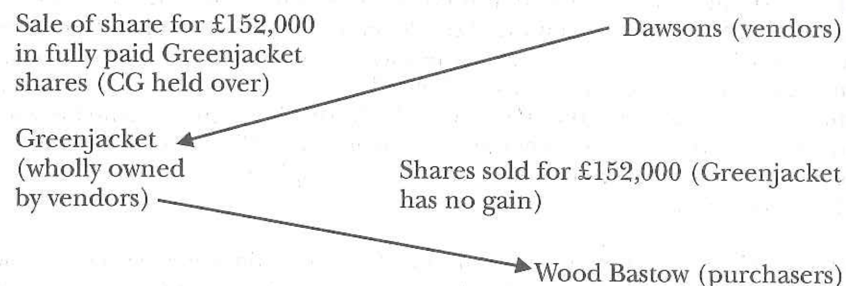
In *Ensign Tankers (Leasing) Ltd v Stokes* (1992) the House of Lords applied the *Ramsay* principle to the single composite transaction made up of 17 documents all dated the same day. **[2.21]**

### 2 Extending *Ramsay*: *Furniss v Dawson*

#### a) *The facts*

It was left to Lord Brightman in *Furniss v Dawson*, building upon the words of Lord Diplock in *Burmah Oil*, to set out the conditions necessary for the application of the *Ramsay* principle: *first*, there must be a pre-ordained series of transactions (or one single composite transaction); *secondly*, there must be steps inserted which have no commercial purpose other than the avoidance of tax. Unlike the *Ramsay* and *Burmah Oil* cases, both of which involved circular self-cancelling schemes, the sole object of which was the avoidance of tax, *Furniss v Dawson* was concerned with the deferment of CGT by channelling the sale of chargeable assets through an intermediary company. The facts of the case are simple. The Dawsons decided to sell shares to Wood Bastow Holdings Ltd ('Wood Bastow') for £152,000. To defer the CGT that would otherwise have been payable, the shares were first sold to a newly incorporated Manx company ('Greenjacket') for the sum of £152,000 that was satisfied by an issue of shares in that company. The purchased shares were then immediately resold by Greenjacket to Wood Bastow for £152,000. The attraction of the scheme was that at no stage did any CGT liability arise: the sale to Greenjacket

was specifically exempted from charge under FA 1965 Sch 7 para 6(2) (see now TCGA 1992 s 135(1)), whilst the resale by Greenjacket did not yield any profit to that company (the shares were purchased and sold for £152,000). As the price paid by Wood Bastow was received and retained by Greenjacket the scheme was not circular or self-cancelling: it involved a separate legal entity (Greenjacket) that ended up with the sale proceeds of the shares. **[2.22]**




b) *The decision*

Before the Special Commissioners, Vinelott J, and a unanimous Court of Appeal, CGT was held not to be payable. The sale proceeds had been paid to Greenjacket and, in the phrase of Slade LJ in the Court of Appeal, the existence of Greenjacket had 'enduring legal consequences'. Before the House of Lords it was accepted that for a *scintilla temporis* legal and beneficial title to the shares passed to Greenjacket. Lord Brightman, however, in the only fully argued speech (which was concurred in by the other Lords) viewed the series of transactions as a pre-planned scheme:

> 'The whole process was planned and executed with faultless precision. The meetings began at 12.45pm on 20 December, at which time the shareholdings of the operating companies were still owned by the Dawsons unaffected by any contract of sale. They ended with the shareholdings in the ownership of Wood Bastow. The minutes do not disclose when the meeting ended but perhaps it was all over in time for lunch.'

As its purpose was to obtain a deferral of CGT, he concluded that the scheme should be viewed as a whole, that is as a composite transaction different from the actual transaction entered into by the parties, and that 'the court must then look at the end result. Precisely how the end result will be taxed will depend on the terms of the taxing statute sought to be applied'. Applying that test 'there was a disposal of the shares by the Dawsons in favour of Wood Bastow in consideration of a sum of money paid with the concurrence of the Dawsons to Greenjacket'. The gain on this disposal was subject to CGT. As already mentioned, Lord Brightman considered that there were two basic requirements for the application of the *Ramsay* principle. *First,* there must be a pre-ordained series of transactions ('a scheme'), although he stressed that, so long as a pre-planned tax saving scheme existed, no distinction should be drawn between the case where steps were carried out in pursuance of a contract and one where, although the steps were pre-ordained, separate binding contracts only arose at each stage. Although Greenjacket was not contractually bound to resell the shares to Wood Bastow, it was pre-ordained (ie there was an informal arrangement) that this would occur. Hence, 'the day is not saved for the taxpayer because the arrangement is unsigned or contains the magic words "this is not a binding contract"'. In a similar vein, Lord Fraser of Tulleybelton considered that 'the series of two transactions ... were planned as a single scheme and ... it should be viewed as a whole'. Furthermore, the scheme may include the attainment of a legitimate business end: the scheme in that case enabled shares to be sold from the Dawsons to Wood Bastow. *Secondly,* there must be steps in the scheme whose sole purpose is to avoid (or defer) a liability to tax. Such steps may have a 'business effect' but no 'business purpose'. The insertion of Greenjacket was such a step: in the words of Lord Brightman 'that inserted step had no business purpose apart from deferment of tax, although it had a business effect. If the sale had taken place in 1964 before CGT was introduced, there would have been no Greenjacket'.



An argument put forward by the Revenue in *Griffin v Citibank Investments Ltd* (2000), that *Ramsay* provided for a 'wider' analysis than *Furniss v Dawson,* and that the court should not be constrained by the preconditions set out therein, was rejected by Patten J in the High Court. He said that to accept that contention would be to convert genuine transactions into something quite different and would attribute to those transactions 'a substance and legal effect which they do not have and which ... the court would not give them upon the application of the ordinary principles of construction ...'. **[2.23]**

## III LIMITS TO THE *RAMSAY* PRINCIPLE

### 1 The difficulty in application

Not only were the requirements just mentioned difficult to apply but, being almost in the nature of a statutory formulation, it was clearly open to later courts to interpret them in 'inventive' ways. Two of their Lordships considered that the *Westminster* case could be distinguished as involving a single and not a composite transaction. Certainly the covenant was a single transaction, but its sole purpose was the avoidance of income tax and it was only entered into on the 'understanding' that the gardeners would not seek to claim their wages. Hence the making of the covenant was a step that had no commercial purpose save for the avoidance of tax. It is arguable, however, that unlike Greenjacket, which was an artificial person under the control of the Dawsons, the gardener's continuing right to sue for his wages serves to distinguish the case. Furthermore, as the covenant was to last for a period of seven years or the joint lives of the parties, it could have continued after the employment had terminated.

Any pre-arranged scheme which involves either tax avoidance, tax deferral or merely the preservation of an existing tax benefit was potentially within the *Ramsay* principle, but a single tax-efficient transaction presumably was not since the case does *not* state that persons must so organise their affairs that they pay the maximum amount of tax! **[2.24]**

### 2 A pre-ordained series of transactions

In the case of *Craven v White* (conjoined on appeal with *Baylis v Gregory* and *IRC v Bowater Property Developments Ltd*), the House of Lords was faced with the question of when a series of transactions forms part of a pre-planned scheme (or, alternatively, when it constitutes a single composite transaction). In all three of these cases, and for differing reasons, the ultimate purchaser remained unknown throughout the relevant transactions. For this reason, the House of Lords held that there could be no pre-ordained scheme. In reaching this conclusion, Lord Jauncey, expressing the view held by the majority, suggested the following definition of a 'composite transaction':

> 'A step in a linear transaction which has no business purpose apart from the avoidance or deferment of tax liability will be treated as forming part of a pre-ordained series of transactions or of a composite transaction if it was taken at a time when negotiations or arrangements for the carrying through as a continuous process of a subsequent transaction which actually takes place had reached a stage when there was no real likelihood that such subsequent transaction would not take place and if thereafter such negotiations or arrangements were carried through to completion without genuine interruption.'

This restrictive view of the meaning of a composite transaction would appear to give a taxpayer a way of surmounting the first part of Lord Brightman's test (see **[2.23]**), although *IRC v Scottish Provident* (2004) suggests that this may not always be successful (see **[2.38]**).

*Fitzwilliam v IRC* (1993) further demonstrates how easy it is to show that there is no composite scheme. Following the death of her husband a year earlier, Lady Fitzwilliam along with Lady Hastings (her daughter) and two beneficiaries, all of whom were the trustees of Lord Fitzwilliam's will, entered into a series of transactions involving five steps, devised by professional advisers, and intended to mitigate the ultimate capital transfer tax (CTT) bill. The transactions were to a large degree artificial (the appointment of interests for short periods) and in some cases circular and the end result was that some £7.8m had been distributed out of the residuary estate – £3.8m to Lady Hastings and £4m to Lady Fitzwilliam – without, it appeared, any CTT liability. The House of Lords held that this did not constitute a pre-ordained single composite transaction as formulated in *Ramsay*. Each step taken pursuant to the scheme had its own fiscal effect, imposing a charge to income tax on the relevant beneficiary for a limited period of time, and there was a potential charge to CTT on the estate of Lady Fitzwilliam in the event of her death while in possession of an interest appointed to her under the scheme. It was therefore not possible to treat the scheme as one composite whole.

For a fuller analysis of the cases discussed in this section, see earlier editions of this book. **[2.25]–[2.28]**

### 3 The insertion of steps with no business purpose

It may be remembered that, in considering whether steps inserted into a series of transactions had as their sole purpose tax avoidance, Lord Brightman made it clear that, for *Ramsay* to apply, such steps may have a 'business effect' but no 'business purpose' (see **[2.23]–[2.24]**). However, in *Fitzwilliam v IRC*, Lord Keith said:



> 'The fact of preordainment … is not sufficient in itself, in my opinion, to negative the application of an exemption from liability to tax which the series of transactions is intended to create, unless the series is capable of being construed in a manner inconsistent with the application of the exemption … in my opinion the series in the present case cannot be … There is no question of running any two or more transactions together as in *Furniss v Dawson* or of disregarding any one or more of them.'

This crucial part of Lord Keith's judgment was strongly rejected by Lord Templeman. In his view, three of the inserted steps had no purpose other than the avoidance of CTT. In truth, none of the steps had any commercial purpose although they had 'enduring legal consequences' in that they gave rise, albeit for a very short period of time, to an income interest in favour of Lady Hastings or Lady Fitzwilliam. Clearly, the distinction drawn by Lord Brightman between *purpose* and *effect* appears to have been ignored by Lord Keith.

Although at the time it was possible to see the failure of the House of Lords to adapt *Ramsay* to the facts in *Fitzwilliam* as at root a failure of will, it can now possibly be better understood as part of a process of learning to understand what the exact effect of *Ramsay* was. **[2.29]–[2.31]**

## IV REAFFIRMATION OF *RAMSAY*

### 1 *IRC v McGuckian*: the facts

The case involved numerous transactions, the strategy behind which was to reduce the assets held by a company (B), thus minimising the risk of exposure to a possible wealth tax on its shareholders, namely the taxpayer and his wife. At the same time to avoid an income tax liability on moneys paid out by B by ensuring that the proceeds were received in the form of capital rather than income. The main features of the scheme involved:

(1) the setting up of a trust under which B shares would be held for the benefit of the taxpayer and his wife by a trustee residing outside the jurisdiction; and
(2) a sale by the trustee of their rights to dividends expected to be declared and paid by B. This was in the form of a written assignment between the trustee and the purchaser, and for a consideration that only just fell short (by 1%) of the eventual dividend declared for that year by B.

The trustees were then – so it was argued – in receipt of a capital sum which could not be attributed to the settlor under eg TA 1988 s 739. As Lord Browne-Wilkinson observed, the crucial question was whether the money received by the trustee as consideration for the assignment of the right to the dividends from B was to be treated as the income of the trustee or as capital. As the proceeds of sale, the sum of money would appear to be capital; however, by applying the *Ramsay* principle, the inserted step (the assignment of the right to the dividends) would be excised, leaving the sum of money to be regarded as income. **[2.32]**

### 2 The House of Lords speeches

Unlike the majority of the Court of Appeal (Northern Ireland), Lord Browne-Wilkinson had no difficulty in applying the *Ramsay* principle; in his judgment, 'nothing in this case turns on the exact scope of the *Ramsay* principle. The case falls squarely within the classic requirements for the application of that principle as stated by Lord Brightman in *Furniss v Dawson* ...'. This was a view shared by Lord Steyn who, although feeling the necessity to analyse the basis of the *Ramsay* decision and to question the literal interpretation of taxation statutes, accepted that the present case was 'a classic case for the application of the *Ramsay* principle'. The inserted step had no commercial purpose apart from the avoidance of income tax, with the consequence that it had to be excised. The other members of the court reached the same conclusion, although the reasoning of each of the four Law Lords who delivered judgments was different in emphasis.

