PURPOSE OR INTENDMENT: SPOT THE DIFFERENCE

by Michael Flesch

The purposive construction of tax statutes is all the rage nowadays. In the landmark House of Lords decision in *Barclays Mercantile Business Finance Ltd v. Mawson* their Lordships refer to "purpose" or "purposive construction" no fewer than eight times in the critical paragraphs of their (single) speech, paragraphs which occupy less than three pages of the report.[1]

It was not ever thus. In *Cape Brandy Syndicate v. IRC*, Rowlatt J. famously said this[2]:

> "... in a taxing Act one has to look merely at what is clearly said. *There is no room for any intendment.* There is no equity about a tax. There is no presumption as to a tax. Nothing is to be read in, nothing is to be implied. One can only look fairly at the language used" (my emphasis).

The Shorter Oxford English Dictionary defines "intendment" as (inter alia) "What a person aims at; purpose, intention" (my emphasis).

Mr. Justice Rowlatt's statement has, over the years, been regularly cited with approval in both the House of Lords and the Privy Council: see e.g. *Canadian Eagle Oil Company v. The King* (HL)[3] and *Mangin v. IRC* (PC).[4] Indeed, in *WT Ramsay Ltd v. CIR*[5] itself – the case that spawned the so-called '*Ramsay* principle'[6] – Lord Wilberforce echoed Rowlatt J's famous words. The first of the "familiar principles" re-stated by Lord Wilberforce in *Ramsay* commences[7]:

> "A subject is only to be taxed on clear words, *not on intendment* or on the 'equity' of an Act. Any taxing Act of Parliament is to be construed in accordance with this principle" (my emphasis).

So that seems pretty clear. No room for any intendment.

But hang on a minute. Was it not Lord Wilberforce's speech in *Ramsay* to which the House of Lords in *Barclays Mercantile* referred in support of purposive construction? Indeed it was. In para.29 of their speech in *Barclays Mercantile*, their Lordships say[8] that it is worth quoting a passage from the influential speech of Lord Wilberforce in *Ramsay* on the general approach to construction:

> "What are "clear words" is to be ascertained on normal principles; these do not confine the courts to literal interpretation. 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."

Now what immediately strikes one about that citation from Lord Wilberforce in *Ramsay* is that something is missing. As it stands it does not really make sense. Surely there must have been an earlier reference to "clear words". And of course there *was* such an earlier reference. Because the passage cited by their Lordships in *Barclays Mercantile* follows on immediately from the passage (set out earlier) from Lord Wilberforce's speech in *Ramsay* in which he echoes Rowlatt J's statement in *Cape*

Brandy Syndicate; the opening of Lord Wilberforce's first "familiar principle". Lord Wilberforce's opening words are worth repeating:

> "A subject is only to be taxed on clear words, not on 'intendment' or on the 'equity' of an Act. Any taxing Act of Parliament is to be construed in accordance with this principle."

It is against the background of that statement that Lord Wilberforce's subsequent comment about "clear words" has to be read. But their Lordships in *Barclays Mercantile*, by omitting those critical opening words of Lord Wilberforce and starting their citation in the middle of Lord Wilberforce's first principle, totally distort Lord Wilberforce's meaning. It is not clear whether this was by accident or design. Clearly their Lordships were anxious to demonstrate top-level judicial support for purposive construction. But one trembles to think what the reaction of the House of Lords – or indeed any Court – would be to Counsel who chose to cite so selectively and misleadingly from an earlier judgment. In the House of Lords however – as Cole Porter famously wrote – anything goes.[9]

But the important point is this. The purposive construction of taxing statutes is here to stay: the 'no intendment' principle has gone. And the practical consequence of this is that Judges can now decide tax cases – and in particular tax cases involving perceived avoidance – very much as they wish. Adapting Lewis Carroll's words in Alice Through the Looking Glass:

> "'When [Parliament uses] a word' [Mr. Justice] Humpty Dumpty said in a rather scornful tone, 'it means just what I choose it to mean – neither more nor less'."

And that, I am afraid, is where we are today.

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[1] See [2005] STC 1, at pp.11c – 14a, paras.28-39.
[2] [1921] KB 64, at p.71.
[3] [1946] AC 119, per Viscount Simon L.C. at p.140.
[4] [1971] AC 739, per Lord Donovan at p.746D.
[5] [1981] STC 174.
[6] Or should it be 'non-principle'? See *Barclays Mercantile* [2005] STC 1, at p.12, para.33. But then what about the reference to "the value of the *Ramsay* principle" in *IRC v. Scottish Provident Institution* [2005] STC 15, at p.26, para.23? An example of the House of Lords 'having its cake and eating it'.
[7] [1981] STC 174, at p.179j.
[8] [2005] STC 1, at p.11, para.29.
[9] Perhaps it should now be: "anything went". Will it be any different in the new Supreme Court? Don't hold your breath.

ON THE NATURE, IN LAW, OF REALITY

David Goldberg

It’s August 2009. I am in the part of the universe that I (and quite a lot of other people) call Andromeda Dieci. Next to me, in Andromeda Nove, is a man reading a book in Greek. The book is about legal philosophy. I can tell that even though I don’t read Greek, because the name of the author – Ronald Dworkin – is, strangely, in English and I know that he writes books – rather good books actually – about that sort of thing.

I am not reading a book about legal philosophy. I am reading a book called Quantum by Manjit Kumar: it’s a very good book about quantum physics. That’s the sort of thing I really really enjoy doing when I am in Andromeda Dieci and I’ve just learnt something – I’ll tell you what in a moment, hold on – that has made me spend some time thinking about the similarities between quantum physics and legal philosophy. Thinking like that allows me to rest my eyeballs, which is another thing I enjoy doing in Andromeda Dieci.

At any rate, all that is my perception of what was going on in my apparent universe on a certain day in August 2009.

What I had just learnt from my book was that physicists – really serious physicists, not nutcases – now believe that we do not live in a universe but, rather, in a multiverse. There are many worlds, parallel universes, all existing all at once and separated from the world we think we are in by membranes which we cannot see or feel, but which are just there, almost but, somehow, not quite, in grasp.

And in these parallel worlds, I exist, but differently from the way I perceive myself to exist here in this world. It’s sort of comforting. Somewhere – but I can’t quite get there with the perception of things I have here – somewhere there is a world in which I not only won *Arrowtown* and *Carreras*, but got the girl too. Or perhaps it needs two other different worlds to win and get the girl: it doesn’t do to be too ambitious in Andromeda Dieci.

All of this kind of thinking has been developed, starting mainly from the work of Nils Bohr and, a bit later, Werner Heisenberg, who came up with something called the uncertainty principle. The description which these physicists provided of what is going on inside the atom is called “the Copenhagen Interpretation”.

Now, of course, I am not a physicist, but, so far as I understand it, the theory is that you can have a pretty good general idea of what is going on inside an atom, but you can’t know everything about that because particles sometimes do things that are unpredictable; there is “spooky interaction at a distance” (so that one particle, billions of light years away, will, even though nothing can travel faster than light, instantaneously react if you do something to a particle near you) and all that sort of thing.

Not every physicist agreed with that sort of idea – it's all right, I am going to get back to law quite soon now – and one of the physicists who liked it least was Erno Schrodinger.

Schrodinger is, of course, famous for his cat which was in a box and, at one and the same time, alive and dead. Until August 2009, I thought that Schrodinger had really meant that the cat was actually alive and dead at the same time, but it turns out that he was ridiculing the notion: the cat could only be alive and dead at the same time if all you were doing was thinking about it in an abstract way; if you actually opened the box and looked at the cat, you would find it either alive or dead, but not both at once.

