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RESERVATION OF BENEFIT AND CHANGE OF DOMICILE

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In January of this year the Inland Revenue released its revised Inheritance Tax Advanced Instruction Manual, from which it appeared that there had been a shift in thinking concerning the effect of a change of domicile on the Gifts with Reservation (hereafter "GWR") provisions of Finance Act 1986. The revised manual gives the impression that the Revenue have changed their long-standing view about the effects of a change of domicile on GWRs out of settlements.

The Issue

Although the Revenue do not actually say how far their views have shifted, the relevant paragraph in their manual says that any appropriate cases "must be referred to the Litigation Team.[1]" Reaction to this change has prompted the Revenue to say that they do not intend to impose their revised views on the IHT position of those who have relied upon their former view. Whether they will seek to do so for others (and to what extent) is currently unclear.

This article accordingly outlines the operation of the GWR provisions, when an individual not domiciled in the United Kingdom makes a gift of excluded property, retains some enjoyment of that property and then acquires a domicile within the United Kingdom.

The Basics: Excluded Property and the IHT Charge

An individual who is not domiciled in the United Kingdom enjoys a privileged position as regards IHT. Section 6(1) IHTA 1984 says:-

> "Property situated outside the United Kingdom is excluded property if the person beneficially entitled to it is an individual domiciled outside the United Kingdom."

There is a further provision dealing with property situated outside the United Kingdom and comprised in a trust. Section 48(3) says:-

> "… the property … is excluded property unless the settlor was domiciled in the United Kingdom at the time the settlement was made ..."

These provisions reduce the incidence of IHT considerably. The basic mechanism is as follows. IHT is charged on the value transferred by a "chargeable transfer[2]" which is a "transfer of value[3]" made by an individual which is not an "exempt transfer[4]."

The definition of "transfer of value" in s. 3 says:-

> "(1) …. A transfer of value is a disposition made by a person (the transferor) as a result of which the value of his estate immediately after the

> disposition is less than it would be but for the disposition; and the the amount by which it is less is the value transferred by the transfer.
>
> (2) No account shall be taken of the value of excluded property which ceases to form part of a person's estate as a result of a disposition."

So a gift by a non-domiciled individual of property situated outside the United Kingdom is ignored in computing the value transferred by a transfer of value.

How does the excluded property regime interact with the GWR provisions if the donor of excluded property retains some kind of interest in it? To answer this it is first necessary to understand the basic thrust of the GWR provisions.

The GWR Provisions

The policy behind the GWR provisions[5] is to deny individuals the benefit of the PET regime[6] and lifetime IHT rates[7] if they continue to benefit from the property gifted.

The basic GWR provision is contained in s. 102 FA 1986:-

> "(1) …. This section applies where … an individual disposes of any property by way of gift and either

(a) possession or enjoyment of the property is not bona fide assumed by the donee … or

(b) … the property is not enjoyed to the entire exclusion … of the donor and of any benefit to him…

(2) If and so long as [the above circumstances obtain] the property is referred to as property subject to a reservation.

(3) If, immediately before the death of the donor, there is any property which in relation to him is property subject to a reservation, then, to the extent that the property would not, apart from this section, form part of the donor's estate immediately before his death, that property shall be treated for the purposes of [IHTA] 1984 as property to which he was beneficially entitled immediately before his death."

Interaction of the GWR and Excluded Property Provisions: Simple Gifts

Plainly, where property is excluded property at the date of the donor's death, the GWR provisions are ineffective. Treating the property as belonging to the donor would not expose the donor's estate to IHT because s. 3(2) says that no account is to be taken of the value of excluded property.

A simple illustration[8] is where a non-domiciled donor makes an outright gift of Australian shares, but continues to receive the dividends on them until death. The gift is certainly one that is subject to a reservation, so it is treated as property to which the donor was beneficially entitled immediately before death. But this has no practical effect so long as the donor does not acquire a domicile within the United Kingdom before death. The property was and remains excluded property, so no account is taken of its value in computing the value of any transfer of value.

But if the donor acquires a United Kingdom domicile[9] after making the gift, the position will be different. The GWR provisions will again operate, but without the overlay of the excluded property provisions of s. 6 IHTA. The property is again treated as property to which the donor was beneficially entitled immediately before death, but it is no longer excluded property on the change of domicile. The GWR provisions can now operate fully. There is nothing in s. 6 IHTA to suggest that the original excluded property status attaching to the shares prevents them from being treated as beneficially owned by the donor for all time.