Worthy of particular note is the rejection by Lord Browne-Wilkinson of the taxpayer's argument that the *Ramsay* principle can only apply to a series of transactions in the absence of a statutory provision that would reverse the effect of such transactions. He said:

> 'The approach pioneered in *Ramsay* and subsequently developed in later decisions is an approach to construction, viz that in construing tax legislation, the statutory provisions are to be applied to the substance of the transaction, disregarding artificial steps in the composite transaction or series of transactions inserted only for the purpose of seeking to obtain a tax advantage. The question is not what was the effect of the insertion of the artificial steps but what was its purpose. Having identified the artificial steps inserted with that purpose and disregarded them, then what is left is to apply the statutory language of the taxing Act to the transaction carried through stripped of its artificial steps. It is irrelevant to consider whether or not the disregarded artificial steps would have been effective to achieve the tax saving purpose for which they were designed.' (See also Lord Cooke who considered that *Ramsay* was antecedent to or collateral with anti-avoidance provisions.)

The importance of *McGuckian* lies in the language used by the House of Lords in relation to tax avoidance schemes: in terms of clarifying when the principle operates, matters were left as unclear as they ever had been (see, for instance, *Piggott v Staines Investments* (1995) which at first glance would appear to fall within the principle but which was not appealed by the Revenue). Thus, in considering *Craven v White*, Lord Cooke noted that it involved facts 'distant from those of the present case' and categorised it as 'a difficult case, partly because of differences of opinion in Your Lordships' House'. **[2.33]**

## V MEANING, SCOPE AND APPLICABILITY OF THE *RAMSAY* PRINCIPLE: THE LATER CASES

### 1 The earlier cases: a doctrine of fiscal nullity or statutory construction?

That there has been uncertainty as to the basis and extent of the *Ramsay* principle from the start, can be evidenced by the words of Lord Scarman in *Furniss v Dawson*:



> 'I am aware, and the legal profession (and others) must understand, that the law in this area is in an early stage of development. Speeches in your Lordships' House and judgments in the appellate courts are concerned more to chart a way forward between principles accepted and not to be rejected than to attempt anything so ambitious as to determine finally the limit beyond which the safe channel of acceptable tax avoidance shelves into the dangerous shallows of unacceptable tax evasion. The law will develop from case to case. Lord Wilberforce in *Ramsay's* case referred to "the emerging principle" of the law. What has been established with certainty by the House in *Ramsay's* case is that the determination of what does, and what does not, constitute unacceptable tax evasion is a subject suited to development by judicial process. Difficult though that task may be for judges, it is one which is beyond the power of the blunt instrument of legislation. Whatever a statute may provide, it has to be interpreted and applied by the courts and ultimately it will prove to be in this area of judge-made law that our elusive journey's end will be found.'

Not only does this passage reveal that Lord Scarman appeared to be giving a new meaning to the terms 'tax avoidance' and 'tax evasion', perhaps a forewarning of the current attitude of HMRC, but it also demonstrates a ready acceptance that new law was being created and that this was the proper function of the judiciary. Such sentiments did not, however, commend themselves to the majority of the House of Lords in the later case of *Craven v White* (and conjoined appeals). Indeed, the majority appeared anxious to distance themselves from any notion of judicial legislation, and sought to explain an alternative and more acceptable basis of the *Ramsay* decision. For instance, Lord Oliver commented that the basis was one of statutory construction:

> 'It has been said that *Furniss v Dawson* is "judge-made law". So it is, but judges are not legislators and if the result of a judicial decision is to contradict the express statutory consequences which have been declared by Parliament to attach to a particular transaction which has been found as a fact to have taken place, that can be justified only because, as a matter of construction of the statute, the court has ascertained that that which has taken place is not, within the meaning of the statute, the transaction to which those consequences attach.'

Having accepted that *Furniss v Dawson* had, in reality, extended the *Ramsay* principle in that it not only applied that principle to a 'linear' transaction, but it also reconstituted the actual constituent transactions into something that they were not in fact, Lord Oliver made this important observation:

> 'It seems ... that the first and critical point to be borne in mind in considering the true ratio of *Furniss v Dawson* is that it rests not upon some fancied principle that anything done with a mind to minimising tax is to be struck down but upon the premise that the intermediate transfer, whose statutory consequences would otherwise have resulted in payment of tax being postponed, did not, upon the true construction of the [statute], constitute a disposal attracting the consequences set out in [the relevant provision]. That is the first point. The second is that, in reaching the conclusion as a matter of construction, this House did not purport to be doing anything more than applying and explaining the principle that had been laid down ... in [*Ramsay*]. It was that decision that explains why and how the question of construction raised in *Furniss v Dawson* came to be answered in the way that it did and it is ... only if these two considerations are borne in mind that

*Furniss v Dawson* itself can be properly understood or rationally justified as a proper exercise of the judicial function.'

It is difficult to fit the speeches in *Furniss v Dawson* into a purely constructional approach but, as later cases show, the fault rests with Lord Brightman (following Lord Diplock in *IRC v Burmah Oil Co Ltd* (1982)) in laying down a detailed, statute-like and fairly inflexible prescription of how the *Ramsay* principle works. As Lord Hoffmann said in *MacNiven v Westmoreland Investments Ltd* (2001) (see **[2.37]**):

> 'In the first flush of victory after the *Ramsay, Burmah* and *Furniss* cases, there was a tendency on the part of the Inland Revenue to treat Lord Brightman's words as if they were a broad spectrum antibiotic which killed off all tax avoidance schemes, whatever the tax and whatever the relevant provisions.'

Patten J, too, in *Griffin v Citibank Investments Ltd* (2000) made it clear that he did not believe that the decision in *Furniss* was in accord with either *IRC v Duke of Westminster* or the ordinary principles of construction and analysis that *Ramsay* applied.

The considerable level of disagreement on the ambit of the principle and the role of the courts in tax avoidance, was revealed by Lord Templeman in *Craven v White*:

> 'I have read the drafts of the speeches to be delivered in these present appeals. Three of those speeches accept the extreme argument of the taxpayer that *Furniss v Dawson* is limited to its own facts or is limited to a transaction which has reached an advanced stage of negotiation (whatever that expression means) before the preceding tax avoidance transaction is carried out. These limitations would distort the effect of *Furniss*, are not based on principle, are not to be derived from the speeches in *Furniss*, and if followed, would only revive a surprised tax avoidance industry and cost the general body of taxpayers hundreds of millions of pounds by enabling artificial tax avoidance schemes to alter the incidence of taxation. In *Furniss*, Lord Brightman was not alone in delivering a magisterial rebuke to those judges who sought to place limitations on *Ramsay* ... In my opinion, a knife-edged majority has no power to limit this principle which has been responsible for four decisions of this House approved by a large number of our predecessors.'

Lord Templeman always considered that the type of transactions envisaged by *Ramsay* and *Furniss v Dawson* were akin to sham transactions and should be treated accordingly. In *Matrix-Securities Ltd v IRC* (1994) he commented: 'Every tax avoidance scheme involves a trick and a pretence. It is the task of the Revenue to unravel the trick and the duty of the Court to ignore the pretence'. The dictionary definition of a 'sham' is a 'trick' or a 'pretence'. **[2.34]**

## 2 The later cases: statutory construction confirmed

Later cases, however, sought to lay this matter to rest. In *Fitzwilliam v IRC*, Nourse LJ summarised the position as follows:

> 'In *Craven v White* each of their Lordships said that the *Ramsay* principle is one of statutory construction. That is without doubt true in the sense that once the single composite transaction has been identified the question is whether it is caught by the taxing statute on which the Crown relies. However, it does not always or even usually involve a question of statutory construction in the sense that the meaning of the statute is in doubt. Usually the question is whether a statute whose meaning is clear applies to the single composite transaction. The principle might equally be described as one of statutory application.'



The approach taken by a majority of the House of Lords in *Fitzwilliam*, encapsulated in a statement by Lord Browne-Wilkinson, would appear to support this view:

> 'Whatever the exact scope of the principles laid down in *W T Ramsay Ltd v IRC* ... as developed and elucidated in *Furniss (HMIT) v Dawson* ... and *Craven (HMIT) v White*, the basic principle cannot be in doubt. The commissioners or the court must identify the real transaction carried out by the taxpayers and, if this real transaction is carried through by a series of artificial steps, apply the words of the taxing provisions to the real transaction, disregarding for fiscal purposes the steps artificially inserted. The provision of the taxing statute is to be construed as applying to the actual transaction the parties were effecting in the real world, not to the artificial forms in which the parties chose to clothe in the surrealist world of tax advisers.'

Of course, this view enabled the majority of the House of Lords to concentrate on matters of detail which, in turn, led to the decision that the transaction undertaken did not form one composite whole (see **[2.33]**) thus allowing £3.8m to pass tax free. As was previously observed (see **[2.34]**), the arrangements in *Fitzwilliam* fell clearly within the spirit and intendment of Lord Brightman's test laid down in *Dawson* and, had Lord Scarman's observations been followed (see **[2.36]**), would have been brought within the tax net. **[2.35]**

## 3 Purposive interpretation: *IRC v McGuckian*

That the approach pioneered in *Ramsay* and developed in later decisions is an approach to construction, was again reiterated by Lord Browne-Wilkinson in *IRC v McGuckian* (1997), expressing the view of the majority of the House of Lords. However, in the same case, Lord Steyn (who would have decided the case without the benefit of the *Ramsay* principle) felt the necessity to analyse the basis of the *Ramsay* decision and to question the literal interpretation of taxation statutes. His view (of necessity an *obiter* view and one with which Lord Cooke concurred) was that *Ramsay* was important for two reasons. *First*, was the rejection by the House of pure literalism in the interpretation of tax statutes, and a move to a more purposive method of construction. This he identified in the following statement made by Lord Wilberforce: 'There may, indeed should, be considered the context and scheme of the relevant Act as a whole, and its purpose may, indeed should, be regarded.' *Secondly*, was the acceptance that a series of transactions, intended to be implemented as a whole, could be regarded for fiscal purposes as one composite transaction. Therefore, according to Lord Steyn, the *Ramsay* principle 'was not based on a linguistic analysis of the meaning of particular words in a statute. It was founded on a broad purposive interpretation, giving effect to the intention

# 16 Trusts and settlements

*Updated by Natalie Lee, Barrister, Professor of Tax Law, University of Southampton*

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## I INTRODUCTION – TRUST MODERNISATION

Provisions were included in the Finance Acts of 2004, 2005 and 2006 aimed at 'trust modernisation' for income and capital gains tax purposes. In addition to the stated aim of simplifying the tax regime for UK trusts, the main thrust behind the these provisions was to move towards a more 'tax neutral' system, in which the amount of income or capital gains tax chargeable should not vary to any great extent depending on whether the property upon which it arises is held under a trust or directly by an individual. In achieving this goal, the Government sought to strike a balance between a system that does not provide artificial incentives to set up a trust, and one that avoids artificial obstacles to the use of trusts where significant non-tax benefits could be gained. Reform began with FA 2004, which increased the special rate applicable for certain trusts ([16.21] ff) to bring it in line with the higher rate of income tax (note that, the special rate for trusts is now aligned with the 'additional rate' of income tax – 45% for 2016–17). In order to mitigate the possible harsh effects of this measure on smaller trusts and trusts with vulnerable beneficiaries, FA 2005 introduced a standard rate band for all trusts that pay tax at the trust or dividend trust rate ([16.21]), and a new regime for trusts with vulnerable beneficiaries ([16.74] ff). The later stage in the process of reform, provided for in FA 2006 and aimed at reducing the burden of administering the taxation of trusts, was an attempt to bring the main trust-related definitions for tax on income and chargeable gains into line with each other, along with an increase in the standard rate band for trustees.