Moreover – and I think every physicist agrees with this – even if the Copenhagen Interpretation is right at the sub-atomic level, it isn't right on a larger scale: particle physics does not tell us what the sun does to the earth; buses do not suddenly and unexpectedly materialise in front of you from nowhere, even if it sometimes seems like that.

What Schrodinger was saying was that the Copenhagen Interpretation did not accord with reality: the physics of the quantum must, in his view, be more predictable than the theory said it was; there must be some coherence between micro and macro physics.

Nonetheless, the Copenhagen Interpretation, despite all its unpredictability, works well enough that physicists can accurately say what will happen in any given set of circumstances, even though they can't say exactly how it will happen.

Or, to put that another way, there are some uncertainties which can be disregarded more or less because they are inherent in the structure. I wonder if you can begin to see where I am going?

To finish with the physics – well, almost – the idea that you could have a cat which was at one and the same time dead and alive, which Schrodinger thought was ridiculous – and I expect most of us do too – was taken seriously by the quantum community, and it was that which led Hugh Everett in 1957 to come up with the multiple worlds theory to which I referred at the beginning of this article. That theory is now taken very seriously by the physics community, even though the differences between micro and macro physics have not been resolved.

The trouble with all this is that it does not accord with anything that you or I would call reality. But it works: the equations which flow from these ideas enable computers to be built and so on.

So let me get to the law. I can do it quite briefly: the physics has done it all for me.

Any statute must now be read and applied bearing in mind the driving principle that:

> "the ultimate question is whether the relevant statutory provisions, construed purposively, were intended to apply to the transaction, viewed realistically."

The quotation comes from the judgment of Ribeiro PJ in *Collector of Stamp Revenue v Arrowtown Assets Ltd* [2003] HKCFA 46 at paragraph 35. It was approved in *Barclays Mercantile v Mawson* [2005] STC 1 at paragraph 36. It was the first express recognition that the so called *Ramsay* principle had a factual aspect.

In *Arrowtown* the Court held that shares, which undoubtedly existed as a matter of company law, did not exist for the purposes of stamp duty: like the cat, the shares were alive and dead at the same time. In a similar way, the debenture in *Carreras* and the real contingencies built into the transaction in *Scottish Provident* were there and not there: the uncertainty did not matter; and something like that has recently happened in *Astell*.

That does not seem to me to involve viewing the transaction or the facts realistically: on the contrary, it seems to me to be viewing them highly artificially in a surreal rather than a real way.

Nonetheless, I have to accept that the sort of analysis adopted by the Courts in the recent cases accords well with the ideas of particle physicists which are supposed to represent what actually happens in the physical world: if in the cold hard world of mathematical equations, things can exist and not exist at the same time, how can anyone say that any Court's analysis is not realistic?

What, in other words, is the test of reality? Is it a question of uncertain physics or is it something which I can perceive? As Bishop Berkeley used to believe, does a stone exist only because I can kick it?

Some modern physicists, by the way, sort of answer that question yes, while also believing that things can sort of be alive and dead at the same time. The point here is that the very act of observation changes things: the cat is, according to these physicists, actually alive and dead until you look in the box; it is the act of looking which makes it one or the other. It follows things are only as they seem to be because we observe them. So, some physicists, like some judges, believe that reality is quite elastic: it can almost be what you want it to be; it is certainly what you see it to be.

For myself, I do not believe – and do not accept – that the idea of reality can, in law, be equated to sub atomic physics. Surely, in law, the concept of reality must accord to the everyday perceptions of large scale physics rather than those of particle physics. Law, after all, needs to operate on a grand scale or it cannot be a useful guide to the correct principle: it is no good if all it does is to micro-manage.

And perhaps I can, after all, get some support for what I have just said from the world of physics. There was one physicist who didn't believe that reality could be what you wanted it to be. He's the man who explained gravity and the bending of space time, who discovered that $E=mc^2$ and made your Sat Nav work accurately. He's my hero, not only because of his hair, but, rather, because by the power of his mind alone he solved some of the great puzzles of the universe. I am, of course, speaking about Albert Einstein.

In 1935, with two other physicists, Podolsky and Rosen, he published a paper, now known as the EPR paper, which questioned the, by then, generally accepted wisdom. The authors said that the Copenhagen Interpretation was correct, but not complete. Before any theory could be said to be complete:

> "every element of the physical reality must have a counterpart in the physical theory."

In the view of Einstein, Podolsky and Rosen, a cat could not be alive and dead at the same time (they used the example of a keg of gunpowder which was both exploding and not exploding at the same time, but it's the same point): the aliveness or deadness of the cat in the actual world did not have a counterpart in the Copenhagen Interpretation, so it could not be complete.

Now, I realise that modern particle physics has moved on and rather left the protestations in the EPR paper behind, but large scale physics has not; and the idea in that paper resonates with me.

The law is that statutes are to be construed purposively. As Michael Flesch has shown elsewhere in this edition, that gives the Court considerable flexibility to make up – invent, if you like, what the law is; and it may be hard for lawyers to control what the Court does with such a flexible tool.

But perhaps there may be some scope for limiting the range of the Court's apparent ambition to tax by insisting on the need for every part of the judicial analysis of a transaction to have a counterpart in the legal analysis of the transaction.

I recognise that, so far, I have not managed to impose this degree of control on Courts dealing with my cases. But it's early days still. The need to take a realistic view of the facts is still only five or six years old and we are still learning how to handle that requirement.

I only learnt about the EPR paper three months ago. The idea that an analysis can only be described as realistic if every part of it has a counterpart in the legal analysis is new ammunition. It may help stop the wastage of the obstinate struggle in which the Courts are, dangerously, trying to make tax law up as they go along. It is surely not too much to ask that, in applying a realistic view of the facts, the Courts take a view which accords with everyday notions of reality – with large scale physics, physics on the human scale – rather than with the uncertainty principle. At any rate, I am determined to do what I can to ensure that that happens, armed as I am with new ideas gleaned from my trip to Andromeda Dieci.

By the way, Andromeda Dieci is a beach hut at Venice Lido. I was hoping you would think I spent last August in another galaxy. Perhaps, in another part of the multiverse, I did, but my perception is that I was on the Lido and that's the reality. I thought I should be real.

THOUGHTS ON *DRUMMOND*[1] AND THE JUDICIAL APPROACH TO TAX AVOIDANCE

by Imran Afzal[2]

On the surface this case was simply concerned with whether an avoidance scheme, based on the surrender of second-hand life insurance policies, produced the tax results envisaged by the taxpayer. However the case also has broader relevance in relation to the interaction between capital gains tax ("CGT") and income tax, and gives an indication of the current attitude of the Courts towards tax avoidance.

In outline the facts were as follows. London & Oxford Capital Markets ("London & Oxford") was a small investment company which operated as a market maker in second hand life assurance policies. It created a stock of such policies by arranging for an interest free loan to be made to one of its employees, Ms Sedgley, and the latter used the loan to effect life insurance policies with the American Life Insurance Company ("AIG") on 23 February 2001. The policies were real ones and the rights of the policyholder were of an arm's length nature. On 26 March 2001 Ms Sedgley assigned the policies to London & Oxford for a small profit. The latter charged the policies as security for an overdraft on 28 March 2001 and on 30 March 2001 it drew down on the overdraft facility and used the funds to pay substantial additional premiums on the AIG policies. Of course from Mr Drummond's point of view the background is largely irrelevant. His concern was to buy and then surrender second-hand life policies: given that the policies were genuine, their provenance was immaterial. Mr Drummond agreed to purchase five of the policies from London & Oxford for £1.962 million. The five policies had a surrender value of £1.751 million (equivalent to the premiums paid). On 05 April 2001 the Appellant surrendered the 5 policies to AIG. The entire process had cost Mr Drummond approximately £210,000 and the object had been to create an allowable CGT loss of £1.962 million.