There is no suggestion that the Revenue's views have changed here.

Interaction of the GWR and Excluded Property Provisions: Settlements

The Revenue's position has however shifted as regards interests in settlements. Their previous position was that the acquisition of a domicile within the United Kingdom by a settlor who retained an interest in a settlement did not bring the GWR provisions into effect. The thinking behind this was that the property in question was settled property, so that s. 48(3) rather than s. 6(1) IHTA 1984 applied to it. It will be remembered that s. 48(3) says that property comprised in a settlement and situated outside the United Kingdom is excluded property, unless the settlor was domiciled in the United Kingdom *when the settlement was made*.

The Revenue now appear to take the view that their original analysis is wrong. It will be recalled that the GWR provisions treat property subject to a reservation as forming part of the donor's estate immediately before his death. The actual words used in s. 102(3) FA 1986 are:

> "If, immediately before the death of the donor, there is any property which in relation to him is property subject to a reservation, then, to the extent that the property would not, apart from this

> section, form part of the donor's estate immediately before his death, that property shall be treated for the purposes of the 1984 Act as property to which he was beneficially entitled immediately before his death."

So if this treatment is to apply "for the purposes of the 1984 Act" it should follow that immediately before death, the property in question should not be treated as comprised in a settlement (where the s. 48(3) excluded property rule applies), but as being beneficially owned by the deceased. If so, then it follows that the s. 6 excluded property rule applies. The acquisition of a domicile within the United Kingdom before death would accordingly expose the individual retaining an interest in an offshore discretionary settlement to the full force of the GWR provisions.

How sound is this approach? In the writer's opinion, the logic of this is approach is difficult to fault. As is well known, a deeming provision such as the one in s 102(3) must be construed by giving the words their ordinary and natural meaning consistent so far is possible with the policy of the Act and the purposes of the provisions. It is only if the construction would lead to injustice or absurdity that the statutory fiction should be limited.[10] The ordinary and natural meaning here is that the property is treated as belonging to the donor for all the purposes of the Act, notwithstanding that it is held by trustees. This seems also to accord with the policy of the legislation, which is directed at preventing the making of gifts in order to benefit from lower rates of tax if the donor retains some form of benefit. The donor is subject to the IHT regime as though he had made no gift at all. The application of this deeming provision to treat the property as belonging to the donor at death and not as part of a settlement is entirely consistent with this. In the writer's opinion, this result would be unpalatable and highly controversial, but that does not mean that it would lead to injustice or absurdity.

There are contrary arguments. For example, s. 49(1) IHTA treats a life tenant of a settlement as beneficially entitled to the property in which the interest subsists. It is widely accepted that the settled property is not treated for all the purposes of the Act as not being settled. Is it therefore arguable that s. 102(3) FA 1996 should not also treat the property in question as not being settled property? The writer thinks not. There are numerous provisions within IHTA 1984 which make it clear that the deeming effect of s. 49(1) is limited[11]. There is also a difference in wording in the two sections, which suggests that s.49(1) is directed towards the treatment of the individual, whereas s. 102(3) FA 1986 is directed towards the treatment of the property which is subject to the reservation. The purpose of s. 49, which is within the part of IHTA 1984 dealing with settlements, is also arguably narrower[12] than the purpose of s. 102(3), which deals with property generally.

A further contrary argument is that the effect of s. 102(3) is transitory. It only treats the property as property to which the donor was beneficially entitled immediately before death. It would be strange for the property to cease to be settled for IHT purposes for this brief moment. Admittedly, this does look strange, but in the writer's view it is no more than a reflection of the unusual nature of the mechanism adopted by the draftsman of s. 102(3). It is not obvious that any anomalies result.

Next Steps

At present, there is some doubt as to whether the Revenue will pursue this change of view. It is known that they will not seek to apply the new view to those who have relied on the old. There is even talk of the possibility of "clarifying" legislation to put the matter beyond doubt. The likelihood is that the enormous policy implications of such a radical change of position are being considered, and that a more definite expression of the Revenue's position will follow in due course.