HMRC stated (HMRC Guidance Note, March 2006) that 'the simplification measure' in FA 2006 that reduced the age limit at which, for inheritance tax purposes, eligible children should become entitled to the assets of a trust from 25 to 18 ([33.72]–[33.111]), aligned the age limit for inheritance tax with those for income tax and capital gains tax, and that this age limit was part of an earlier public consultation on modernising the tax system for trusts. Interestingly, nothing in the relevant documents suggested that this was the case and, moreover, there was no mention of this measure in the Regulatory Impact Assessment for Trust Modernisation (8 March 2006). This is an important measure, which has had an enormous impact on the use of the Accumulation & Maintenance (A&M) trust as it had been structured prior to March 2006 (see [32.53]). **[16.1]**

## II DEFINITIONS

### 1 What is a settlement?

Although the term settlement is not statutorily defined, the idea behind the provisions in FA 2006 is the alignment of what is treated as a settlement for the general purposes of income tax and tax on chargeable gains. This is achieved through a common definition of 'settled property', being any property held in trust other than property held by one person as nominee for another, or held by a person as trustee for another person who is absolutely entitled to the property as against the trustee, or as a trustee for another who, but for being an infant or under some disability, is absolutely entitled against the trustee (ITA 2007 s 466). This definition mirrors the equivalent capital gains tax provisions ([25.2]). **[16.2]**

### 2 The settlor

A person is a settlor in relation to a settlement if the settlement was made, or is treated as having been made, by that person. A person is treated as having made a settlement if he has made or directly or indirectly entered into it, if he has provided, or undertaken to provide, property directly or indirectly for the purposes of the settlement, or if the settlement arose on his death and any of the settled property is, or is derived from, property of which he was competent to dispose immediately before his death (ITA 2007 s 467). Once again, the provisions are almost identical to their capital gains tax counterparts ([25.21]–[25.40]). **[16.3]**

### 3 The trustees

ITA 2007 s 474 provides that the trustees of a settlement are to be treated as a single person, meaning that the trustees are distinct from the persons who may from time to time be trustees of the settlement. A common test to determine whether the trustees of a settlement are resident in the UK is provided by ITA 2007 s 475 ([18.13]–[18.15]). **[16.4]**



## III GENERAL PRINCIPLES

### 1 Trustees' liability at basic rate

Trustees are subject to basic rate income tax under the appropriate statutory provisions on all the income produced by the fund regardless of their own personal tax position and that of the beneficiary. The basis for taxing trustees under ITTOIA 2005 is that although not *beneficially* entitled to the income, they are 'persons receiving or entitled to' the income. Trustees are 'persons' but not individuals – hence their liability is normally limited to tax at the basic rate and they have no personal allowances (the trust income is, after all, not their property) (see *Trusts, Settlements and Estates Manual* (TSEM) 3610). A beneficiary, entitled to the income under the terms of the trust, enjoys a credit for the tax paid by the trustees – see [16.62].

Expenses incurred in administering the fund may not be deducted in computing the tax liability of the trustees and are, therefore, paid out of taxed income (see TSEM 8010 ff). **[16.5]**

**EXAMPLE 16.1**

(1) The trustees of the Jenkinson family trust run a bakery. The profits of that business will be calculated in accordance with the normal rules applicable to trading income under ITTOIA 2005 and be subject to basic rate income tax in the trustees' hands (but note that the profits of a business carried on by trustees are not 'earned income': see *Fry v Shiels' Trustees* (1915)).

(2) A and B, trustees of the Joel family settlement, farm trust land in partnership with Sir Joel (head of the family) who owns adjacent land. Normal rules of partnership taxation apply and, as the trustees have entered the partnership agreement *qua* trustees, any change in their composition will not lead to a cessation of a trade carried on by that retiring trustee. In the event of losses arising, the relevant proportion may be set against other trust income.

### 2 Trust returns, direct assessment and deduction at source

Where trustees, for example, carry on a trade or engage in a letting of land, assessment to income tax at the basic rate is made upon them directly; where, however, they receive investment income arising, for example, under ITTOIA 2005 Parts 4 and 5, prior to 2016–17, tax would have been deducted at source (for the taxation of savings income, see [7.23]) and the tax deducted would have satisfied the trustees' liability to pay tax at the basic rate. From 6 April 2016, as a result of the introduction of the Personal Savings Allowance, banks, building societies and National Savings and Investments (NS&I) will no longer deduct tax on the interest they pay to customers ([7.23]; [7.26]). Accordingly, some trustees who do not currently complete a tax return or make informal payments to HMRC may face new reporting requirements. In order to ease the burden on such trustees, as an interim arrangement for the tax year 2016–2017 HMRC will not require notification from trustees where the only source of income is savings interest and the tax liability is below £100. The longer term position is currently being reviewed.

Prior to 2016–17, dividends and other distributions paid by UK companies carried a tax credit of 10%, which was treated as satisfying the trustees' liability to pay basic rate tax. From 6 April 2016 the dividend tax credit has been abolished. Unlike individuals, trustees do not qualify for the new £5,000 tax-free dividend allowance (see **[7.27]**), and must pay tax on all dividends depending upon the tax band they fall within (ie the dividend ordinary rate of 7.5%, the dividend upper rate of 32.5% and the dividend additional rate of 38.1%).

The normal self-assessment rules apply to trustees, but note that every person who was a trustee when the income arose or who subsequently becomes one is responsible for making trust returns etc (TMA 1970 s 7(9)). However, anything done by one trustee satisfies the liability of all and penalties can only be recovered once (from a person who was a trustee when the penalty was triggered). Trustees are generally required to complete the trust and estate tax return: there is, however, no requirement on bare trustees to complete a self-assessment tax return or to make any payment on account unless they choose to do so (see *Tax Bulletin*, February 1997, p 395 and *Tax Bulletin*, December 1997). **[16.6]**

### 3 Exceptional cases

In exceptional cases trustees do not have to complete a return. The main situation is where professional trustees are acting; there is no untaxed income or any such income is mandated directly to a beneficiary; it is clear because of the small value of the fund that CGT will not arise and the trustees undertake to notify the Revenue of any change in their circumstances. A similar rule is applied where the sole or main asset is a residential property, which is occupied rent free by a beneficiary under the terms of the trust. In cases not falling within the above but where the payment of untaxed income is made directly to an interest in possession beneficiary under the authority of the trustee, that income is excluded from the trust and estate tax return and the beneficiary will be directly assessed on that income. This practice has been extended to trustees of settlor interested trusts where the settlor (or the settlor's spouse or civil partner) is also an interest in possession beneficiary and the trust income is mandated to them (see TSEM 3040). Further to FA 2005 s 14 (see **[16.21]**) as amended by FA 2006, trustees whose income does not exceed £1,000 (for 2006–07 and subsequent years) and is made up of net interest and UK dividends, may need to make a return only periodically (*Tax Bulletin*, August 2005, pp 1217–1218; *Regulatory Impact Assessment for Trust Modernisation* (March 2006)). Note also the interim measure for 2016–17 whereby HMRC will not require notification from trustees where the only source of income is savings interest and the tax liability is below £100 (see **[16.6]**). **[16.7]**

### 4 Trustees' remuneration

If a trust instrument authorises the remuneration of a trustee, the payment will be regarded as an annual payment subject to deduction of income tax at source (ITA 2007 Part 15 Chapter 6 and Part 8 Chapter 4, formerly TA 1988 ss 348–349; see **[14.21]**), but is nonetheless treated as earned income in the trustees' hands (*Dale v IRC* (1954) and see TSEM 6237). **[16.8]**



### 5 Other matters

The UK treatment of non-resident trustees is discussed at **[18.79]**; and the treatment of foreign source income received by trustees at **[18.38]**. **[16.9]–[16.20]**

## IV INCOME ARISING TO TRUSTEES WHICH IS TAXED AT SPECIAL RATES (ITA 2007 PART 9 CHAPTER 3)

### 1 The charge imposed by ITA 2007 s 479

#### a) *Special rates: the 'trust rate' and the 'dividend trust rate'*

Trustees are not liable to income tax at the higher or additional rate because they are not individuals. Trustees receiving income falling within s 479(1) (and defined in s 480) are, however, liable to pay income tax at single flat rates known as the trust rates. The trust rate is 45% for 2016–17 (ITA 2007 s 9(1) as amended by FA 2012 s 1), which equates with the additional rate of tax for individuals. The rate in respect of dividends and company distributions, the dividend trust rate, is 38.1 % for 2016–17 (ITA 2007 s 9(2) as amended by FA 2012 s 1), the same as the additional rate applicable to dividend income (see **[42.76]**).

The general effect of these rates which, prior to April 2004, were 34% and 25% respectively, is, in most cases, to remove the advantages that previously could have been gained by using trusts falling within s 479(1). The following matters should be noted:

(1) in the case of savings income which has suffered a deduction of tax at 20% at source the result for 2016–17 is an additional tax charge at a rate of 25%;
(2) although the charge is levied on *income* arising to trustees of a settlement, ITA 2007 ss 481, 482 provide for certain payments of a capital nature to be treated as income for the purposes of s 497. These include lease premiums, which prior to 2006–07, were not subject to the special rate and only suffered tax at the basic rate: see further **[16.28]**;
(3) the charge is on net income, ie income after the deduction of permitted expenses (see further **[16.23]**). For 2006–07 and subsequent years, the first £1,000 of income taxable at the special rates for trustees is taxed instead, depending upon the source of the income, at either the basic or dividend ordinary rate (the first slice rate band: ITA 2007 s 491). This applies equally to payments of a capital nature that are deemed to be income by virtue of ss 481, 482 (**[16.28]**). Although not specified in the provision:
    (a) the first slice rate band should apply after deduction of allowable trust management expenses (see **[16.23]**);
    (b) where the trustees have annual income above £1,000, the excess should be chargeable at the special rates for trustees, but the first slice rate band should apply to the first £1,000 of the income.

(For the effect of the first slice rate band on ITA 2007 s 493, see *Examples 16.4* and *16.5*). **[16.21]**

b) *Which trusts are caught?*

ITA 2007 s 479 provides that the special rates for trustees apply if the income arising under a trust, not being one that is established for charitable purposes only, is accumulated or discretionary income. By virtue of s 480(1), income is accumulated or discretionary income in so far as:

'(a) it must be accumulated, or
(b) it is payable at the discretion of the trustees or any other person, and it is not excluded by subsection (3).'

Section 480(2) provides guidance as to when income is payable at the discretion of the trustees or any other person. These will include:

'cases where the trustees have, or any other person has, any discretion over one or more of the following matters –
(a) whether, or the extent to which, the income is to be accumulated,
(b) the persons to whom the income is to be paid, and
(c) how much of the income is to be paid to any person.'

Income excluded by s 480(3) includes income that, before being distributed, is the income of any person other than the trustees.

Settlements containing a power for trustees to accumulate income, and those which give the trustees a discretion over the distribution of the income are caught (a typical example would be the A&M settlement, which, until the changes provided by FA 2006, was largely established for its IHT advantages: see **[34.91]**). The result is not only to increase the cost of accumulating income in such settlements but, with the trust rate standing at 45%, the effect is to remove altogether any tax advantage that might otherwise have been enjoyed.

**EXAMPLE 16.2**

Magnus is a wealthy individual who pays income tax at the additional (highest) rate (currently 45%). He creates a settlement of income-producing assets on discretionary trusts for his children, giving the trustees power to accumulate the income for 21 years. Under the general principles discussed above, the income which was accumulated would suffer tax at only 20% (other than dividend income for which there are special rules) (instead of 45% in Magnus' hands) and would subsequently be paid out as capital and so be free from any further income tax. As a result of s 479, however, the trustees have to pay an extra 25% rate of tax respectively (making a 45% rate in all) so that the attractions of the settlement to Magnus are wholly removed.