The surrender of the 5 policies triggered a charge to CGT and income tax. The dispute with HMRC ("the Revenue") concerned the amounts which could be excluded from the disposal consideration for CGT purposes ("the section 37 issue") and the sums which could be deducted as allowable expenditure ("the section 38 issue"). The taxpayer's position was that the disposal consideration should be reduced to nil, whilst there should be allowable expenditure of £1.962 million, thus creating an allowable loss in the latter amount.

The Scheme of the Legislation

The surrender of an insurance policy resulted in an income tax charge under Chapter II of the Income and Corporation Taxes Act 1988 ("ICTA 1988"). Section 539 of that Chapter provided that it had effect "for the purposes of imposing…charges to tax…in respect of gains to be treated…as arising in connection with policies of life insurance…". In turn s.540(1)(a)(iii) identified the surrender of the whole of the rights conferred by a non-qualifying policy as a "chargeable event". Section 541(1)(b) then provided that:

> "On the happening of a chargeable event…there shall be treated as a gain arising in connection with the policy… (b) if the event is… the surrender in whole of the rights, thereby conferred, the excess (if any) of the amount or value of the sum payable plus the amount or value of any relevant capital payments arising by reason of the event…over the sum of the following (i) the total amount previously paid under the policy by way of premiums; and (ii) the total amount treated as a gain…on the previous happening of chargeable events."

The effect of the above section was to produce a deemed gain ("the chargeable event gain") of £1,351 which was the difference between the surrender value and the premiums paid. An income tax charge was imposed on this deemed gain by s.547(1)(a) which treated the gain as "…part of the individual's total income for the year in which the event happened…".

However in addition to the income tax charge the surrender also triggered CGT consequences. Section 210(3) of the Taxation of Chargeable Gains Act 1992 ("TCGA 1992") provides that subject to subsection (2) "…the occasion of the surrender of a policy of assurance, shall be the occasion of a disposal of the rights under the policy of assurance". Subsection (2) of that section stated that a chargeable gain would only accrue where the disponer was not the original beneficial owner of the policy and acquired the rights for a consideration in money or money's worth. As such the surrender of the 5 policies by the taxpayer was a chargeable event for CGT purposes.

Clearly the application of both taxes created the scope for double taxation. This was addressed by ss.37 and 38 TCGA 1992, and it was over the operation of these sections that the dispute arose as follows.

The Section 37 Issue

Section 37 TCGA 1992 provides that:

> "(1) There shall be excluded from the consideration for a disposal of assets taken into account in the computation of the gain any money or money's worth charged to income tax as income of *("the First Limb")*, or taken into account as a receipt in computing income or profits or gains or losses of, *("the Second Limb")* the person making the disposal for the purposes of the Income Tax Acts." [limb references added]

Prima facie the disposal consideration for CGT consisted of £1.751 million (i.e. the surrender proceeds), and the dispute concerned the amount, if any, to be excluded from this. The Revenue argued that the chargeable event gain fell under the First Limb of s.37, such that only £1,351 fell to be excluded. By contrast Mr Drummond contended that the entire surrender proceeds should be excluded under the Second Limb, on the basis that it was taken into account under section 541(1)(b) ICTA 1988 in calculating the deemed gain. The effect would be to reduce the disposal consideration to nil, and in turn the effect of any allowable expenditure under s.38 would be to produce a loss: this, of course, was the object of the scheme.

Patrick Way, counsel for the taxpayer, made a number of arguments in support of this contention. In outline his main submissions were as follows:-

(i) The chargeable event gain was not "money" or "money's worth" and as such could not fall under the First Limb. Although it was calculated by deducting one sum of money from another this did not mean it was money: on the contrary it was simply the product of an arithmetical calculation. Even though money was the unit of measurement, nonetheless the chargeable event gain was not actually money, e.g. it could not be spent in a shop. Further the phrase "money's worth" meant something of value which could be converted into money, but this was not the case with a chargeable event gain.

(ii) Treating the chargeable event gain as money satisfying the First Limb meant that both parts of s.37 would be satisfied without the section making clear which Limb would take priority. The Second Limb was satisfied because the surrender proceeds were money and they were taken into account in computing the gains (i.e. the chargeable event gains) of the taxpayer for income tax purposes. Mr Drummond's construction, whereby the First Limb was not satisfied, would avoid any overlap between the two Limbs.

(iii) More generally, the First Limb was not applicable because the structure of s.37 showed that the two Limbs were mutually exclusive. The First Limb was concerned with "pure income profits", i.e. sums in relation to which no computation was necessary to determine the amount subject to income tax, for example interest from a building society or a dividend. By contrast, the Second Limb was aimed at amounts which were not themselves subject to income tax but were taken into account in the computation of amounts so charged. The chargeable event gain was not a pure income profit and thus did not satisfy the First Limb, but the surrender proceeds did satisfy the Second Limb.

(iv) The taxpayer's approach was consistent with purposive interpretation. Admittedly, the aim of s.37 was to prevent double taxation and not to allow the creation of artificial losses for tax purposes. However, in adopting highly detailed legislation Parliament's purpose had been to achieve certainty, and it had accepted the risk of anomaly as part of this overall purpose. Indeed HMRC itself had recognised this anomaly since on 09 April 2003 it issued a Budget Note[3] in which it recognised that a taxpayer could create a tax loss where there was no economic loss and it was to correct this "defect" that the legislation was amended by the Finance Act 2003.

The Special Commissioner rejected the taxpayer's argument and held that the First Limb applied. In essence his reasoning was that the surrender proceeds were not monies taken into account in computing Mr Drummond's income, profits or gains for income tax purposes, and instead the only amount so taken into account was the actual chargeable event gain of £1,351.

Similarly Norris J found in favour of the Revenue. His view was that the chargeable gain was “money”, since it was the difference between two other sums of money, and thus the First Limb was satisfied. In turn it was not necessary to consider if there was some other sum of money (i.e. the surrender proceeds) which also satisfied s.37. Further and in any event the judge held that the Second Limb was inapplicable because the policy proceeds were not brought directly into the computation of Mr Drummond’s total income; on the contrary they simply provided the starting point for the statutory calculation.

The taxpayer appealed against the judge’s decision, and in addition to the main arguments above Mr Drummond’s counsel also made the following submissions:-

(i) The surrender proceeds were taken into account in computing Mr Drummond’s gains, i.e. chargeable event gains. The judge had relied on *Hirsch v Crowthers Cloth Ltd*[4] (“*Hirsch*”) in which Vinelott J held that “taken into account” meant being brought “directly” into a computation, but in the present case the judge considered that this had not happened. However a comparison with what Vinelott J regarded as sufficiently direct in *Hirsch* showed that the surrender proceeds did satisfy the Second Limb.

(ii) Norris J introduced a hierarchy into s.37 by saying that once the First Limb was satisfied it was not necessary to see if there was any other money which fell within the section. As such the First Limb took priority over the Second Limb: not only was this not warranted by the wording of the section but in addition would lead to double taxation, as illustrated by the following example.

Assume X Ltd. carried on the business of constructing and selling large retail developments, making up its accounts to the 31st December each year. In the year ended 31 December 2001 it made only one disposal (of a shopping centre) for £100 million. It had acquired the site for £10 million and spent £30 million on development. As such its trading computation for the year would result in a taxable profit of £60 million.

Under the judge’s interpretation of s.37 the disposal consideration (which was *prima facie* £100 million) would be reduced by £60 million; the latter would be treated as money since it resulted from the difference between sums of money. £100 million would not be excluded under the Second Limb since the latter would not be considered – instead the First Limb would take priority but this would only allow an exclusion of £60 million.