Assuming that the Revenue do decide to adopt this new position, and that it is upheld by the Courts, so that the excluded property provision relevant to reservations of benefits in trusts are those in s. 6 IHTA 1984, what course of action should non-domicilliaries take? The first point to make is that no precipitate action should be taken until the Revenue's views and intentions are more clearly expressed. If it then emerges that they intend to follow up their views, it will be necessary to understand whether all individuals will be affected or only those creating settlements after a specified date.

Once that becomes clear, there is the question of what action could be taken to forestall the effects of a change of domicile. Even where steps are taken to preserve a foreign domicile, the deemed domicile provisions in s. 267 IHTA 1984 will always, of course, pose a threat. Advance planning will always be required. Obvious tactics would be the termination of the settlor's interest before the acquisition of deemed domicile, and greater use of settlements in which the settlor's spouse (but not the settlor) has an interest. Greater use might also be made of the gaps in the GWR provisions as exposed in *Ingram*.[13]

But if the Revenue do decide to stand by this revised view, it will be because they have decided to adopt a firmer policy line which is less sympathetic to foreign domicilliaries. Given the Budget statement concerning a further review of domicile, it is likely that there will be some delay before a definitive pronouncement is made.

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1 IR Advance Instruction Manual, Vol. 1 Para D8
2 See s. 1 IHTA (all references are to IHTA 1984 unless otherwise stated)
3 See s. 2
4 See Part II for the kinds of transfer which are exempt.
5 See IR Advance Instruction Manual, Vol. 1 Para D3
6 See s. 3A(4)
7 See s. 7(4)
8 Used in the Revenue's manual
9 Either under the general law or under s. 267
10 See *Marshall v. Kerr* 67 Tax Cases 56
11 See, for example, s. 81 IHTA 1984.
12 There is internal evidence to that effect within IHTA 1984.
13 [1999] STC 37

SECTION 739 AND FOREIGN DOMICILIARIES: SOME REFLECTIONS

Michael Flesch, Q.C.

The favourable – indeed bizarre – tax treatment of a UK resident who has the good fortune to be domiciled outside the UK ("a foreign domiciliary") is very much in the news at present. This is therefore an opportune moment to reflect on one particular aspect of this tax treatment, namely the application of section 739 to a foreign domiciliary. (All statutory references are to ICTA 1988.)

Section 739 provides, in essence, that where a UK resident individual (who set up the structure) has "power to enjoy" the income of a non-resident entity, then that income is deemed to be the income of that individual for all income tax purposes. That is the basic rule. But as one might expect, a UK resident foreign domiciliary is accorded favourable treatment under section 739: just how favourable is, however, sometimes not fully appreciated.

Section 743(3) is the provision that confers a measure of protection on a foreign domiciliary. It provides that

> "An individual who is domiciled outside the United Kingdom shall not be chargeable to tax in respect of any income deemed to be his by virtue of [section 739] if he would not, by reason of his being so domiciled, have been chargeable to tax in respect of it if it had in fact been his income."

This is generally assumed to mean that, where the income in question has a non-UK source, a foreign domiciliary will only be taxable on it under section 739 insofar as the income is remitted to the UK. But I believe that the protection afforded to a foreign domiciliary by section 743(3) goes much further than that.

Let us take a simple example. Suppose our UK-resident foreign domiciliary, Mr. X, forms and subscribes for shares in a non-resident company.[1] If the company invests in, say, UK land Mr. X will, in principle, be liable to tax under section 739 in respect of the (net) rental income as it arises to the company. So much is clear.

But suppose the non-resident company invests in non-UK land. The rent paid to the company will certainly not be taxable on Mr. X under section 739 insofar as the company retains the rent outside the UK: see section 743(3). No-one would disagree with that. But in my opinion Mr. X will still not be liable under section 739 if, in the tax year following receipt of the rent, the company is liquidated, the land and the monies comprising the rental income are distributed to Mr. X in the liquidation and he then remits the monies in question to the UK.

The reason for Mr. X's non-taxability is as follows.

When considering the section 739 liability of a foreign domiciliary in respect of non-UK source income one must test the position either at the time of actual receipt of the income in question by the non-resident entity or, at latest, at the end of the year of assessment in which the income arises to the non-resident entity. There is in my view nothing in section 739 itself, or in section 743(3), that tells us that a subsequent remittance of that income can affect the situation.