The ambit of the predecessor provision to ITA 2007 ss 479, 480 (ICTA 1988 s 686(2)(a)) was considered in *IRC v Berrill* (1982) and more recently in *The Trustees of Mrs PL Travers Will Trust v R & C Comrs* (2013). In the former case, the settlor's son was entitled to the income from the fund unless the trustees exercised a power to accumulate it. Vinelott J held that the section applied since the income was 'income … which is payable at the discretion of the trustees'. 'Discretion' is wide enough to cover a discretion or power to withhold income. The rewritten legislation makes it absolutely clear that



accumulated income refers to income which the trustees are under a positive duty to accumulate. A mere power to accumulate is not sufficient, although it will usually mean that the income 'is payable at the discretion of the trustees' within para (b). *The Trustees of Mrs PL Travers Will Trust v R & C Comrs* (2013) concerned royalties received by the Will Trust in respect of a stage musical based on the Marry Poppins books. The main thrust of the case was to determine whether the royalties were of an income or capital nature; if they were income, it then had to be decided whether a direction not to distribute the royalties as income was a direction to 'accumulate' income. In 1994 the author of the Mary Poppins books agreed a licence to enable a company to produce a stage musical based on the books. The author died before the musical was staged, leaving her literary estate in trust with instructions to pay income to certain beneficiaries for 80 years and then to distribute the capital to selected beneficiaries. In 2004 the trustees amended the 1994 agreement and assigned the right to stage the musical in exchange for royalties. The trustees treated the royalties as capital for tax purposes. HMRC took the view that the royalties should be taxed as income. The First-tier Tribunal followed the decisions in a line of Scottish cases, concerned, in the main, with mining, which held that where an existing mine was put into trust, the receipts were income and payable to the life tenant. However, where the trustees opened new mines or granted new rights, the receipts were capital for the benefit of the remaindermen. Applying those principles, which had been approved by the House of Lords, to the facts of the case before it, the Tribunal held that the receipts prior to the 2004 agreement were income whereas the royalties paid under the terms of the 2004 agreement were not income. In relation to those royalties that were income, the Tribunal rejected the trustees' argument that the manner in which the Trustees were required to deal with the receipts could not amount to accumulation because copyright has a limited life and the building up of a fund to replace such a wasting asset does not amount to an accumulation, and held that the former TA 1988 s 686 (now ITA 2007 s 479) and the rate applicable to trusts applied. **[16.22]**

c) *Management expenses*

Expenses which are properly chargeable to income by statute or case law (which includes, for instance, the cost of preparing trust accounts) are not deductible against the trustees' liability to tax at the basic rate but may be deducted in arriving at the amount of income chargeable at the special rates for trustees (ITA 2007 s 284).

In *Carver v Duncan* (1985) trustees paid premiums on policies of life assurance out of the income of the fund as they were permitted to do under the trust deed. The House of Lords held that the payments did not fall to be deducted under s 686(2)(d) (forerunner of ITA 2007 s 284) which was limited to expenses which were properly chargeable to income under the general law. As the life assurance premiums were for 'the benefit of the whole estate' they should, as a matter of principle, be borne by capital and accordingly, the express authority in the instrument did not bring the sums within the section. The all-important question of what is for 'the benefit of the whole estate' was considered in *Trustees of the Peter Clay Discretionary Trust* (2008). The High Court in that case accepted that accountancy fees and bank charges

were not *wholly* incurred for the benefit of the whole estate, and could thus be apportioned so as fairly to attribute part of the expense to capital and part to income. However, at issue before the Court of Appeal were the fees (fixed in amount) paid to non-executive trustees of a discretionary trust and investment management fees, which the trustees had argued related partly to income, and should thus be apportioned fairly between income and capital, with the part attributable to income being deductible. Chadwick LJ said that 'when the purpose or object for which the expense is incurred is to confer benefit both on the income beneficiaries and on those entitled to capital on determination of the income trusts', the expense is undoubtedly incurred 'for the benefit of the whole estate' and cannot therefore be deducted. By the time of the trustees' appeal to the Court of Appeal, the Revenue had conceded that the rule that an expense incurred for the benefit of both the income and capital beneficiaries must be regarded as incurred for the benefit of the whole estate did not preclude the apportionment of a single expense. This concession is not based on any notion of fairness between beneficiaries but, rather, upon the ability to demonstrate that part of the expenses relates to the trustee's duties to income beneficiaries alone. Thus it was that apportionment of the executive trustee's fee (which varied considerably depending on actual work undertaken) was permissible. Since the non-executive trustees also spent time addressing matters relating exclusively to the income beneficiaries, the Court of Appeal held that, despite the fact that the fees were fixed, part should similarly be attributed to income and be deductible. Investment management fees, however, were a different story. Since, in the present case, the advice was being given in relation to the investment of capital and of income already accumulated, no part of the expenses could be said to have been incurred exclusively for the benefit of the income beneficiaries. The advice inured for the benefit of the whole estate; for the capital beneficiaries because the capital of the trust would be augmented and for the benefit of the income beneficiaries because the income of the trust would be increased because of the augmentation of the capital. Had the expenses been incurred *before* the trustees had taken the decision to accumulate the income (which was not so in the present case), to the extent that the expenses could be said to be incurred for the purpose of temporarily investing income whilst the trustees were deciding whether or not to accumulate, in the event that the income was distributed and not accumulated, the expenses could be said to have been incurred exclusively for the benefit of the income beneficiaries.

A further example of an income expense is the cost of collecting and distributing the income. The costs of preparing the trust accounts (which had previously been accepted as a concession by the Revenue) has now been endorsed by the court in *Peter Clay* and reflected in Revenue guidance (TSEM 8120 ff). Against which sources of income should allowable expenses be met? ITA 2007 s 486 provides that the order is:

(1) against dividend income (ITTOIA 2005 Part 4);
(2) against dividends from non-UK resident companies (as defined in ITTOIA 2005 Part 4 Chapter 4);
(3) against savings income; and finally
(4) against other income.

See further *Example 16.4* below and TSEM 8010 ff). **[16.23]**



d) *Income of a person other than the trustees*

The special rates for trustees will not apply to income that is treated as that of any person other than the trustees. This will be the case where the beneficiary has 'a complete right' to receive the capital without having to satisfy any conditions, ie where the beneficiary has 'an indefeasibly vested interest in capital'. Any income arising to the trust in such circumstances is to be treated as the beneficiary's income so long as he is alive or unless and until the trustees exercise an overriding power of appointment in respect of that income in favour of another. This will also be the case where a beneficiary has a vested interest in the income (eg a life tenant). These cases must be contrasted with the settlement in *Pearson v IRC* (1981), in which the income of a life tenant could be taken from him after it had arisen by the exercise of a power to accumulate it. Accordingly, it would be subject to the surcharge as the income still 'belongs' to the trustees. **[16.24]**

e) *Income taxed on the settlor*

The trust rate does not apply to settlements where the anti-avoidance provisions of ITTOIA 2005 Part 5 Chapter 5 (formerly TA 1988 Part XV) operate to deem the income to be that of the settlor (see **[16.91]**). Section 480(3)(a) provides that this exception applies only to income so treated *before it is distributed*. Under the rules in ITTOIA 2005 s 629 (see **[16.95]–[16.97]**), income will only be treated as that of the settlor for income tax purposes if it is actually paid to or for the benefit of the settlor's unmarried minor child. In the event of a distribution out of a discretionary or accumulation trust in favour of such a child, ITA 2007 s 484 provides that it will be treated as a payment net of the additional and basic rate tax. **[16.25]**

f) *Will trusts*

ITA 2007 s 479 does not apply to the income of an estate of a deceased person during administration: of course if distributed to the trustees by the personal representatives, it will then be subject to the 45% rate (with a credit for tax suffered by the personal representatives). **[16.26]**

g) *Deduction of tax at source from relevant deposits*

Prior to 6 April 2016, income tax at the basic rate was deducted from bank interest on deposits (ITA 2007 s 851). If the trustees made a declaration that they were not resident in the UK and had no reasonable grounds for believing that any beneficiary of the trust was either an individual who was resident in the UK, or a company which is resident in the UK, bank interest could be paid gross (see ITA 2007 ss 856, 861, 873 and **[7.28]** and **[14.33]**). From 6 April, bank and building society interest on deposits are paid gross and the issue discussed above will not arise. **[16.27]**

h) *What is 'income' for s 479 purposes?*

Although the section only applies to income in a trust sense, and generally would not apply to capital sums treated as income under a provision in ITTOIA 2005, ITA 2007 s 481 provides specifically that certain payments

will be treated as income for the purposes of s 479, and s 482 sets out the types of amounts to be charged at the special rates for trustees. Thus it is that the payment of a lease premium (treated as an income receipt under ITTOIA 2005 s 277) on or after 6 April 2006 will also be treated as income for the purposes of the special rates for trustees. This has not always been the case. Further examples include certain deemed income receipts of employee share ownership trusts, profits or gains from the disposal of interests in certain offshore funds and gains from contracts for life insurance. It should be noted that the first slice rate band applies equally to such deemed income ([16.21]). **[16.28]**

**EXAMPLE 16.3**

Discretionary trustees granted a lease for 35 years over a commercial property taking a premium on the grant of £100,000. For income tax purposes a part of that premium is taxed as income (see ITTOIA 2005 s 277 [**12.82**]). For 2005–06, the trustees would accordingly have suffered income tax at the basic rate (then 22%) on that sum (£22,000). They would not, however, have suffered a further charge under s 686 since the sum would have been viewed as a capital receipt. (Contrast the position of an individual taxpayer who may have suffered tax at 40% on the chargeable slice of the premium.) For 2006–07 and subsequent years, the receipt is now treated as income for s 479 purposes, with the result that the trustees will suffer a further charge. Thus, assuming the trustees receive no other income during 2016–17, their liability would be as follows:

| | | £ |
|---|---|---|
| Deemed income | | 100,000 |
| Tax at first slice rate | £1,000 at 20% = | 200 |
| Tax at the trust rate | £99,000 at 45% = | 44,550 |
| Tax liability | | 44,750 |

## 2 Dividends and the s 479 charge

### a) *The 6 April 2016 changes*

Prior to 6 April 2016 (and from 6 April 2013) distributions from UK companies were paid with an irrecoverable tax credit of 10%, and the dividend trust rate payable by trustees under s 479 was 37.5%. From 6 April, dividends are paid gross with a dividend tax rate of 38.1%. The following tables compare these two positions. In each case, the trustees actually receive from the distributing company £2,500. It will be seen that the trustees are left with less after-tax income tax under the new regime:

*Dividends paid pre-6 April 2016*

| | £ |
|---|---|
| Dividend | 2,500.00 |
| Tax credit (10%) | 277.78 |
| Income | 2,777.78 |
| s 479 tax (37.5%) | 1,041.67 |
| After-tax income | £1,736.10 |



*Dividends paid post-6 April 2016*

| | £ |
|---|---|
| Dividend | 2,500.00 |
| s 479 tax: first £1,000 at 7.5% = £75 | |
| £1,500 at 38.1% = £571.50 | £646.50 |
| After-tax income | £1,853.50 |

The withdrawal of the 10% dividend tax credit along with an increase in the dividend trust rate to 38.1% (albeit that the first £1,000 of income is taxed at the dividend ordinary rate of 7.5%) clearly means that trustees pay much more income tax, and must be considered in the context of the reform of the taxation of trusts, discussed at both the beginning and end of this chapter [**16.1**] and [**16.108**]). **[16.29]**

### b) *The removal of the tax credit*

Prior to 6 April 2016, although dividends were received by the trustees with a tax credit of 10%, that tax credit did not enter the trust tax pool (the 'tax pool' is considered at [**16.32**]). Further, since management expenses (considered at [**16.23**]) are regarded as being paid out of income after it has suffered tax at the normal rate, the amount of income arising to trustees which is applied in defraying expenses is an amount of income sufficient to meet both the tax and the expenses. Accordingly, in order to arrive at that amount of income, the expenses have to be grossed up at the appropriate rate, namely 10% prior to 6 April 2016 and 7.5% on or after 6 April 2016 (ITA 2007 s 486).

Since dividends are paid gross on and after 6 April 2016: (i) necessarily there is no tax credit; and (ii) the amount of tax paid applying the dividend ordinary rate to the first £1,000 of dividends and the dividend trust rate of 38.1% will enter the trust tax pool.