However, X Ltd’s allowable expenditure would still be reduced by £40 million as a result of s.39 TCGA 1992. This would mean that X Ltd would have a chargeable gain of £40 million and be subject to income tax on £60 million – in total the taxable amount would be £100 million although the economic profit was only £60 million.

(iii) The taxpayer’s approach was supported by *Revenue & Customs Commissioners v Smallwood*[5] (“*Smallwood*”). In that case the Court of Appeal considered the interaction between ss.38-9 TCGA 1992. Section 39 excluded certain items *prima facie* allowable as deductions under s.38, and the Court held that the word “excluded” was designed to ensure that s.39 could only exclude things which would otherwise be included under s.38. The same reasoning could be applied to s.37, which also contained the word “excluded”. Based on *Smallwood* the only sums that could be excluded from the disposal consideration were those which formed part of it in the first place – the chargeable event gain never did so.

The Court of Appeal unanimously found in favour of the Revenue and a single judgment was given by Rimer LJ. In outline the Court’s reasoning was as follows:

(i) Interpretation requires more than black letter literalism. The purpose of ss.37-39 was to prevent double taxation, not to “enable the creation of an imaginary loss”, and this must be borne in mind when construing s.37.

(ii) This was a case falling within the First Limb. The chargeable event gain was “money” chargeable to income tax, and was a figure which would feature in the taxpayer’s tax return like dividends or interest.

(iii) By contrast this was not a Second Limb case. The surrender proceeds were not “taken into account as a receipt in computing income” since they did not feature in the taxpayer’s tax return or in accounts he might have to prepare for the purpose of their completion. The Second Limb was aimed more naturally at the case of traders, i.e. it would catch trading receipts and in turn trading expenses would be excluded from deduction by s.39.

The taxpayer’s argument that the judgments below were “driven by a desired result rather than by an objective analysis of the language of section 37(1)” was rejected by the Court as unjustified. The Court of Appeal’s judgment may leave the reader with a similar feeling. Undoubtedly the result achieved would accord with most people’s sense of fairness: it is a “sensible” result, but nonetheless it does not sit easily with the wording of the legislation and in particular the way in which it is applied in other contexts. A number of arguments made by the taxpayer were not addressed, and some of the reasons given by the Court are open to challenge. Some of the key problems are as follows:

(i) It is true that the surrender proceeds do not feature on a tax return, but nor do individual trading receipts, yet the Court accepted that the latter satisfy the Second Limb. Trading receipts do of course feature in accounts, whereas surrender proceeds may not, but in any event it is not clear why a figure must appear in a tax return or accounts for the Second Limb to be satisfied. All that is required is that a receipt be taken into account in a computation, and the surrender proceeds were. Indeed it is noteworthy that the Court said the policy proceeds were not taken into account in computing "income", but the First Limb also refers to the computation of "gains" – the latter should include chargeable event gains.

(ii) The Court of Appeal's conclusion that the chargeable event gain was "money" within the meaning of the legislation is defensible. However the taxpayer's more fundamental point was that the First Limb was concerned with "pure income profits", i.e. amounts which are subject to income tax without any prior calculations, and chargeable event gains do not fall within this category. The problem is that if chargeable event gains, which are the product of a calculation, can fall within the First Limb then there is no reason why net trading income cannot also. However, the Court recognised that individual trading receipts satisfy the Second Limb, and therefore there would be overlap between the two Limbs and scope for double taxation as indicated by the taxpayer. Unfortunately the judgment does not address the point. The Court may have been comforted by the knowledge that the Revenue is unlikely to apply the legislation to traders in "ordinary" cases in a way that leads to double taxation, but it is questionable whether this should prevent the legislation being applied in a way which is internally coherent. On the one hand it achieves what might be called a "common-sense result", but on the other, the decision if examined closely does violence to the provisions.

(iii) The Court did not explore in depth the underlying cause of the anomalous result contended for by the taxpayer. In an "ordinary" case if a person is subject to both income tax and CGT it is the same figures which are used for both. In turn ss.37 and 39 exclude from the CGT computations the amounts taken into account for income tax purposes. Since they are the same figures the CGT amounts are reduced to nil, such that there is only an income tax charge. This can be illustrated by an example.

Assume a trader bought a widget for £2 and sold it for £10. For income tax purposes he will have a trading receipt of £10 and an expense of £2, leading to a taxable profit of £8. Similarly for CGT his disposal consideration will *prima facie* have been £10 and his allowable expenditure under s.38 £2, producing a chargeable gain of £8. However the effect of ss.37 and 39 would be reduce both by the amounts taken into account in the income tax computation, such that both would be become nil and there would be no chargeable gain.

The mismatch in relation to second-hand life insurance policies flows from the fact that for income tax purposes the chargeable event gain is calculated by deducting from £1.751 million the premiums paid by other persons. However, for CGT purposes the gain is *prima facie* calculated by deducting from £1.751 million the price paid for the policy by the taxpayer himself. Thus whilst s.37 reduces the disposal consideration to nil, because the same figure was taken into account for income tax purposes, s.39 does not reduce the allowable expenditure to nil because that sum was not used in the income tax computation. This mismatch creates the artificial loss. An appreciation of this might have made the taxpayer's contentions more acceptable notwithstanding the anomalous result.

The Section 38 Issue

The allowable expenditure for CGT was governed by s.38 TCGA 1992 which allows the consideration given wholly and exclusively for the acquisition of an asset to be deducted from the disposal consideration in calculating a gain/loss. The taxpayer argued that the entire £1.962 million paid should have been allowable as a deduction: if he was correct on the s.37 issue, such that the disposal consideration was reduced to nil, the effect would be to create a net loss of £1.962 million for tax purposes. By contrast the Revenue argued that none of the expenditure should have been deductible since Mr Drummond's purpose in acquiring the insurance policies was simply to create a loss for CGT purposes.

The Special Commissioner found in favour of the Revenue, whereas Norris J took a "middle ground". Bizarrely, had the Special Commissioner's decision been upheld Mr Drummond would have made a chargeable gain of £1.75 million. However, Norris J held that expenditure could be allowed under s.38, as a general proposition, because there was no purpose test for CGT (unlike the test that applied pursuant to s.74 ICTA 1988). However only £1.751 million was allowable; the difference of approximately £210,000 represented scheme costs (e.g. London & Oxford's profit, an introductory commission, a contribution to a fighting fund etc.) and as such was not spent wholly and exclusively on acquiring the policies, with the result that it was not allowable.

Mr Drummond appealed on the basis that the various benefits and services acquired in addition to the policies were an integral part of the acquisition, such that their cost should be allowable. Alternatively, the figure of £210,000 was not necessarily correct. The appropriate course was to value the various services and benefits, and in turn the balance would be attributable to the acquisition of the policies: it was wrong to assume that the amount spent on acquiring the policies was limited to their market value of £1.751 million since sometimes a person is willing to pay a greater amount.

The Court of Appeal rejected the taxpayer's arguments. It seems the Court was correct to reject the primary argument that the entire £1.962 million should be deductible; it was clear that some of the expenditure was on scheme costs and this should not have been allowable. The contention that the exact amount attributable to the scheme costs may not have been £210,000 had greater merit, but the Special Commissioner had found that this was the amount as a fact and his decision does not seem to have been so unreasonable that no reasonable tribunal could reach it.

Conclusion

The Court of Appeal's rejection of the taxpayer's s.38 arguments should not create much controversy, but its approach to s37 is noteworthy as a reminder of the judicial distaste for tax avoidance schemes. The Court's conclusion was sensible in terms of the fiscal result, but it was at the expense of an in depth analysis of the provisions and the consequences which could potentially flow from the decision. Of course it is a comfort that the Revenue is unlikely to interpret the judgment so as to allow it to impose double taxation in "ordinary" cases.