The position in this respect can be contrasted with the provisions relating to settlor interested settlements, i.e. section 660A et seq. The settlement provisions afford – and have always afforded – some protection to a foreign domiciled settlor in respect of non-UK source settlement income. Indeed, until the 'tidying-up' of the settlement provisions in 1995 the position as I have described it in relation to section 739 applied equally to the settlement provisions. But in 1995 there was inserted – rather sneakily – a new concluding paragraph to section 660G(4), the subsection designed to protect foreign domiciliaries. The effect of this final paragraph is that a subsequent remittance of non-UK source settlement income will in principle trigger a liability to income tax. But – and this is the important point – there is no provision in section 739 et seq. which corresponds to the last paragraph in section 660G(4).

Thus, a foreign domiciliary will always (absent a section 741 defence) be liable to tax under section 739 in respect of UK source income. But he will not, in my view, be liable to tax under that section in respect of foreign source income even if that income is subsequently remitted to the UK, provided that the remittance takes place in a later year of assessment.

Five further points should be noted.

First, the above conclusion does not depend in any way on the source-ceasing rules – although these rules can, in an appropriate case, afford a further defence to a section 739 charge.[2]

Second, Mr. X in the above example could not be taxed under section 740 in respect of the money remitted to the UK. This is because *inter alia* the Revenue accept – rightly in my view – that a section 739 transferor who is not liable to tax under that section because of section 743(3) cannot be assessed instead under section 740: see Revenue Interpretation 201 (April 1999).

Thirdly, given the final paragraph of section 660G(4) the 'loophole' described above is likely to be relevant only when the section 739 non-resident entity is an offshore company rather than the non-resident trustee of a settlement.

Fourthly, if in the above example the non-resident company had *dividended* its rental income to Mr. X he would, if he remitted the dividend to the UK, be taxed on that dividend income under Case V of Schedule D, unless he could take advantage of the source-ceasing rules.

Fifthly – and perhaps most importantly – the view advanced above as to the inter-action of section 739 and remittances is not one that I have seen expressed elsewhere. It is unlikely to be shared by the Inland Revenue. So readers should beware! But if there is a flaw in the argument then I would be grateful if someone could point it out to me.

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Reference was made earlier to section 740. The keen-eyed reader will have noticed the words "*inter alia*" in the relevant paragraph. The point I have in mind can be illustrated as follows.

Suppose the company in the above example had been funded not by Mr. X but by Mr. X's father, who subsequently gifted all the shares in the company to Mr. X. Since, on this assumption, Mr. X was not the 'creator' of the offshore structure he could not be liable to tax under section 739. But there remains the possibility of a liability falling on Mr. X under section 740.

Section 740, in essence, imposes a charge to income tax on a UK resident who "receives a [capital] benefit" from an offshore structure where there is within the structure income which could have been used to benefit him. And again, as one would expect, there is a provision designed to protect a foreign domiciliary from a section 740 liability in certain circumstances. In particular, section 740(5) provides that insofar as the income within the structure is not UK source income, the foreign domiciliary will not be liable to income tax in respect of any "benefit not received in the United Kingdom".

Reverting to the above example, Mr. X is in principle probably vulnerable under section 740 since, as owner of the shares in the offshore company (following his father's gift), he could have received dividend income from the company. And on the winding up of the company Mr. X receives in capital form an amount (reflecting the rent) that he could have received as dividend income.[3]

Suppose, however, that on the winding up of the offshore company the money distributed to Mr. X is first paid into an offshore account in Mr. X's name. And then suppose that, say, 3 months later Mr. X transfers that money into his UK bank account.

In those circumstances is Mr. X caught by section 740? Or is he protected by section 740(5)? The answer depends on whether or not Mr. X's capital benefit (i.e. the money distributed in the liquidation) was "received in the United Kingdom".

In my opinion Mr. X is, in the above circumstances, protected by section 740(5). This is because the only benefit Mr. X received was received by him, from the company, *outside* the UK. When, three months later, Mr. X brought the money to the UK he was merely transferring money he already owned from one bank account to another. And that is not, in my view, the receipt of a benefit within section 740(5).[4]

Putting it another way, just as one cannot step into the same river twice, so too one cannot receive the same benefit more than once.

Again, I have not seen this argument advanced by other tax practitioners – although there are some Indian tax authorities that support my view. The Revenue are unlikely to agree with me. The result is certainly unintended. But again, if there is a flaw in the analysis would someone please put me right.