The following example shows the order of set-off of management expenses against different types of trust income, together with the use of the first slice rate band. **[16.30]**

**EXAMPLE 16.4**

(i) *Facts (for 2016–17)*

| *Income* | *Gross (£)* | *Tax (£)* | *Net (£)* |
|---|---|---|---|
| Untaxed interest | 692 | | |
| Foreign income | 308 | 61.60(a) | 246.40 |
| Dividends | 8,717 | | |
| | £9,717 | | |
| *Trust management expenses* | £1,251 | | |

*(ii) Tax calculation*

*(i) Basic rate of untaxed interest*

| *Income (£)* | *Rate of Tax* | *Tax due (£)* |
|---|---|---|
| 692 | @ 20% | 138.40 (b) |

*(ii) Excess due to the special rates for trustees*

| *Income (£)* | *Rate of Tax* | *Tax due (£)* |
|---|---|---|
| 692 (within first slice rate band and no further tax liability) | | |
| 308 (within first slice rate band and no further liability) | | |
| 8,717 – 1,352.43* = 7,364.57 | @ 38.1% | 2,805.90 |
| *S 479 charge on trustees* | | £2,944.30 |

*£1,352.43 = Trust management expenses £1,251 grossed up @ 7.5%, ie £1,251 × 100/92.5. Since the expenses are regarded as being paid out of income after it has suffered tax at the normal rate, the amount of income arising to trustees which is applied in defraying expenses is an amount of income sufficient to meet both the tax and the expenses. In order to arrive at that amount of income, the expenses have to be grossed up at the appropriate rate. Although this has always been accepted practice, the rewritten legislation explicitly provides for such grossing up (ITA 2007 s 486).

*(iii) Income available for distribution*

To establish the income available to distribute it will be necessary to make two separate calculations, one for the dividend income and another for the non-dividend income. These figures will then need to be added together on the form R185 (the charge imposed on trustees under ITA 2007 s 496 when distributions are made to beneficiaries is considered at **[16.31]–[16.60]** and readers may wish to read this before considering the rest of this example).

*(iv) Non-dividend income*

Tax entering the tax pool and available to frank payments (a) + (b) = 200.*

| *Gross (£)* | *Tax (£)* | *Net (£)* |
|---|---|---|
| 1000 | 200 | 800 |

* Tax charged at the basic rate under s 491 (first slice rate band) enters the tax pool (ITA 2007 s 497).
Available to pay out to the beneficiary[ies] 200 × 100/45 = 444.44

*(v) Dividend income*

Tax entering the tax pool available to frank payments is £8,717 less gross expenses of £1,352.43 (£7,364.57) @ 38.1% = £2,805.90

| *Gross (£)* | *Tax (£)* | *Net (£)* |
|---|---|---|
| 7,364.57 | 2,805.90 | 4,558.67 |

The above only shows the amount of income available to distribute on which the tax payable will not exceed the tax pool (ie so that no additional tax is payable under s 496).



*(vi) Maximum income distribution without use of capital*

To establish how much income is available to distribute it is necessary to multiply the dividend distribution received less gross trust management expenses tax due (£8,717 – £1,352.43 = £7,364.57: this is the income actually held by the trustee) by 45%, ie £7,364.57 × 45% = £3,314.06, which is the net income available to pay out to the beneficiary without using capital to satisfy any tax charged on the trustees under s 496. The figures to be included on the R185 are as follows:

| *Gross (£)* | *Tax (£)* | *Net (£)* |
|---|---|---|
| 7,364.57 | 3,314.06 | 4,050.51 |

To satisfy the tax shown above, the trustee will be charged under s 496 for the difference between the tax included on the R185 of £3,314.06 and the tax entering the tax pool of £2,805.90 = £508.16.

Total distribution of both non-dividend and dividend income is as follows:

| *Gross (£)* | *Tax (£)* | *Net (£)* |
|---|---|---|
| 7,364.57 | 3,314.06 | 4,050.51 |
| 1,000.00 | 200.00 | 800.00 |
| *R185 figures* | | |
| 8,364.57 | 3,514.06 | 4,850.51 |

Therefore the tax paid by the trustees is:

| | £ |
|---|---|
| s 479 | 2,944.30 |
| Tax deducted at source | 61.60 |
| s 496 | 508.16 |
| | £3,514.06 |

*(vii) Summary*

This can be balanced by the following computations:

| | £ |
|---|---|
| Dividend distribution | 8,717.00 |
| Other gross income | 1,000.00 |
| | 9,717.00 |
| *Less:* gross trust management expenses | 1,352.43 |
| | £8,364.57 |

| | £ |
|---|---|
| Tax @ 20% on 1,000 | 200.00 |
| Tax @ 38.1% on dividends | 2,805.90 |
| s 496 charge | 508.16 |
| Net distribution to beneficiary | 4,850.51 |
| | £8,364.57 |

# 26 CGT – companies and shareholders

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I CGT problems involving companies [26.1]
II Capital distributions paid to shareholders [26.21]
III The disposal of shares [26.41]
IV Value-shifting [26.61]

## I CGT PROBLEMS INVOLVING COMPANIES

### 1 CGT and corporation tax

Companies and unincorporated associations are not subject to CGT; instead chargeable gains are assessed to corporation tax. Broadly, and with the important exception of indexation relief, the principles involved in computing the chargeable gain (or allowable loss) are the same as for individuals.

Disposals from one company in a group (as defined) to another will generally be treated as taking place at a value giving rise to neither gain nor loss (TCGA 1992 s 171). Any gain is deferred until the asset is sold outside the group or if the company owning the asset leaves the group within six years of the transfer (TCGA 1992 s 179). **[26.1]**

### 2 Company reorganisations

The basic principle is that there is neither a disposal of the original shares nor the acquisition of a new holding: instead, the original shares and new holding are treated as a single asset acquired when the original shares were acquired. When new consideration is given on a reorganisation (for instance, on a rights issue), that is added to the base cost of the original shares and treated as having been given when they were acquired (TCGA 1992 ss 126–131). However, if there is an election under TCGA 1992, s 169Q, a claim for entrepreneurs' relief can be made as if the re-organisation involved a disposal of the original shares, and s 127 will not apply. **[26.2]**

### 3 Company takeovers and demergers

If the takeover is by means of an issue of shares or debentures by the purchasing company (a 'paper for paper exchange'), CGT on the gain

made by the disposing shareholder may generally be postponed until the consideration shares are sold (TCGA 1992 ss 135–137). If the consideration for the acquisition is partly shares and partly cash, the cash element is treated as a part disposal of the shareholding and s 135 will apply to the balance. The purchaser must obtain more than 25% of the shares in the target company (subject to a number of conditions) for these rules to apply. Furthermore the transaction must be effected for *bona fide* commercial reasons and not form part of any scheme or arrangement of which the main purpose or one of the main purposes is to avoid a liability to CGT or corporation tax. An advance clearance may be sought (TCGA 1992 s 138) to ensure the bona fide commercial reasons test is met.

Where the assets of the target company are acquired for a cash consideration, any chargeable gain arising on this disposal of those assets will be chargeable on the target company. An exemption might apply, such as the substantial shareholdings exemption, see **[41.75]** or a deferral such as roll-over relief under TCGA 1992 ss 152–159 (see **[22.72]**). From the point of view of the target's shareholders, they may be left with the problem of what to do with a 'cash shell' company see **Chapter 47**.

TCGA 1992 s 192 contains provisions aimed at facilitating arrangements whereby trading activities of a single company or group are split up in order to be carried on either by two or more companies or by separate groups of companies, see **Chapter 47** (demergers). **[26.3]**

### 4 Incorporation of an existing business

TCGA 1992 s 162 provides relief in cases where an unincorporated business is transferred to a company as a going concern in return for the issue of shares in the company. The relief enables the gains on the business assets transferred to the company to be rolled over into the acquisition of the shares. (For detailed examination of the rules see **[47.2]**.) **[26.4]–[26.20]**

## II CAPITAL DISTRIBUTIONS PAID TO SHAREHOLDERS

A capital distribution (whether in cash or assets) is treated in the hands of a shareholder as a disposal or part disposal of the shares in respect of which the distribution is received (TCGA 1992 s 122(1)). 'Capital distribution' is restrictively defined to exclude any distribution that is subject to income tax in the hands of the recipient (s 122(5)(b)). As the definition of a distribution is extremely wide (see **[42.1]**) the CGT charge is confined to repayments of share capital and to distributions in the course of winding up.

**EXAMPLE 26.1**

(1) Prunella buys shares in Zaba Ltd for £40,000. Some years later the company repays to her £12,000 on a reduction of share capital. The value of Prunella's remaining shares immediately after that reduction is £84,000.

The company has made a capital distribution for CGT purposes and Prunella has disposed of an interest in her shares in return for that payment. The part disposal rules must, therefore, be applied as follows:

(i) consideration for part disposal: £12,000



(ii) allocation of base cost of shares:

$$£40{,}000 \times \frac{A}{A+B} = £40{,}000 \times \frac{£12{,}000}{£12{,}000 + £84{,}000} = £5{,}000$$

(iii) gain on part disposal: £12,000 – £5,000 = £7,000.

(2) Stanley buys shares in Monley Ltd for £60,000. The company is wound up and Stanley is paid £75,000 in the liquidation. Stanley has disposed of his shares in return for the payment by the liquidator and, therefore, has a chargeable gain of £15,000 (£75,000 – £60,000).

If the company had been insolvent so that the shares were worthless, Stanley should claim loss relief on the grounds that his shares had become of negligible value (see TCGA 1992 s 24(2); *Williams v Bullivant* (1983); and **[19.69]**). He has an allowable loss of £60,000. Income tax relief may be available for this loss under ITA 2007 s 131 (see **[11.121]**).

These rules are also applied when a shareholder disposes of a right to acquire further shares in the company (TCGA 1992 s 123). The consideration received on the disposal is treated as if it were a capital distribution received from the company in respect of the shares held.

Under s 122(2), if HMRC are satisfied that the amount distributed is small, the part disposal rules are not applied but the capital distribution is deducted from the allowable expenditure on the subsequent disposal of the shares, with the result of increasing the subsequent gain (in effect the provision operates as a postponement of CGT). For these purposes, a capital distribution is treated as small if it amounts to no more than 5% of the value of the shares in respect of which it is made. However, a revised approach was announced in *Tax Bulletin* 27 in February 1997 as a result of *dicta* in *O'Rourke v Binks* (1992) which noted that the purpose of the legislation was to avoid the need for an assessment in trivial cases, an approach that would have regard to the likely costs of carrying out the part disposal computation and the likely tax consequences in each case. As a result, in addition to the 5% test, HMRC now considers that s 122(2) can apply in cases where the distribution is £3,000 or less (see CG 57836).

Under s 122(4) where the allowable expenditure is *less than* the amount distributed the taxpayer may elect that the part disposal rules shall not apply and that the expenditure shall be deducted from the amount distributed. In *O'Rourke v Binks* (1992), the Court of Appeal held that the capital distribution must be small for the purpose of this subsection and that what was 'small' would be a question of fact for the Tribunal to decide.

On a liquidation there will often be a number of payments made prior to the final winding up and each is a part disposal of shares (subject to the relief for small distributions) but the shares will not necessarily need to be valued each time a distribution is made (see Statement of Practice D3).

**EXAMPLE 26.2**

Mark purchased 5,000 shares in Rothko Ltd for £5,000. The company makes a 1:5 rights issue at £1.25 per share. Mark is, therefore, entitled to a further 1,000 shares but, having no spare money, sells his rights to David for £250. At that time his 5,000 shares were worth £7,500. As the capital distribution (£250) is less than 5% of £7,500 the part disposal rules will not apply. Therefore, £250 will be

deducted from Mark's £5,000 base cost. (NB Mark may have preferred the part disposal rules to apply since any gain resulting may be covered by his annual exemption.) **[26.21]–[26.40]**

## III THE DISPOSAL OF SHARES

### 1 Introduction

#### a) *Pre-FA 1982 system*

Before FA 1982, the CGT rules were relatively straightforward and involved treating identical shares as a single asset. This 'pooling' system involved a cumulative total of shares with sales being treated as part disposals from the pool and not as a disposal of a particular parcel of shares. Special rules applied where all or part of a shareholding was acquired before 6 April 1965. **[26.41]**

#### b) *FA 1982 regime – operative from 6 April 1982 to 6 April 1985*

Shares of the same class acquired after 5 April 1982 and before 6 April 1985 were not pooled. Instead, each acquisition was treated as the acquisition of a separate asset. A disposal of shares was then matched with a particular acquisition in accordance with detailed identification rules that applied even where the shares were distinguishable from each other by, for instance, being individually numbered. Shares were therefore treated as a 'fungible' asset. These rules were introduced because of the indexation allowance which made it necessary to know whether the shares disposed of had been acquired within 12 months (when no allowance was available) or, in other cases, to calculate the indexation allowance by reference to the original expenditure. **[26.42]**

#### c) *The 1985 regime – operative from 6 April 1985 to 6 April 1998*

Major changes in the indexation allowance in 1985 enabled a form of pooling to be re-introduced. Shares of the same class acquired after 5 April 1982 and still owned by the taxpayer on 6 April 1985 were treated as one asset and further acquisitions of the shares after that date formed part of this single holding (TCGA 1992 s 104). There was an indexed pool of expenditure for each class of share and, if shares in the pool were acquired between 1982 and 1985, the initial value of this pool on 6 April 1985 comprised the acquisition costs of the relevant shares together with the indexation allowance (including an allowance for the first 12 months of ownership) that would have been given had the shares been sold on 5 April 1985.