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[1] *Drummond v Revenue & Customs Commissioners* [2009] EWCA Civ 609

[2] The author was involved in the case as a pupil of the taxpayer's counsel. The views expressed here are his own.

[3] REV BN 30 Capital Gains: Second Hand Life Insurance Policies

[4] 62 TC 759

[5] [2007] STC 1237

STAMP DUTY: AN EPILOGUE

The decision in *Parinv* in aid of the taxpayer

by Marika Lemos

In accepting a cheque in full and final settlement of the liability of a husband and his wife (Husband and Wife) to stamp duty (no payment of interest or penalties having been made), HMRC appear to have agreed that the decision in *Parinv*[1] can operate in favour of the taxpayer, at least in respect of extinguishing any potential claim to interest and penalties.

The facts were these. In late March 1999, an agreement for sale was executed between a wholly owned husband-and-wife company (the Vendor) and Husband and Wife (the Purchasers), the terms of which were that a property (the Property) would be sold to the Purchasers for a consideration of less than £500,000 payable upon signature, and that "On payment of the purchase price the Vendor shall forthwith execute and hand over to the Purchasers a declaration of trust in the form of the draft annexed hereto." Absent the execution of a declaration of trust in accordance with the terms of the agreement for sale, a liability to stamp duty would not have arisen on the sale. The intention was to implement a familiar avoidance mechanism used to get round stamp duty known as "resting on contracts": the equitable interest in the Property would pass to the purchasers by operation of law but the contract itself would not have been an instrument of transfer within ss.54 and 59 of the Stamp Act 1891. The Property could subsequently have been sold to a third party, who would then have been liable to stamp duty on the conveyance of the legal estate to it. The Purchasers would have relied on sub-sale relief under s.58(4) of the Stamp Act 1891: only the consideration from the third party would have been chargeable to *ad valorem* duty.

Husband and Wife should have rested on contracts. Meanwhile, the Vendor would have continued to occupy the Property with the benefit of a lease. Unfortunately the taxpayers were ill advised: a declaration of trust was in fact executed on the same day as the agreement for sale. The transaction was therefore not effective in avoiding stamp duty in the manner intended. If the declaration of trust were to be presented for stamping, *ad valorem* stamp duty rates applicable from 16 March to 30 September 1999 would have applied, i.e. 3.5% (in this case, because the declaration of trust had not been certified): a liability to duty, plus penalties and interest, had been incurred.

The stamp duty legislation contains no provision which enables HMRC to sue for stamp duty. This is because no legal obligation is imposed on taxpayers to pay the duty or even to submit the instruments for adjudication or stamping. The need to stamp an instrument arises from the inability to rely upon or enforce or register the instrument unless it is duly stamped: see s.14(4) of the Stamp Act 1891. The position is summarised by Donovan LJ in *Henry and Constable (Brewers) Ltd v IRC* [1961] 1 WLR 1504 at 1511: "There was ... no legal obligation on [the taxpayers] to stamp the transfers: there was simply the prospect of future disabilities if they did not." As Husband and Wife controlled the Vendor company, there was no immediate need to prove their equitable interest in the Property and therefore no pressing need or requirement to present the declaration of trust for stamping. However, they wanted to regularise their affairs, as they wanted to be able to sell the company and to be in a position to assert their ownership of the Property if necessary. They did not want to pay interest and penalties.

They were able to achieve this by procuring the conveyance to them of the bare legal title to the Property. In so doing they incurred a liability to *ad valorem* stamp duty on the conveyance of the bare legal title executed in 2009.[2] On its face, the conveyance (on Transfer Form TR1) was for nil consideration, but Husband and Wife were prepared to accept that consideration had in fact been paid for the Property under the original Agreement for Sale executed in 1999. TR1 was certified and 2.5% (instead of 3.5%) duty was paid on the initial consideration for the transfer. HMRC accepted that the liability to *ad valorem* stamp duty arose in 2009, and thereby relinquished any right to pursue interest and penalties.

The argument that was accepted by HMRC went as follows:

1. Husband and Wife do not propose to present the Declaration of Trust executed in late March 1999 by the vendor pursuant to an Agreement for Sale, for stamping;

2. In the absence of a stamped Declaration of Trust, Husband and Wife are in principle unable either to prove or otherwise to rely on the fact that equitable title to the whole of the Property passed to them in late March 1999 (section 14(4) of the Stamp Act 1891);

3. Following the Court of Appeal decision in *Parinv* and in the absence of any explanation to the contrary, which secondary evidence of the existence of the Declaration of Trust cannot provide (per Lindsay J in *Parinv* in the High Court),[3] the Stamp Office was entitled to regard the transfer effected by transfer form TR1 as a 'transfer on sale', chargeable by reference to the amount of consideration supplied for the transfer of the interest in the Property which is properly to be taken to be transferred by transfer form TR1. In other words, transfer form TR1 was to be taken to transfer so much of the equitable interest in the Property as Husband and Wife were not able to prove already vested in them. For stamp duty purposes, the consideration for the transfer effected by TR1 therefore included the consideration supplied pursuant to the 1999 agreement for sale;[4]

4. Following *Parinv*, transfer form TR1 was stampable with *ad valorem* stamp duty with reference to the consideration paid under the 1999 Agreement for Sale;

5. Transfer Form TR1 was certified as being a transaction which did not exceed the amount of consideration payable under the 1999 Agreement for Sale. The rate of duty applicable for transfers giving effect to contracts made before 22 March 2000 is 2.5% if the instrument was certified and the amount or value of the consideration was £500,000 or under (see Paragraph 4 Schedule 13 FA 1999 as effective for such transfers), which it was.

The result is perhaps not surprising, given the taxpayers' willingness to pay the tax due. It is likely that HMRC took a pragmatic view: it was better to collect some tax and to relinquish possible claims to interest and penalties, rather than to pursue these come what may. But it was also a good result for taxpayers. For those wishing to regularise their affairs, there is a strong legal argument that interest and penalties (which in this case were each at least equal to the tax due) can be sidestepped. In this case, the taxpayers were also able to reduce their liability to tax a further 1% by ensuring that the 2009 conveyance was properly certified. Perhaps most importantly, the costs and aggravation of having to investigate and/or pursue claims against those who had failed properly to advise them that the Declaration of Trust should not have been executed were avoided.

[1] *Parinv (Hatfield) Ltd v IRC* [1996] STC 933 (HC), [1998] STC 305 (CA) ("*Parinv*").

[2] On the basis that the conveyance was "effected in pursuance of" the agreement for sale executed in 1999 (see FA 2003, s.125 and Schedule 19).

[3] [1996] STC 933.

[4] In fact, the position was a little more complicated than set out above. The agreement for sale was for the purchase of the Property by Husband and Wife as to 50% and by a third party ("X") as to the remaining 50%. In April 2008, X had assigned her share of the Property to Husband and Wife for consideration. This assignment could not be argued to have been effected in pursuance of the March 1999 Agreement for Sale and was therefore an "SDLT transaction" subject to SDLT and not stamp duty (see Schedule 19 to FA 2003). It was argued on behalf of the taxpayers that as Husband and Wife had discharged their liability to SDLT on this transaction and HMRC had accepted the payment in satisfaction of their liability under FA 2003, HMRC must be taken to have acknowledged and to have accepted (and Husband and Wife to have proved) that an equitable interest in 50% of the Property had already been acquired by Husband and Wife. Accordingly, transfer form TR1 could not properly be taken to be giving effect to a transfer to Husband and Wife of more than the remaining 50% equitable interest the Property, and the legal title thereto. That argument was not accepted by HMRC. Unfortunately, given HMRC's stance in respect of interest and penalties, the taxpayers did not want to pursue this point.