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[1] If Mr. X *purchased* the shares in the non-resident company he would not in any event be liable under section 739.
[2] See generally *Brown v. National Provident Institution* 8 TC 57.
[3] It is arguable that this is not in fact a "benefit" within section 740 since Mr. X receives no more than the value of his shares: but let us leave this particular argument on one side.
[4] The 'incorporation' of section 65(6) to (9) into section 740 does not, in my view, affect the position in this respect.

The Offshore Trust in Barbados

Milton Grundy[1]

Barbados is a high-tax jurisdiction, with an Income Tax Act dating from its colonial days and tax rates rising to 40%. Like the United Kingdom – but more radically – it offers a privileged tax regime for trusts established by non-residents.[2] More exactly – and indeed more confusingly – it offers two such regimes. One governs the trust established under the International Trusts Act, and this is referred to in the Act (and here) as an "international trust". An international trust used to be regarded for tax purposes as non-resident, but it is now regarded as resident in Barbados, but not domiciled there[3]. It is therefore fully liable to tax on such income as has its source in Barbados, but it is now liable only on the "remittance basis" on income arising outside Barbados.[4] The other regime is provided by the Offshore Banking Act.[5] Here, the statute provides that the trust is … "exempt from any tax, duty or impost in Barbados." It is here referred to as an "exempt trust", though the expression is not used in the Act. The conditions to be satisfied are slightly different in each case,[6] but the essential fiscal difference is between exemption and the remittance basis. The particular attraction of Barbados as a host jurisdiction for trusts[7] lies in the possibilities it offers of taking advantage of the tax treaties to which it is party – notably those with Canada, the United Kingdom and the United States.[8]

In the treaty between Barbados and Canada, a resident of Barbados is defined as a:

> … person who, under the law of [Barbados] is liable to taxation by reason of his …. residence …[9]

And the General Definitions Article provides that:

> … unless the context otherwise requires … the term "person" includes … a trust …[10]

The international and the exempt trust are each, therefore, a "person" for the purposes of the treaty, but only the international trust is "liable to taxation" in Barbados – albeit on a remittance basis. But is it liable to taxation *by reason of his residence*? Section 40(1) of the Income Tax Act says:

> For the purposes of this Act, a trust …, other than a unit trust, shall, in respect of the trust … property and in respect of the income arising therefrom, be deemed to be a separate individual.

Where does this *separate individual* reside?" Clearly, one cannot ask about an imaginary individual, whether or not he spent 182 days in Barbados during the income year or whether he has a permanent home in Barbados.[11] It is a requirement of the Act[12] that an international trust has at least one resident trustee; typically, a company resident in Barbados will be the sole trustee, and it submitted that in such a case there could be no serious argument that the trust was resident anywhere else.[13] It is entitled to the benefit of the treaty with Canada, whether income is remitted or not: if the income is not remitted, it may be distributed without a tax charge, because of the exemption expressly provided by the International Trusts Act.[14] Those who feel that this exemption is too good to last may prefer to make a distribution while the going is good. The recipient of a distribution does not, of course, need to be an individual: an exempt trust could be the recipient, or a distribution might be made to a trust or company in another jurisdiction which levies no tax on such receipts.[15]

Treaties which follow the OECD 1977 Model require the recipient of dividends, interest and royalties to be the "beneficial owner" thereof. It seems that the use of this expression is intended to make it clear that treaty relief will not be afforded where the recipient is a mere agent or nominee for another person – and that other person is resident elsewhere, or for some other reason not entitled to the benefit of the treaty[16], but it is submitted that such agent or nominee is not entitled to treaty benefit whether the expression is used or not. A trustee, however, is not a nominee or agent for his beneficiaries (though see note 23 below), and the trust income is accordingly entitled to treaty benefit so long as one of the criteria of taxability required for the trustee to be "resident" is satisfied.