If identical shares were acquired after 6 April 1985 they were added to the share pool with the cost of their acquisition increasing the indexed pool of expenditure (a similar result occurred if a rights issue was taken up).

When some of the shares were sold the part disposal rules were applied to both the qualifying expenditure and the indexed pool of expenditure. The indexation allowance was then found by deducting a proportion of the qualifying expenditure from a proportion of the indexed pool. The indexation allowance could only be used to reduce a gain – not to create or increase a loss. **[26.43]**



### 2 The regime introduced by FA 1998

#### a) *Basic rule*

With the introduction of taper relief in 1998, which depended upon the length of ownership of an asset, pooling was ended for individuals, PRs and trustees. As a result:

(1) acquisitions of shares on or after 6 April 1998 were not pooled (except for reorganisations being rights or bonus issues under TCGA 1992 s 127 (see **[26.2]**));
(2) pools at 5 April 1998 were preserved as a single asset (a 's 104 holding'). **[26.44]**

Where shares of the same class are acquired on the same day they were treated as having been acquired by a single transaction.

#### b) *The identification rules*

Each acquisition of shares was treated as a separate asset and new acquisition rules prescribed the order of disposals on the basis of 'last in first out' (LIFO). The order of disposals is therefore as follows (subject to what is said in the next section about bed and breakfasting):

(1) the most recently acquired unpooled shares;
(2) shares from a s 104 holding (this is treated as a single asset when the pool first came into being);
(3) 1982 pools (see **[26.43]**);
(4) shares held on 6 April 1965 (see **[26.41]**);
(5) later acquired shares. **[26.45]**

#### c) *Bed and breakfasting*

In simple terms, bed and breakfasting involved the disposal of shares on day one and their repurchase on day two: a transaction that was commonly employed to realise a loss on the shares for relief against other gains, or to realise a gain to enable the annual exemption to be utilised.

**EXAMPLE 26.3**

Alberich has unused CGT losses. He owns shares which have an unrealised gain and which he wishes to retain. He sells the shares at close of business one day, reduces or extinguishes the gain with his losses and repurchases the shares at the start of business the next.

TCGA 1992 s 105 was introduced to match securities bought and sold on the same day but was able to be avoided by buying back the following day. FA 1998 introduced a more widespread provision aimed at stopping bed and breakfasting by providing that disposals are to be matched with acquisitions in the following 30-day period (matching with the first securities acquired during this period): see TCGA 1992 s 106A(5). This brought an end to traditional bed and breakfasting whilst leaving some continuing opportunities: for instance, A sells his shares and his wife purchases an identical shareholding; or the disposal is triggered by the transfer to a trust for A. These simple arrangements are not caught by this provision but any transfers into trust must now take into

account the inheritance tax implications following the FA 2006. It may now be necessary to consider the impact of the General Anti Abuse Rule (GAAR) in these circumstances (see [3.79]–[3.82]).

The '30-day rule' may produce surprising results, see the example below. [26.46]

**EXAMPLE 26.4**

(1) Rover is returning to the UK after a period of non-residence. He 'bed and breakfasts' his investment portfolio with the intention that on his return to the UK his base cost will be market value. The 30-day rule will apply and needs to be taken into consideration by Rover (see *Tax Bulletin*, April 2001, p 839).

(2) With effect from 22 March 2006 the rules were amended so that they do not now apply where the person acquiring the shares is not resident in the UK. This followed the case of *Davies v Hicks* (2005) which highlighted the mismatch of the bed and breakfast rules with the exit charge arising when a trust ceases to be resident in the UK. In that case the trustees successfully argued that the exit charge under TCGA 1992 s 80 involved a deemed disposal and reacquisition of the shares by trust. However, under TCGA 1992 s 106A(5), the bed and breakfast rules applied to eliminate the gain on the deemed disposal. To correct this anomaly s 106A(5) will not apply to any acquisition on or after 22 March 2006 by a person who is not resident, or a person who is resident but is treated as non-resident by reason of a Double Taxation Agreement: s 106A(5A).

### 3 Simplification of pooling from 6 April 2008

From 6 April 2008, and with the abolition of taper relief, the position is considerably simplified and all shares will now be included in the s 104 pool and matched as follows:

(1) assets acquired on the date of disposal;
(2) assets acquired in the 30 days following disposal;
(3) assets in the s 104 pool.

These changes only apply to individuals and capital gains tax. The rules for corporation tax are unchanged. [26.47]

### 4 Shares acquired before 6 April 1965

For unquoted shares any gain is deemed to accrue evenly (the 'straight-line method') and it is only the portion of the gain since 6 April 1965 that is chargeable. The disponer may elect to have the gain computed by reference to the value of the shares on 6 April 1965. This election may only reduce a gain; it cannot increase a loss or replace a gain with a loss. Where different shares are disposed of on different dates the general rule of identification is last in, first out (LIFO) (TCGA 1992 Sch 2 paras 18–19).

For listed shares and securities the general principle is that a gain is calculated by reference to their market value on 6 April 1965 (the rules for ascertaining the market value are laid down in TCGA 1992 Sch 2 paras 1–6). If, however, a computation based upon the original cost of the shares



produces a smaller gain or loss, it is the smaller gain or loss that is taken. If one calculation produces a gain, and one a loss, there is deemed to be neither. [26.48]–[26.60]

## IV VALUE-SHIFTING

Complex provisions designed to prevent 'value-shifting' are found in TCGA 1992 ss 29–31. Although the sections are not limited to shares, the commonest examples of value-shifting involve shares.

Under s 29 three types of transaction are treated as disposals of an asset for CGT purposes, despite the absence of any consideration, so long as the person making the disposal could have obtained consideration. The three circumstances are outlined below. Section 29 provides that in these circumstances, the disposal is deemed not to be at arm's length and the substituted market value of the asset for the CGT computation is the consideration actually received plus the value of the 'consideration foregone'. Instances of value-shifting are to be found in the following paragraphs. [26.61]

### 1 Controlling shareholdings (see CG 58853)

Section 29(2) applies when a person having control (defined in CTA 2010 s 449) of a company exercises that control so that value passes out of shares (or out of rights over the company) in a company owned by him, or by a person connected with him, into other shares in the company or into other rights over the company. In *Floor v Davis* (1979) the House of Lords decided that the provision could apply where more than one person exercised collective control over the company, and that it covered inertia as well as positive acts. [26.62]

**EXAMPLE 26.5**

Ron owns 9,900 ordinary £1 shares in Wronk Ltd and his son, Ray, owns 100. Each share is worth £40. A further 10,000 shares are offered by the company to the existing shareholders at their par value (a 1:1 rights issue). Ron declines to take up his quota and all the shares are subscribed by Ray. Value has passed out of Ron's shares as he now holds a minority of the issued shares. He is treated as making a disposal of his shares by reason of s 29(2).

### 2 Leases

Section 29(4) provides as follows:

> 'If, after a transaction which results in the owner of land or of any other description of property becoming the lessee of the property, there is any adjustment of the rights and liabilities under the lease, whether or not involving the grant of a new lease, which is as a whole favourable to the lessor, there shall be a disposal by the lessee of an interest in the property.' (And see CG 58860.) [26.63]

**EXAMPLE 26.6**

Andrew conveys property to Edward by way of gift, but reserves to himself in the conveyance a long lease at a low rent. As the lease is valuable, the part disposal will give rise to a relatively small gain. Andrew later agrees to pay a rack rent so that the value of Edward's freehold is increased. When the rent is increased tax is charged on the consideration that could have been obtained for Andrew agreeing to pay that increased sum.

### 3 Tax-free benefits resulting from an arrangement

In contrast to s 29, s 30 applies only if there is an actual disposal of an asset. It strikes at schemes or arrangements, whether made before or after that disposal, as a result of which the value of the asset in question (or a 'relevant asset', as defined) has been reduced and 'a tax-free benefit has been or will be conferred on the person making the disposal or a person with whom he is connected; or on any other person'.

When it applies, the inspector is given power to adjust, as may be just and reasonable, the amount of gain or loss shown by the disposal (s 30(4)). This widely drafted provision will not operate if the taxpayer shows that the avoidance of tax was not the main purpose, or one of the main purposes, of the arrangement or scheme. Further, it does not catch disposals between husband and wife (within TCGA 1992 s 58); disposals between PRs and legatees; or disposals between companies that are members of a group. TCGA 1992 s 31 (as amended by FA 2011 Sch 9) extends the scope of these provisions to arrangements whereby the value of shares is materially reduced, for example where a distribution is made out of profits created by an intra group transfer to reduce the value of a shareholding prior to sale.

**EXAMPLE 26.7**

H Ltd has two subsidiaries, A Ltd and B Ltd. A Ltd is to be sold for a gain of £1 million. A Ltd has distributable profits of only £300,000 but it has a valuable property which it sells intra group to B Ltd for a profit of £700,000. No tax arises on this transfer by reason of TCGA 1992 s 171 but A Ltd still increases its distributable profits.

A Ltd pays a dividend of £1 million to H Ltd and A Ltd is then sold for a nominal sum. The idea is for the tax on the £1 million to be avoided.

Section 31 applies here to bring s 30 into play, allowing HMRC to make a just and reasonable adjustment to the capital gain to counteract the tax-free benefit intended to be obtained from these arrangements. **[26.64]**

# 27 CGT – Offshore matters for individuals

*Updated by Robin Vos, Macfarlanes LLP*

I Residence [27.1]
II Capital gains tax liability of non-residents and residents; temporary non-residents [27.41]
III The capital gains tax regime for foreign domiciliaries [27.81]
IV Non-resident companies and UK resident individuals [27.111]

## I RESIDENCE

### 1 Introduction

Significant changes to the tax treatment of UK residents who remain domiciled abroad were enacted in FA 2008.

In the July 2015 Budget, further significant changes were announced. These changes will take effect from 6 April 2017. Individuals who have been resident in the UK for 15 out of the previous 20 years will be deemed to be domiciled in the UK for all tax purposes, including capital gains tax. Similarly, individuals who were born in the UK with a UK domicile of origin will be deemed to be domiciled in the UK for all tax purposes (including capital gains tax) at any time when they are UK resident. At the time of writing, full details of the proposed changes are not yet known but there is no doubt that they will have a significant impact on those individuals who are affected.

A statutory residence test which applies to individuals for both income and capital gains tax purposes was introduced with effect from 6 April 2013. Ordinary residence has been abolished in the tax legislation and 'overseas work day relief' put on a statutory footing. These changes are discussed below (see [27.17]–[27.40]).

This chapter discusses the rules governing an individual's residence for capital gains tax purposes both before and after 2013. The chapter then goes on to discuss the capital gains tax regimes for non-residents including temporary non-residents and for foreign domiciliaries from April 2008. The next chapter discusses the capital gains tax regime for offshore trusts. **[27.1]**

## 2 The general law on residence up to 5 April 2013 – problems

Residency is the principal connecting factor in determining whether an individual is subject to income tax and capital gains tax. However, it was never previously defined in the UK's tax legislation. All that statute did (prior to the 2013 changes) was to provide three specific rules qualifying the general meaning of the term if certain conditions are met. See ITA 2007 ss 829–832 and TCGA 1992 s 9.