SOME OBSERVATIONS ON THE RESIDENCE OF CORPORATE TRUSTEES

by Aparna Nathan

Introduction

The legal test to determine the residence of trustees was harmonised by FA 2006 with effect from April 2007. However, the legislation was so poorly conceived and badly drafted that practitioners are still beset with uncertainty on the limits of the test. In this article, I shall deal with a few issues arising from the new statutory test and HMRC's Final Guidance.

The Legislation

The starting point for income tax is at para 474 ITA 2007. That provides:

> "(1) For the purposes of the Income Tax Acts (except where the context otherwise requires), the trustees of a settlement are together treated as if they were a single person (distinct from the persons who are the trustees of the settlement from time to time)."

Section 475 ITA 2007 then provides:

> "(1) This section applies for income tax purposes and explains how to work out, in relation to the trustees of a settlement—
>
> (a) whether or not the single person mentioned in section 474(1) is UK resident, and
>
> (b) whether or not that person is ordinarily UK resident.
>
> (2) If at a time either condition A or condition B is met, then at that time the single person is both UK resident and ordinarily UK resident.
>
> (3) If at a time neither condition A nor condition B is met, then at that time the single person is both non-UK resident and not ordinarily UK resident.
>
> (4) Condition A is met at a time if, at that time, all the persons who are trustees of the settlement are UK resident.
>
> (5) Condition B is met at a time if at that time—
>
> (a) at least one person who is a trustee of the settlement is UK resident and at least one such person is non-UK resident, and
>
> (b) a settlor in relation to the settlement meets condition C (see section 476).
>
> (6) **If at a time a person ("T") who is a trustee of the settlement acts as trustee in the course of a business which T carries on in the United Kingdom through a branch, agency or permanent establishment there, then for the purposes of subsections (4) and (5) assume that T is UK resident at that time."** (my emphasis)

The CGT provision is in s69 TCGA 1992 and is not in identical terms but is materially similar:

> "[(1) For the purposes of this Act the trustees of a settlement shall, unless the context otherwise requires, together be treated as if they were a single person (distinct from the persons who are trustees of the settlement from time to time).
>
> (2) The deemed person referred to in subsection (1) shall be treated for the purposes of this Act as resident and ordinarily resident in the United Kingdom at any time when a condition in subsection (2A) or (2B) is satisfied.
>
> (2A) Condition 1 is that all the trustees are resident in the United Kingdom.
>
> (2B) Condition 2 is that—
>
> (a) at least one trustee is resident in the United Kingdom,
>
> (b) at least one is not resident in the United Kingdom, and
>
> (c) a settlor in relation to the settlement was resident, ordinarily resident or domiciled in the United Kingdom at a time which is a relevant time in relation to him.
>
> (2C) In subsection (2B)(*c*) "relevant time" in relation to a settlor—
>
> (a) means, where the settlement arose on the settlor's death (whether by will, intestacy or otherwise), the time immediately before his death, and
>
> (b) in any other case, means a time when the settlor made the settlement (or was treated for the purposes of this Act as making the settlement);
>
> and, in the case of a transfer of property from Settlement 1 to Settlement 2 in relation to which section 68B applies, "relevant time" in relation to a settlor of the transferred property in respect of Settlement 2 includes any time which, immediately before the time of the disposal by the **trustees** of Settlement 1, was a relevant time in relation to that settlor in respect of Settlement 1.
>
> **(2D) A trustee who is not resident in the United Kingdom shall be treated for the purposes of subsections (2A) and (2B) as if he were resident in the United Kingdom at any time when he acts as trustee in the course of a business which he carries on in the United Kingdom through a branch, agency or permanent establishment there.**
>
> (2E) If the deemed person referred to in subsection (1) is not treated for the purposes of this Act as resident and ordinarily resident in the United Kingdom, then for the purposes of this Act it shall be treated as neither resident nor ordinarily resident in the United Kingdom.][1]" (my emphasis)

So, for a trust of which the settlor is UK domiciled, resident or ordinarily resident, it is necessary, if the "deemed person" is to be non-resident, to ensure that no person who is a trustee is UK resident. What does this mean in practice? For corporate trustees, it means that the corporate trustee must not be UK resident on basic principles. In other words, assuming that it is foreign incorporated, the company's place of central management and control must be outside the UK. In effect, the place where the decisions of top level and strategic importance in relation to the business of the company are taken must be outside the UK. Nothing in the recent case of *Laerstate* changes that basic rule.

Once the corporate trustees have satisfied the first test of actual non-residence, they must next satisfy the test of deemed non-residence set out at s475(6) ITA 2007 and s69(2D) TCGA 1992. In other words, the corporate trustee must make sure that it does not:

- act as trustee,
- in the course of
    1. a business which he/ it carries on
    2. in the United Kingdom,
- through a branch, agency or permanent establishment there.

In relation to (a), it is important to determine in the first place whether the person is acting in his capacity as trustee. If he is not, the deeming provision does not apply.

Re (b)(i), what is required is that the trustee must be carrying on a "business" of acting as trustee. What does this mean? It is well settled that "business" is a wider concept than "trade" (*American Leaf Blending* [1978] 3 All ER 1185). It is generally taken to mean an activity conscientiously pursued rather than a pastime (see *CEC v Lord Fisher* [1981] 2All ER 147).

A question sometimes asked is whether a trustee of just one trust can be carrying on a "business"? We have the authority of *American Leaf Blending* which states that what may not be a business if carried on by and individual may well amount to a business when carried on by a company: in Lord Diplock's words at p1189:

> "in the case of a company incorporated for the purpose of making profits for its shareholders any gainful use to which it puts any of its assets prima facie amounts to the carrying on of a business."

So, a corporate trustee which is trustee of only one trust but is properly remunerated for it is likely to be carrying on a business.

What the legislation also requires is that the trustee must be carrying on his business – note the use of the term "which he carries on". So an individual acting as trustee not in the course of his own business but in the course of his principal's business does not satisfy this requirement. This issue is likely only to be relevant in the context of individual trustees where the question may arise whether they are acting on their own behalves or whether they are simply named representatives of their employer.

Re (b)(ii)) above, what is required is that the business of the trustee must be carried on in the UK. In other words, the acts of being a trustee must be conducted in the UK.

Re (c) – this is the requirement that the business of trustee must be carried on in the UK "through a branch, agency or permanent establishment in the UK".

The strict words of the legislation appear to stipulate that all three parts apply to both individual trustees and corporate trustees. However, this uncertainty has been removed by HMRC Guidance para 5 which states that the "branch" and "agency" parts apply to non-corporate trustees and the "permanent establishment" part applies to corporate trustees.

Turning to the meaning of "permanent establishment", we find that there is no specific definition set out in this part of the legislation. As a result, the general definition of PE that applies for the purposes of the Income Tax Acts applies here. This definition is set out in s148(3) FA 2003. It provides that:

> "(1) **For the purposes of the Tax Acts a company has a permanent establishment in a territory if, and only if—**
>
> **(a) it has a fixed place of business there through which the business of the company is wholly or partly carried on, or**
>
> **(b) an agent acting on behalf of the company has and habitually exercises there authority to do business on behalf of the company.**
>
> This general definition is subject to the following provisions.
>
> (2) For this purpose a **"fixed place of business" includes** (without prejudice to the generality of that expression)—
>
> (a) **a place of management;**
>
> **(b) a branch;**
>
> **(c) an office;**
>
> (d) a factory;
>
> (e) a workshop;
>
> (f) an installation or structure for the exploration of natural resources;
>
> (g) a mine, an oil or gas well, a quarry or any other place of extraction of natural resources;
>
> (h) a building site or construction or installation project.
>
> (3) **A company is not regarded as having a permanent establishment in a territory by reason of the fact that it carries on business there through an agent of independent status acting in the ordinary course of his business.**
>
> (4) A company is not regarded as having a permanent **establishment** in a territory by reason of the fact that—
>
> (a) a fixed place of business is maintained there for the purpose of carrying on activities for the company, or

> (b) an agent carries on activities there for and on behalf of the company,
>
> **if, in relation to the business of the company as a whole, the activities carried on are only of a preparatory or auxiliary character**.
>
> (5) For this purpose "activities of a preparatory or auxiliary character" include (without prejudice to the generality of that expression)—
>
> (a) the use of facilities for the purpose of storage, display or delivery of goods or merchandise belonging to the company;
>
> (b) the maintenance of a stock of goods or merchandise belonging to the company for the purpose of storage, display or delivery;
>
> (c) the maintenance of a stock of goods or merchandise belonging to the company for the purpose of processing by another person;
>
> (d) purchasing goods or merchandise, or collecting information, for the company." (my emphasis)

It is clear therefore that there are two *separate* and alternative types of permanent establishment: first, the fixed place of business PE; and, second, the agency PE. It is important, as is well-known, to ensure that a non-resident corporate trustee has neither kind of PE. I shall deal with each in turn.