The treaty with the United Kingdom has a definition of "resident" similar to the one in the treaty with Canada, but identification of the *person* resident is not here complicated by the definition of "person" including a trust, and in consequence it is simply the trustee whose residence is to be determined. The UK treaty is, however, different from the Canadian in two further respects. First, it offers no effective capital gains tax exemption[17] - but this, in the present context, is not important, because the United Kingdom does not tax the capital gains of a non-resident[18]. Second, and more importantly, Article 5 of the UK treaty provides that "where any income is exempt from tax … in [the United Kingdom] if … it is subject to tax in [Barbados] and that income is subject to tax in [Barbados] by reference to the amount thereof which is remitted …, the exemption … shall apply only to the amounts so remitted …" To obtain the benefit of the treaty, therefore, the income has to be remitted to Barbados. But such income does not have to suffer tax: the international trust has a feature which it shares with domestic trusts – that its taxable income is calculated after deduction of the distributions it makes. Subsections (2) and (3) of section 40 of the Income Tax Act provide as follows –

> (2) In calculating the assessable income of a trust … other than a unit trust, for an income year, there shall be deducted such part of the amount that would otherwise form its assessable income for the income year as is payable to a beneficiary in that income year.
>
> (3) For the purposes of this section …, an amount shall not be considered to be payable in an income year unless it was paid in the income year to the person to whom it was payable or that person was entitled in that year to enforce payment thereof.

In a domestic trust, the deductibility of the distribution in the hands of the trustee is balanced by the chargeability of the distribution in the hands of the beneficiary. The same is true of an international trust which makes distributions to beneficiaries resident in Barbados. But, as noted above, distribution to non-resident beneficiaries out of international trusts are exempt from tax. Thus, for example, where the income takes the form of a royalty whose source is outside Barbados, the international trust may remit this income to Barbados and then distribute virtually all of it in the same year: the trust income is then fully subject to tax, but, after deducting the amount distributed, the taxable amount will be only a nominal sum[19].

The treaty with the United States includes a trust in the definition of "person"[20] and provides that the term "resident of Barbados" means:

> "any person … resident in Barbados for the purposes of Barbados tax, but in the case of a … trust, only to the extent the income derived by such … trust is subject to Barbados tax as the income of a resident either in its hands or in the hands of its partners or beneficiaries."

So far, so good. Article 22, however, which is an early – and relatively unsophisticated – version of the "Limitation of Benefits" article, effectively prevents the international trust from obtaining the benefit of the treaty, unless it carries on an active business. The treaty is nevertheless used – notably in connection with royalties, by interposing a "shield company" between an exempt trust and the user of the copyright, patent etc. The shield company is a regular, tax-paying company, engaged in the business of taking and granting licences[21]. It takes a small "turn" on each transaction, on which Barbados tax is duly paid. Exempt trusts in high-tax jurisdictions generally confine their tax advantage to foreign income,[22] which precludes the use of the shield company, but this is not true of the exempt trust in Barbados. The shield company structure does not have to be confined to transactions taking advantage of the treaty with the United States. It may also be used in relation to sources of income in Canada or the United Kingdom.

The traditional offshore trust is a settlement, generally holding shares and cash on accumulating and discretionary trusts. The Barbados regimes, however, are expressed in terms of trusts, and are not therefore simply confined to settlements of this kind. A settlement with a life tenant or other beneficiary with an interest in possession[23] may take advantage of the capital gains article in the Canadian treaty, or a settlement with powers to carry on a trade may take advantage of the business profits articles in the Canadian and UK treaties.[24] There are also possibilities for the use of unit trusts and trusts for joint ventures.

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[1] I am indebted to Anthony Murty of Thorpe & Atkinson Ltd and Andrew Vanroy Thornhill, of George Walton Payne & Co for their help in preparing this piece.

[2] Under the International Trusts Act 1995 (as amended) and the Offshore Banking Act; *Cf* the UK Taxation of Chargeable Gains Act 1992 s.69(2).
[3] International Trusts Act 1995 (as amended) s.29(5).
[4] Income Tax Act s.17.
[5] S.105.
[6] The Offshore Banking Act requires that the … "funds of the trust consist solely of foreign currency or foreign securities." There appears to be nothing to prevent the trustee of an exempt trust holding assets which do not come under the heading of "funds" – e.g. a copyright. The restriction applying to the trustee of an international trust is that it may not hold any interest in immovable property situate in Barbados. The required status of the two trustees is also slightly different: the trustee of an exempt trust must be licensed under the Offshore Banking Act, whereas the trustee of an International Trust – or at least one of the trustees – merely needs to be resident in Barbados.
[7] If a corporate vehicle is preferred, consideration may be given to the use of an English (or Scottish or Northern Irish) company resident in Barbados – see Income Tax Act s.17 and UK Finance Act 1994 s.249.
[8] Barbados also has treaties with China, Cuba, Finland, Norway, Sweden, Switzerland, Venezuela and the 11 CARICOM countries.
[9] Art IV.1
[10] Art III.1(c)
[11] Income Tax Act s.85(5).
[12] s.2(1)(c)(ii).
[13] Such an argument could run if, to take an unlikely example, there were four trustees, one resident in Barbados and three resident in the Bahamas.
[14] s.29(1) and (2).
[15] Grenada is geographically the closest of these. See, in Grenada, International Trusts Act 1996 s.49 and International Companies Act s.110.
[16] See Draft Contents of the 2002 Update to the Model Tax Convention (OECD, 2 October 2001) and the discussion of the point in Philip Baker: *Double Tax Conventions and International Law* (Sweet & Maxwell, 1994) paras.10-05 to 10-07.