The difficulties caused by the lack of definition were compounded by the fact that one was dealing with not one term but two, namely 'residence' and 'ordinary residence'. Some tax liabilities were governed by residence, some by ordinary residence and some by both. For capital gains tax purposes it was enough if the taxpayer was resident or ordinarily resident in the UK.

The lack of statutory definition meant that the law on what constitutes residence or ordinary residence rested largely on decided cases. The case law presents three problems:

The first is that many of the cases are old, relating to a very different world in terms of travel and ease of communications. See for example *Levene v IRC* (1928) and *Lysaght v IRC* (1928). Hence judicial reasoning, while binding, is often inappropriate to modern conditions. Moreover many of the older cases do not clearly indicate whether days of arrival and departure have been included in the day count largely because it was often irrelevant (taxpayers could not then flit in and out of the country in the way that they can do now.)

The second problem is that because 'residence' and 'ordinary residence' are not defined for tax purposes, cases decided in other areas of the law where the term residence is used are also relevant. Thus the leading case on ordinary residence, *Shah v Barnet LBC* (1983), concerned not tax but eligibility for student grants. Similarly, cases on residence have arisen not in tax but in the context of determining whether a defendant is able to be sued in the UK under the Civil Jurisdiction and Judgments Act 1982 s 41 which in large measure turns on whether the defendant resides in the UK (*High Tech International v Deripaska* (2006); *Cherney v Deripaska* (2007) and *Yugraneft v Abramovich* (2008)).

The third problem is that the issue of whether an individual is resident or ordinarily resident is one of fact, to be determined by the tax tribunal. The higher courts will only interfere if the fact finding tribunal has erred in law or reached a conclusion so unreasonable that no reasonable body could have reached it. As a result most of the tax cases do not set out issues of principle on what constitutes residency but are decisions based on a set of facts. Very similar facts can give rise to the opposite results. The decision cannot be appealed unless it can be shown that the tribunal was not entitled to find as it did. In practice, unless the tribunal has clearly misdirected itself as a matter of law, a successful appeal is very difficult. **[27.2]–[27.3]**

The problems of the case-by-case approach were perceived long ago and a precise definition of residence was called for by both the Committee on



Codification of Income Tax Law in 1936 and by the Royal Commission on the Taxation of Profits and Income in 1955. The 1936 Committee concluded that:

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

Disputes over residence decreased after that statement because of HMRC's published guidance and practice eventually embodied in booklet IR20 (but in existence before then) which essentially imposed a day count test. The 1955 Royal Commission noted that this was 'unsatisfactory' in that it operated on the good faith of HMRC rather than on the rule of law. But IR20 was a pragmatic solution and practitioners followed it as rigorously as if it were a code of law. Eventually, however this compromise broke down and the number of residence cases and disputes greatly increased, demonstrating that the law was not satisfactory as it stood.

In particular there was dispute (no doubt caused by increased mobility) as to whether IR20 did set out 'clear bright lines' and whether if a taxpayer spent less than 91 days in the UK over a four-year period this was sufficient in itself to lose UK resident status or whether the taxpayer had to 'leave' the UK before the 91-day test became relevant at all. IR20 became subject to judicial review.

In *R (on the application of Davies and another) v IRC and R (on the application of Gaines-Cooper)* (2011) the taxpayers brought an application for judicial review in respect of whether HMRC was bound by IR20 and if they were so bound whether the taxpayers were within its scope. With Lord Mance dissenting, the Supreme Court found in favour of the Revenue on the basis that, although the guidance was in principle binding, on the particular facts the two sets of taxpayers had not satisfied the conditions set out in paragraphs 2.7–2.9 of IR20 because they had not demonstrated 'a distinct break'. Lord Wilson noted that, in his view, these paragraphs in IR20 showed two important features were required, namely (a) that the individual must take steps to create a permanent home abroad; and (b) that he must come to the UK as a visitor. The taxpayer had to leave the UK in a more profound sense than merely spending fewer days here, namely permanently or indefinitely leave or leave for full-time employment abroad and relinquish 'his usual residence' in the UK. In summary, Lord Wilson said:

> 'The reference to visits to the UK therefore underlined the need for a change in the individual's usual residence and therefore, by ready inference, for a distinct break in the pattern of his life in the UK … it might be permissible for him to maintain in the UK not a home but property … for his use but … if he did so, he would fail to secure non-resident status unless his reason for doing so survived the test of consistency with his stated aim. (i.e. the UK property was used for the purpose of visits rather than as a place of settled residence.)'

The problems increased for both arrivers and leavers because HMRC ceased to give formal rulings on which the taxpayer could rely and showed an increased tendency to litigate even on quite low day counts. This uncertainty affects liability not only in one year but in subsequent years because the length of time an individual has been in the UK will be relevant for other tax purposes, for example in terms of ordinary residence, liability for the £30,000/£60,000/£90,000 remittance basis charge and inheritance tax and deemed domicile.

A person naturally wants to know where he is resident. A double tax treaty may not resolve the issue satisfactorily and will not necessarily apply for all taxes, eg deemed domicile and the remittance basis charge. Unlike the US, foreigners visiting the UK for extended periods could not safely assess their residence status simply on the basis of day-counting.

These problems and uncertainty were the driver for the introduction of a comprehensive statutory residence test (which took effect on 6 April 2013). See **[27.17]–[27.40]**.

For years prior to April 2013, taxpayers will need to determine their residence status based on the case law although clearly prior to April 2009 taxpayers can rely on IR20 as explained in the Supreme Court decision, above.

Although the statutory residence test provides a right for the taxpayer to elect that in determining residence status for 2013–14 onwards the statutory test can be applied for earlier years, this election only applies for the purpose of determining whether someone is an arriver or leaver for the purposes of the statutory residence test from 2013–14 and not for determining an individual's actual residence status in earlier tax years.

In this chapter Revenue practice is set out first, followed by the limited statutory provisions and then an analysis of the case law. The new statutory residence test which applies from 6 April 2013 is then explained briefly. For a full explanation see **Chapter 18**. **[27.4]**

### a) *HMRC practice – IR20: 'Residents and non-residents: liability to tax in the United Kingdom' and HMRC 6*

As noted earlier, the fact that there was conflicting case law on residence did not really matter for much of the latter half of the 20th century, as the then Inland Revenue formulated practical rules, published in the booklet IR20 '*Residents and non-residents*'. These rules operated more or less unchanged from the 1940s and gave rise to the belief that if you did not spend more than 90 days in the UK each year you would not be treated as UK resident. IR20 was withdrawn from 6 April 2009 and replaced by HMRC 6.

IR20 was described as a concession and could not be used for tax avoidance purposes. It was prefaced by the comment that it set out only the main factors to be taken into account and that each case had to be determined on its own facts. However, IR20 seemed to be a clear statement of practice which could be relied on by taxpayers in cases which clearly fell within its terms. Even before it was withdrawn disputes had surfaced over its interpretation, no doubt reflecting the more mobile workforce; the ease of travel in and out of the UK and the fact that a day count test alone in determining residence was proving inadequate to stop significant tax leakage.



*Coming to the UK*

Under IR20 an individual was stated to be UK tax resident for a tax year if he met one of the following conditions:

(i) he was physically present in the UK for 183 days or more: '*the 183 day rule*'. Until 6 April 2008 it was normal practice to ignore days of arrival and departure. From 6 April 2008 midnights were included in the 183-day computation unless the person was 'in transit';
(ii) he visited the UK regularly on average 91 days or more in each tax year. The average was taken over a period of up to four years from the year of departure (so does not include days in years when he was UK resident): the '*91-day rule*';
(iii) he came to the UK with the intention of residing here permanently or for at least three years, in which case he was resident (and ordinarily resident) in the UK from the date when he arrived;
(iv) he came to the UK for a settled purpose (eg to take up employment) which meant he remained in the UK for at least two years. In this situation he was also resident in the UK from the date he arrived;
(v) he intended from the start to make regular visits of the type described in (ii), in which case he was treated as resident and ordinarily resident from 6 April of the first tax year;
(vi) he decided, before the fifth year, that he was going to make such visits, in which case he was resident and ordinarily resident from the beginning of the tax year in which he made that decision;
(vii) he was both UK resident and ordinarily resident and had left the UK only for occasional residence abroad.

*Leaving the UK*

An individual leaving the UK was therefore regarded as non-resident under IR20 if he satisfied the 183-and 91-day rules and fell into one of the following categories:

(i) he had emigrated permanently;
(ii) he or his spouse had left the UK to work full time abroad under a contract of employment or on a self-employed basis for a period which included at least one complete tax year;
(iii) he went abroad for some other settled purpose which lasted for at least one complete tax year.

An individual who departed without satisfying any of the above was treated as remaining UK resident. However, if, in fact, he satisfied the 183- and 91-day rules for three complete tax years his status was reviewed.

IR20 therefore suggested that residence was basically a question of counting days and given that days of arrival and departure did not normally count as days in the UK before 6 April 2008, it was possible in theory for an individual living abroad to work for four days each week in the UK for 45 weeks in the year and still be non-resident.

In *Tax Bulletin* 52 the Revenue began to move away from a pure day count when they stated that mobile workers who retained a home and settled domestic life in the UK but worked abroad in the week to such an extent that

they were under the 90-day limit (eg lorry drivers) nevertheless remained UK resident.

IR20 broke down further in *Shepherd v R & C Comrs* (2005), where an airline pilot's claim to have been non-resident was examined in detail and rejected by the Special Commissioner. Although he satisfied the conditions of IR20 in terms of a strict day count, HMRC contended that this was not enough to establish non-residence. Subsequently, the High Court confirmed that the Special Commissioner had not misdirected herself in law but had accurately set out the legal test that she was required to apply. In that case, the taxpayer spent half the year outside the UK flying. He rented a flat in Cyprus and was in the UK for less than 90 days from 1999 to 2000 (excluding days of arrival and departure). However he continued to live mostly in the matrimonial home when returning to the UK (despite being separated from his wife) and was not granted an immigration permit in Cyprus until February 2000. He had to be in the UK before and after each flight. The Special Commissioner concluded that he had never left the UK: there was no distinct break in the pattern of his life and even if he was resident in Cyprus during that year this was not sufficient to lose UK residence.

Matters came to a head in *Gaines-Cooper* (2007) (SCD); domicile status affirmed (2008); judicial review application in *R (Davies) v R & C Comrs* (2010); *Gaines-Cooper* (2011) (Supreme Court decision. See **[27.4]**). This is perhaps the most celebrated case on non-residence. **[27.5]**

*The Gaines-Cooper litigation*

The saga began in October 2006. Gaines-Cooper was English by birth and at no time gave up his British passport. He was born in 1937 and owned a home in the UK through an offshore structure. He began a manufacturing business in the Seychelles in 1975, bought a house there and was granted a residency permit. From 1976 to 1980, he let his UK house and, in fact, ended up letting his Seychelles house between 1976 and 1979 for financial reasons. He spent 50 days or less per year in the UK during that period and appears to have been treated as non-resident for exchange control purposes. He spent between 100 and 200 days per year in the Seychelles from 1976 to 1980. He was also carrying on business and living in California from 1979 to at least 1986. However, he had international businesses operating in the Seychelles, California and the UK. In 1993, he remarried and his second wife was Seychellois. She had been living in the UK since 1977 and in 1994 she took British nationality. After her marriage, she spent most of her time in the UK home working in the UK operation. Their child, James, was born in 1998 and went to school in the UK until 2005.

Gaines-Cooper argued that he was non-resident from 1993–94 onwards on the basis of IR20. However, before proceedings began, he made a significant concession: he accepted that he was UK resident in 1992–93 because of what was then perceived to be the 'available accommodation' rule. It is arguable that this concession was unnecessary – see below. If he had not made it, he could have argued that he had never come to the UK and was therefore not a leaver. He would not then have had to show a distinct break. Hence he would not have had to satisfy the greater criteria that the Court of Appeal has held was required under IR20 for leavers.