Fixed Place of business PE: This terms includes:

(a) a place of management;

(b) a branch;

(c) an office;

(d) a factory;

(e) a workshop. (s148(2) FA 2003).

The term, fixed place of business PE, is defined further in the OECD Commentary and in the HMRC Guidance. Put briefly, a fixed place of business PE exists where there is:

1. A physical location,
2. Which is fixed in time,
3. And is more than temporary,
4. Which is at the disposal of the enterprise (i.e. the corporate trustee),
5. Which is not used solely for preparatory or auxiliary activities,
6. through which the business of the enterprise (i.e. the corporate trustee) is wholly or partly carried on.

Focusing on point 1 (“a physical location”), para 4 of the OECD Commentary makes clear that a place of business may exist where no premises are available or required for carrying on the business of the enterprise and it simply has a certain amount of space at its disposal. This space may be within the premises of another enterprise, for example where the foreign enterprise has at its constant disposal certain premises or part thereof owned by another enterprise.

Further, it is irrelevant to the question of whether a particular location is the fixed place of business of a foreign enterprise whether the location is rented or loaned or simply available in some other way. Additionally, there need be no formal legal right to occupy the premises so that illegal occupation could also create a PE.

Point 2 above (“which is fixed in time”) recognises the importance of the word “fixed” in the term “fixed place of business”. Para 5 of the Commentary makes the following points:

- There must be a link between the place of business and a specific geographical point: if the place of business is itinerant then it cannot be regarded as “fixed”.

- However, where activities are moved between different physical locations, this may not avoid the “fixed” requirement if the location within which the place of business is moved forms a coherent commercial and geographical whole.

Point 3 above (“and is more than temporary”) also focuses on the term “fixed” and recognises that it carries with it the concept of some degree of permanence. – in other words something that is more than purely temporary.

Turning to point 4 (“at the disposal of the enterprise”), it is necessary that the physical location is available to the enterprise. The Commentary states that mere presence in a place does not mean that that place is at the enterprise’s disposal. What is required is that the enterprise is able to use it as of right – it does not need to ask permission every time for its use and is not limited by time constraints concerning how long it can use that premises.

Point 5 (“not preparatory or auxiliary activities”) recognises that the carrying on of preparatory or auxiliary activities does not render the place from which they are carried on a fixed place of business PE (echoing s148(4) FA 2003). What are preparatory or auxiliary activities will vary from one enterprise to the next. In relation to trustees activities they raise interesting issues –

i. is meeting beneficiaries a preparatory or auxiliary activity?

ii. Is reading minutes a preparatory or auxiliary activity?

HMRC Guidance indicates what HMRC consider to be “core” trustee activities. But the Guidance is not exhaustive. The “core” activities are set out in para 10 which states:

> “A trustee is the person who has a legal duty to manage the assets of that trust in the best interests of the beneficiary or beneficiaries. The trustee manages, employs and disposes of the trust assets in accordance with both the terms of the trust and the duties and responsibilities which the law places upon trustees. The core activities of a trustee would therefore be regarded *as including*:
>
> 10.1 the general administration of the trusts

> 10.2 the over-arching investment strategy.
>
> 10.3 monitoring the performance of those investments.
>
> 10.4 decisions on how trust income will be dealt with and whether distributions should be made."

Point 6 above focuses on the fact that it is the business of the enterprise that must be carried on in the place of business in the UK i.e. it is the corporate trustee's business that must be carried on in the UK place of business and not the business of the UK place of business itself.

An Agency PE: Put briefly, an agency PE exists where there is a dependent agent. This term does not appear in the legislation but is used in contra-distinction to the term "agent of independent status". A dependent agent exists where the agent:

- Has authority to do business on behalf of the corporate trustee; and
- Habitually exercises this authority.

It should be noted that s148 FA 2003 uses the term "authority to do business" which is narrower that the term used in the OECD Model Convention which refers to "authority to conclude contracts". Consequently, care must be taken by the non-resident corporate trustee to ensure that no-one in the UK has authority to bind the corporate trustee or to carry on any core activity in the UK.

An employee of the corporate trustee is regarded as its agent (*Puddu v Doleman* [1995] STC (SCD) 236) and so if that employee has and habitually exercises his authority to carry out core activities in the UK, this will create an agency PE.

It must be noted that the dependent agent must have authority to do business which relates to the business proper of the corporate trustee i.e. it must relate to the core activities. If the authority relates merely to internal operations of the corporate trustee, that will not create an agency PE. Internal operations could include engaging employees of the corporate trustee or drawing up accounts of the corporate trustee rather than, say, accounts of the trusts in respect of which the corporate trustee acts as trustee.

However no agency PE will be created if the agent is an independent agent. Broadly speaking, an independent agent is someone who is:

- Independent of the corporate trustee; and
- Acts in the ordinary course of his business when acting on behalf of the corporate trustee.

Para 37 of the OECD Commentary explains that the putative independent agent will need to be both legally and economically independent of the enterprise i.e. the corporate trustee. As explained below, ownership of an entity by the corporate trustee does not of itself make that subsidiary an agent of the corporate trustee. (para 38.1).

Quite apart from being independent economically and legally, the putative independent agent must also act in the ordinary course of his business when he acts for the corporate trustee. In other words, he must act in much the same way and on the same terms for the corporate trustee as he acts for his other clients.

Finally, HMRC Final Guidance para 3 deals with agency PE and places great emphasis on the existence of arm's length terms: where they exist there is no dependent agent.

Two Practical Issues

These principles are relatively easy to state but can prove somewhat difficult to apply in practice. For example, let us consider the one-off decision making in the UK. It may have been thought that a single decision taken in the UK was not capable of jeopardising the residence status of the trust. However, in the light of the HMRC Final Guidance, in particular Example 2b, one-off meetings with beneficiaries at which trust matters are discussed in such a way as to bind the corporate trustee or where decisions are taken should be avoided.

Example 2b suggests that even a single core activity (i.e. trustee decision) made in the UK may be relevant. However, in example 2b, the corporate trustee has a fixed place of business in the UK at which the meeting in the example takes place.

It is unclear whether, if there were no fixed place of business in the UK, HMRC would claim that there was a PE where a single trustee decision was taken in the UK. My concern is that although there may be no fixed place of business PE there be an agency PE because a director or other representative of the corporate trustee had exercised his authority to do business in the UK in such a way as to bind the corporate trustee

Another practical difficulty centres around the existence of UK resident directors of the corporate trustee. We know that an employee or director of an entity may be a dependent agent of that entity (*Puddu v Doleman* & HMRC Guidance para 4):

1. If he carries out in the UK the business of the entity;
2. And that business is not preparatory or auxiliary.

Therefore, in my view, UK resident directors of the Corporate trustee should make sure that they only carry out, at most, preparatory or auxiliary activities in the UK. These, in my view, include:

1. reading trust documents (whether on email or hard copy) before trustee meetings;
2. preparing documents containing matters for discussion at trustee meetings;
3. taking phone calls relating to the mechanics of setting up trustee meetings (but with no discussion of the substantive issues) e.g. dates and venues for meetings or travel arrangements.