[17] The exemption is conditional on liability to capital gains tax in Barbados – which does not have a tax on capital gains. See Art 13 of the UK treaty, and *cf.* Art XIV of the Canadian and Art 13 of the US one.

[18] Unless he has a branch or agency in the United Kingdom: UK Taxation of Chargeable Gains Act s.10.

[19] Can the UK treaty be used to exempt a UK beneficiary from UK tax on e.g. business profits arising to a Barbados international trust? The decision in *IRC v. Padmore* (62 TC 341) might lead one to suppose that trust income attributed to a UK-resident individual under s.739 Income and Corporation Taxes Act would be protected by the priority accorded to treaty exemption by s.788. The view of the Special Commissioner in *IRC v. Willoughby* [1995] STC 143 was that in the hands of the individual the income loses its original character and is therefore not exempted by the terms of the treaty (see paragraph 14 of the case stated – page 169 at letter C). Perhaps a distinction is to be drawn between income attributed to a taxpayer by a deeming provision and income attributed to a beneficiary by the rules of equity – see *Archer-Shee v. Baker* 11 TC 749, and especially the analysis of Lord Wrenbury at pages 779-781.

[20] Art 3.1(b).

[21] The company is not entitled to the benefit of paragraph (d) or (e) of Article 22(1), but is intended to fall within paragraph (c).

[22] See e.g. in Cyprus, The International Trusts Law of 1992; in New Zealand, the Income Tax Act 1994, subpart HH.

[23] Where the settlor is the life tenant, with a power of appointment over the reversion, the settlement is sometimes referred to as a "Thin" trust. In countries which have adapted the English rules of equity (including Barbados), the trust income in such a case is income of the life tenant, and although it is the trustee who may be entitled to the benefit of a capital gains tax article, it is the life tenant who needs to claim the benefit of articles relating to income.

[24] Art VII in the Canadian and Art 6 in the UK treaty.

TAX LITIGATION: A PRACTICAL GUIDE[1]

Hugh McKay

Introduction

The secret of effective litigation is communication: after all, even the most complicated and obstruse tax case involves telling a story. We all enjoy a good story; and we enjoy it better if the storyteller is enjoying telling the story and the storyteller is sympathetic to the audience.

This article covers the basics of first instance tax litigation before either the Special or General Commissioners or the VAT and Duties Tribunal (I will use the phrase 'the Tribunal' to cover all three of them) and it aims to give practical guidance.

Pre-trial preparation

I said that litigation is really a form of storytelling; but tax litigation marries storytelling with an analysis of the particular tax statutes and relevant case law. Bearing this in mind, the most important practical part of tax litigation is thorough and comprehensive preparation. This cannot be stressed enough. Especially since much of modern civil litigation takes place mainly on paper. By this I mean - Witness Statements (setting out what the witness has to say), Statements of Agreed Facts (where facts not in dispute can be put before the Tribunal), a Skeleton Arguments (where a party's analysis of the law and facts is set out), as well as the more obvious documentary evidence behind the dispute.

Each of these will be mentioned separately, but the key thing to stress at this point is the sooner that research into finding relevant bits of evidence is done and the sooner witnesses are encouraged to put their recollections down on paper, the better. Cases are won by good preparation and they are definitely lost by insufficient or half-hearted preparation.