A key part of Gaines-Cooper's case was that he had spent less than 91 days a year in the UK ignoring days of arrival in and departure from the UK. The Special Commissioners did not follow the day-counting rules in IR20 but adopted a midnight test. The result was that until at least 2000–01 he was held to have spent more than 120 midnights in the UK for all years after 1992–93. The Special Commissioners expressly did not follow IR20 but applied the case law. They took a multi-factor approach, in particular:

(i) he had a settled abode in Henley where he dwelt permanently or indefinitely;
(ii) he spent more time in the UK than he spent in the Seychelles or anywhere else;
(iii) he had both family and business ties in the UK;
(iv) his wife and son lived in the UK and his wife considered herself UK resident;
(v) he purchased and restored expensive UK business property.

The Special Commissioner decided that he was not a visitor who was in the UK for temporary purposes but an ordinarily resident individual who had left the UK merely for occasional residence abroad. He was not here for a casual purpose but rather in pursuance of 'the regular habits of life':

> 'A decision to visit the UK on a large number of days each year to be with one's wife and child is not a temporary purpose.'

Gaines-Cooper did not challenge the decision of the Special Commissioners on his residence status although he did appeal on the domicile point, losing that case as well in the High Court. However, he pursued judicial review proceedings on the residence issue on the basis that he had followed the terms of IR20, and therefore had a legitimate expectation that HMRC would apply it, *regardless of whether those terms accorded with the actual law.*

In Brief 1/2007 issued in early 2007, HMRC effectively asserted what they later argued in the judicial review proceedings, namely, that even if they were bound by IR20 as a matter of principle, Gaines Cooper had not satisfied IR20 because he had misinterpreted the 90-day rule which applied only to individuals who had left the UK or to visitors coming here. It did not apply in determining whether an individual had 'left' the UK in the first place. In deciding this latter question, Brief 1/2007 stated that HMRC considers all relevant evidence, including the pattern of presence in the UK and elsewhere. Hence the retention of family and accommodation would suggest the individual had not left. HMRC summarised the position as follows:

> 'In considering the issues of residence, ordinary residence and domicile in the *Gaines-Cooper* case, the Special Commissioners needed to build up a full picture of the taxpayer's life. A very important element of the picture was the pattern of his presence in the UK compared to the pattern of his presence overseas. The Special Commissioners decided that, in looking at these patterns, it would be misleading wholly to disregard days of arrival and departure. They used the taxpayer's patterns of presence in the UK as part of the evidence of his lifestyle and habits during the years in question. Based on this, and a wide range of other evidence, the Special Commissioners found that he had been continuously resident in the UK. From HMRC's perspective, therefore, the 91-day test was not relevant to the *Gaines-Cooper* case since the taxpayer did not leave the UK.'

Gaines-Cooper pursued his judicial review proceedings along with two other taxpayers, Messrs Davies and James. He said he had abided by the terms of IR20 and therefore should be treated as non-resident. He had a legitimate expectation that HMRC would follow their own guidance and had relied on it to his detriment. HMRC initially resisted this, because of words in the Preface to IR20 which said:

> '… 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 …'

and because of words in para 1.1 which said:

> '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 …'

despite the unequivocal wording of Chapters 2 and 3. They also argued that IR20 cannot be allowed to produce a different result in any individual case from the strict law of residence because to have issued such a booklet would have been '*ultra vires*', outside HMRC's 'care and management' powers; and further, that once a person's residence status on the strict law has been decided against him by the Tax Tribunal, any 'legitimate expectation' the person had to be treated as non-resident would have become 'illegitimate'.

HMRC therefore strongly resisted Gaines-Cooper's application for permission to bring judicial review proceedings. As noted above, the Court of Appeal accepted that IR20 was subject to judicial review but did not accept that Mr Gaines Cooper had followed its terms. This decision was eventually upheld in the Supreme Court (see **[27.4]**). **[27.6]**

*HMRC 6*

This replaced IR20 in April 2009 and was far less prescriptive. It was amended in December 2010 and November 2011 but is heavily caveated throughout to avoid any argument that it raises a legitimate expectation. About the only useful part on which a taxpayer can rely relates to those working full-time abroad:

> **'8.5 Leaving the UK to work abroad as an employee**
>
> If you are leaving the UK to work abroad full-time, you will only become not resident and not ordinarily resident from the day after the day of your departure, as long as:
>
> - you are leaving to work abroad under a contract of employment for at least a whole tax year
> - you have actually physically left the UK to begin your employment abroad and not, for example, to have a holiday until you begin your employment
> - you will be absent from the UK for at least a whole tax year
> - your visits to the UK after you have left to begin your overseas employment will
>   - total less than 183 days in any tax year, and
>   - average less than 91 days a tax year. This average is taken over the period of absence up to a maximum of four years.



> **8.6 Returning to the UK after working abroad**
>
> If you were not resident and not ordinarily resident when you were working abroad and you return to the UK when your employment ends, you will be not resident and not ordinarily resident in the UK until the day before you return to the UK. You will become resident and ordinarily resident on the day you return to the UK unless you can show that your return was simply a short visit to the UK between two periods of full-time employment abroad.
>
> However, if you have previously been resident in the UK and are returning to become resident here again after a period of residence abroad, you might need to consider whether your absence from the UK was a period of "temporary non-residence". If you were temporarily non-resident in the UK, this may affect your liability to UK tax when you return to become resident in the UK again.'

HMRC accept that up to ten days' work in the UK is permitted in addition to any incidental duties here. However, there is no justification for arguing that those who leave the UK for a purpose only become non-resident when the purpose commences as distinct from when they leave the UK. For example someone leaving for full-time work abroad will rarely start such work immediately. They may well settle into new accommodation first during the school holidays. On HMRC's view they do not lose UK residence until the day the work commences. Hence someone leaving for full time work in March will need to commence such work prior to 6 April. **[27.7]–[27.8]**

b) *Statutory provisions*

Prior to 2013 there were three statutory income tax rules, not all of which were replicated in the capital gains tax legislation.

*Occasional residence abroad*

ITA 2007 s 829 applied to an individual if:

- he had left the UK for the purpose of only occasional residence abroad, and
- at the time of leaving he was both resident and ordinarily resident in the UK.

Where s 829 applied, the individual was charged to income tax as if he were still residing in the UK. The section was of very limited impact, and there is no reported case where it alone resulted in liability to tax. This is because an individual is normally found to retain residence in the UK if he has left the UK for only occasional residence abroad. Thus in *Levene v IRC*, the taxpayer was found to have left the UK for only occasional residence abroad, but equally he was resident in the UK all along (see below). Conversely, in *IRC v Combe* (1932), the taxpayer went to serve an apprenticeship in New York for three years and that was not found to be for the purposes of occasional residence abroad.

The leading case on occasional residence is *Reed v Clark* (1985). Here the taxpayer was absent for only a little over a year, but there was a distinct break in the pattern of his life and throughout his absence he had made his permanent home and place of business in California. On these facts Nicholls J

decided his residence in California was not occasional. Section 829 did not apply to CGT. This presumably is because ordinary residence alone rendered a person subject to CGT (TCGA 1992 s 2). Section 829 is discussed further at **Chapter 18**. However, in *Reed v Clark* the judge noted that 'the researches of very experienced Counsel have not revealed any reported decision in which a claim to tax has succeeded only by virtue of [statutory provisions]'.

In *Grace v R & C Comrs* (2008), HMRC having at one point agreed that s 829 did not apply and that Mr Grace had not left the UK for the purpose only of occasional residence abroad, then argued at the rehearing that they were not bound by this concession and that his residence in Cape Town was not occasional but for settled purposes as part of a regular order of his life adopted voluntarily. The argument was dismissed. This case was first heard by the Special Commissioner Nuala Brice who found in favour of the taxpayer (2008), whose decision was reversed on appeal by HMRC to the High Court (2008). The taxpayer appealed to the Court of Appeal successfully (2009) and the case was then remitted back to the First-tier Tax Tribunal for a rehearing where he lost (2011). The case is discussed further below at **[27.14]**.

Lord Wilson made some helpful comments on the context of s 829 in *Gaines-Cooper* (2011). He explained this section as follows:

> 'it is therefore clear that whether in order to become non-resident in the UK, or *whether at any rate to avoid being deemed by the statutory provision still to be* resident in the UK, the ordinary law requires the UK resident to effect a distinct break in the pattern of his life in the UK. The requirement of a distinct break mandates a multifactorial inquiry. In my view however the controversial references in the judgment of Moses LJ in the decision under appeal of the need in law for "severance of social and family ties" pitch the requirement at any rate by implication, at too high a level. The distinct break relates to the pattern of the taxpayer's life in the UK and no doubt it encompasses a substantial loosening of social and family ties; but the allowance to which I will refer, of limited visits to the UK on the part of the taxpayer who has become non-resident, clearly foreshadows *their continued existence in a loosened form.* "Severance" of such ties is too strong a word in this context.' (emphasis added)

The above comments of Lord Wilson are important in demonstrating that a taxpayer does not have to sever all ties; what he has to show is that he has not gone abroad for occasional purposes. In recent years HMRC have tended to elide this requirement with those for domicile and argued all ties must be broken with the UK. In the light of Lord Wilson's comments, the Revenue's approach is clearly wrong and should be resisted. **[27.9]**

*Temporary purposes in the UK*

This was relevant to both income tax and capital gains tax. ITA 2007 ss 831 and 832 applied to an individual if he was in the UK:

- for some temporary purpose only; and
- with no view to establishing his residence there.

Where these conditions were met, the relevant foreign income of the individual was not taxed (s 831) and he was treated as non-resident for the purposes of taxing employment income (s 832). But if he spent 183 days or more in the tax year in the UK, his relevant foreign income was taxable and he was treated as UK resident in taxing employment income. A similar provision was found for capital gains tax purposes in TCGA 1992 s 9 although this seemed more clearly in the nature of a relieving provision: the visitor who would otherwise be resident here was not treated as resident for capital gains tax purposes if he came here for temporary purposes and his stay was not more than 183 days. If his stay was more than 183 days then unlike ITA 2007 s 831(4) he was not automatically deemed to be UK resident. Instead he just lost the benefit of s 9(3) protection and his residence status was determined under general law although HMRC did and do not accept someone can be present for 183 days and not also *automatically* UK resident.



In determining whether the conditions of s 9 (or ss 831–832) were met, since 1993 living accommodation in the UK was ignored.

In computing how many days the individual spent in the UK a day counted only if the individual was in the UK at the end of the day. This, the so-called midnight rule, was first enacted in 2008 (FA 2008 s 24 and TCGA 1992 s 9(5)). An exception was made, and the day of arrival was disregarded, if the individual left the UK on the next day and did not while in the UK engage in activities unrelated to his passage through the UK. This was called 'the transit rule' and protected passengers who needed to stay overnight near an airport to get a connecting flight.

In *Grace v R & C Comrs* (see above), the Court of Appeal confirmed that ss 831 and 832 (and TCGA 1992 s 9) were not substantive rules as to residence. They conferred relief where the temporary visitor was UK resident or, had he exceeded the 183-day threshold, imposed income tax (but not necessarily capital gains tax) as if he were resident even if in fact he was not.

*Grace* also emphasises that what has to be temporary was not the individual's presence in the UK but his purpose (ibid at para 36). Was the reason for being in the UK casual or transitory? In *Grace* itself, the taxpayer was a BA pilot who had to be in the UK both before and after flights. This, the judge held, was not casual or transitory as it would continue from year to year so long as the pilot remained employed. Further guidance as to the meaning of temporary purposes was given in *Cooper v Cadwalader* (1904). Here an American had taken a lease of a shooting-lodge in Scotland, and he spent a continuous period of two months there each year during the grouse-shooting season. His principal residence and the place where he worked were in New York. The General Commissioners found that he was not resident in the UK, but this finding was reversed by the Court of Session. The question then arose of whether he was exempted by what later became s 831. All three judges who gave reasoned opinions held that it did not apply as the shooting-lodge was a residence and so meant he was in the UK with the view or intent of establishing his residence here. This point has been reversed by the 1993 change and so is now not good. But Lords Adam and McLaren then gave an additional reason for s 831 not applying, namely that coming to Scotland year after year for the shooting season was not a temporary purpose. In a significant passage Lord McLaren observed that 'temporary purposes means casual purposes as distinguished from the case of a person who is here in pursuance of his regular habits of life'. If this case is correctly decided then a person who spent less than three months in the UK and worked full-time abroad was nevertheless held to be UK resident, a result that seems directly to contradict HMRC stated practice and would