Conclusion

There are myriad other practical issues arising directly from the deemed trustee residence provisions. It is understood that the representative professional bodies are actively seeking further clarification from HMRC on these issues. What would be infinitely preferable to receiving further HMRC Guidance or Briefings is a well thought through re-write of the offending provisions so that their meaning, scope and effect are clearer.

WHAT REVERSE PREMIUMS ARE TAX FREE?

by Patrick Soares

Introduction

With the present state of the economy, we are going through a "reverse premium" phase:-

- tenants paying reverse premiums to landlords to rid of their leases;
- landlords paying extraordinary premiums to tenants to take on leases (in the form of cash payments and very long rent-free periods);
- tenants ridding of leases, which they find too onerous, to new tenants.

Two types of reverse premiums could potentially be tax free in the hands of the recipient.

General Principles

Generally, if the taxpayer is paid monies to take on a lease the receipt should be free of capital gains tax in his hands. He could hardly be said to have disposed of an asset in consideration of the monies received. See, for good measure, CGT Manual 70835 which reads thus:-

> **70835. Recipient of reverse premium**
>
> If the receipt cannot be charged to Income Tax, you will need to consider whether it is chargeable to Capital Gains Tax. It will only be so chargeable if it is derived from an asset held by the tenant. Normally, the reverse premium will be paid before the tenant has actually entered into the lease and in these circumstances it is not possible to argue that the reverse premium is derived from the lease. Unless there is some other asset from which the reverse premium derived, it will be exempt from Capital Gains Tax.

When it comes to income tax, the tenant is paid a lump sum to take a lease. One would expect the sum to be capital in nature (unless the recipient is a land dealer) and indeed generally case law indicates that the receipt would not be of an income tax nature (*CIR v Wattie and Lawrence* 72 TC 639: see HMRC's caveats in IRM/BIM 35610).

The Special Reverse Premium Code

There is, however, a special code contained in ITTOIA 2005 ss.99-103(for corporation tax see CTA 2009 s.96-100) which ensures that there is an income tax charge on the recipient of a reverse premium in certain circumstances.

This code applies if three conditions are satisfied (ITTOIA 2005 s.99).

Condition A is that the recipient or a person connected with the recipient receives a payment or other benefit by way of an inducement to enter into a transaction.

Condition B is the transaction is one under which the recipient or a person connected with the recipient becomes entitled to an estate, interest or right in or over land.

Condition C is the payment or other benefit is paid or provided by one or other of the following persons:-

(a) the person ("the grantor") by whom the estate, interest or right is *granted* or was granted at an earlier time; or

(b) a person connected with the grantor; or

(c) a nominee of the grantor or a person connected with the grantor; or

(d) a person acting on the directions of the grantor or a person connected with the grantor.

The offending payers are thus:

→ Grantor (G)

→ Person connected with grantor (C)

→ Nominee of G or C

→ Person acting on the directions of G or C

(N.B. it would seem that a payment made by a person connected only with a person acting on the directions of the grantor would not be caught!)

HMRC accept that the use of the words "grantor" and "granted" means that these provisions only apply where some sort of sub-interest is created out of the interest in question.

If a freeholder grants a lease to a tenant the provision would have application (IRM/BIM 41105).

On the other hand, if the freeholder assigned his freehold to the purchaser and paid the purchaser for taking over the freehold the payment would not fall within this legislation. There may be scope for planning here.

Equally, if a tenant of an onerous lease, who is not connected with the landlord, assigns his lease to an incoming tenant, and the outgoing tenant pays the incoming tenant a reverse premium, these provisions would not apply: IRM/BIM 41110 states:-

> Thus, a commercial payment by an existing tenant to induce a new tenant to take over an onerous lease will not normally result in a charge on the new tenant. There will be a charge only if the tenant paying the reverse premium is connected with the landlord, or is acting on the landlord's behalf in making the payment.

Two Situations

Thus the first situation where a reverse premium can potentially be paid tax free is one where a tenant assigns an onerous lease to an incoming tenant and the incoming tenant is paid a premium by the outgoing tenant.

The reverse premium provisions do not apply in this situation. Under general principles the incoming tenant does not receive income and he will not have disposed of an asset for capital gains tax purposes: the payment is therefore free of income tax and free of capital gains tax.

The second situation where a reverse premium can be tax free is if a lease is granted by the landlord to the tenant and the person paying the premium to the incoming tenant is not in one of the four categories mentioned above. It may be, for example, that a developer, who is unconnected with the land owner, is keen to enter into development agreement with the land owner and would be content to pay out of its own funds (the developer's funds) monies to the incoming tenant as an inducement for the incoming tenant to take a lease which would have the knock on effect that the developer would be able to enter into the development contract. If this is the case then the special reverse premium provisions in ITTOIA 2005 should not have application and thus the incoming tenant would receive a sum which is chargeable neither to capital gains tax nor income tax.

PROPERTY TAX PLANNING – THE FUTURE IS CAPITAL AND LOANS

by Patrick Soares

"Capital Fees" for Developers

The rate of tax on income profits in the hands of individuals and trustees is 40% and going up next year to 50%. There is an unmistakable clear trend in property transactions for individuals (through LLPs) and trustees to make capital profits where the tax rate is 18%.

An investor who is employing a developer to provide him with development services may well pay him a fee in the form of a land interest. The value of that interest would be chargeable to income tax. However, if the land interest is paid over in return for the services at a time when the interest has a low value, then the amount of that charge to income tax will be low and the future growth in the property assuming, it is held as a capital asset by the developer, will (depending on all the facts of the case) only bear tax at 18%.

These structures are based on (inter alia) the House of Lords' decision of *Abbott v Philbin* 39 TC 82 where an option to buy shares was given to an employee who was taxed on the value of that option but not taxed on the growth in the value of the option: the profit made on the exercise of the option, which arose from that growth, was thus free of income tax. The growth did not derive from the employment but from the exercise of the option. It seems that the same argument would apply if an interest in land were given ab initio as the fee, even though the developer would be working on that land pursuant to the contractual obligations he entered into with the investment landowner.

Accountancy advice would have to be obtained as many of the key tax questions in these areas are determined by what is commonly accepted accountancy practice.

It is not too dissimilar from situations where an accountant may take on a new client and agree not to charge for tax and other advice in connection with the earlier years of the venture when the client is cash starved and takes instead a small shareholding in the company. If ultimately it is proved successful and the company is sold the accountant should make a capital profit taxable only at 18%.

"Cheap Loans"

The other area of planning concerns loans.

If a company makes a loan to an employee, who is not a shareholder in the company or connected to a shareholder, the annual income tax payable, charge on present rates, on the benefit of that loan, is a mere 1.9%. Note there is also an annual NIC on present rates on the benefit of the loan of .608%.

If shareholders want to receive loans, it may be necessary for the company to settle monies into an employee benefit trust which then makes the loan.

Inheritance tax has to be taken into consideration but in many cases one should be in a position to rely on the exemption in IHTA 1984 s.10. See *Postlethwaite's Executors v HMRC* (2007) STC (SCD) 83 but note the recent HMRC statement of 12th August 2009 (designed to spoil some taxpayers' summer holidays) entitled "HMRC's view on the IHT position in relation to Contributions to an EBT".

Conclusion

The trend is to think capital but if you must think income then think in terms of making loans.