The starting point when considering taking a matter to appeal is usually a decision of the relevant tax collecting authority ('Taxation Authority'), for example - a decision to raise an assessment or a decision not to allow a particular relief. At this time, the various points each side wants to put will have generally been ventilated several times in correspondence. So, once the decision to appeal has been taken, it is good practice to pause and review the case before taking matters further.

Such a review should ideally consist of a meeting with the client and as many potential witnesses as may be involved, as well as the person who will argue the case ('the advocate'), particularly if that advocate has not been involved before this point.

The review should first address what facts need to be proved and *how* they should be proved - whether by reference to documents executing a transaction or the witnesses explaining what the particular commercial considerations at the time were. This will usually entail setting a variety of tasks for the client, and any other witnesses; however, the successful prosecution of any appeal very much relies on whole-hearted involvement from the client at an early stage. It is also very important to involve clients as much as possible at the early stages so that they can be made aware of what the process involves; and the demands that will be made of them. For example, they should be told about committing their management time to preparing the appeal as well as appearing at the hearing. They will also want to know about interest on tax if they lose; the further appeals processes; and the costs implications for each stage and whether they can be recovered by the client if successful, as well as how long it will take. A VAT or Duties appeal may take a year from starting the appeal to the hearing and a Special Commissioners' appeal may take longer; after that an appeal to the High Court may add another 6 months; a further appeal to the Court of Appeal, another 12 months; and the House of Lords, 12-18 months. If a reference is made to the European Court expect it to take two years or so from reference to outcome in that Court and a further delay if there are significant matters for the National Court.

Documentary evidence

No matter what kind of tax appeal the documentary evidence will undoubtedly be important. By "documentary evidence", I mean those pieces of paper which, first, effect the particular transaction or the events under scrutiny; second, those other pieces of paper which explain that transaction or those events - such as board minutes, correspondence between the taxpayer and third parties. Deciding whether something has evidential value is a fairly simple process. You simply ask yourself: "What particular fact does this document establish?"

By contrast, a letter from, say, an accountant to the Inland Revenue disputing the Revenue's position often does not demonstrate any matter of fact (though it might recite various facts). And it is often wise, especially if there are lots of documents, to exclude correspondence, since the contents can often be much better put at the hearing by the advocate.

If a document has evidential value it should be included in the 'Bundle of Documents' (the collective term for the documentary evidence). The Bundle of Documents, however, does not exist in a vacuum. It is definitely good practice, and often a formal rule of the law of evidence, that witnesses should be able to establish the provenance of particular documents. This is known as 'speaking to documents.'

An example may help. If it is disputed that a particular transaction took place, and that is one of the central issues in the case, it is not enough to merely produce a signed receipt. Preferably both parties to the transaction should give evidence that it took place; that a receipt passed between them; and that one or both of them signed it as evidence of the transaction. As well as the receipt it would also be necessary to produce any correspondence setting out the negotiations between the parties, bank statements or cheques to demonstrate that the price had been paid and received and the Witness

Statements (below) should explain what happened next with the transferred item(s).

Of course, at this point the reader may feel like saying: 'But if you do all of this, then there will not be any need for an appeal hearing.' To which the answer is: 'Exactly.' Many more tax appeals begin each year than actually find their way to a hearing. Appeals are settled for a variety of reasons. But, so far as clients are concerned, the best reason is because the advisers have assembled an overwhelming case that the Taxation Authority recognises is irresistible, so that they withdraw their disputed decision and the taxpayer succeeds. That must always be the ideal objective. Sometimes it becomes plain during preparation, however, that the client's case is hopeless and the Taxation Authority has the overwhelming arguments. It is better to find this out sooner so that the expense of a hearing can be avoided and so that a settlement can be reached.

With this in mind, the better the case is, the better it is to make full disclosure of all of the points sooner rather than later. It saves time and costs *and* wear and tear on the client.

In times gone by it was the practice to disclose as little as possible to the Taxation Authority at all at any early stage. Most recently, this has attracted fierce criticism in *IRC v McGuckian* [1997] STC 908. Nowadays, I would say it is absolutely not in the client's interests to fail to disclose important and relevant documents - subject to the requirement to examine legal professional privilege - at the earliest possible stage.

To elaborate, it prevents the Taxation Authority feeling that it has no option except to use its most draconian information gathering powers, such as section 20 Taxes Management Act 1970. If those powers are invoked complying with the Taxation Authority's demands will be much more time consuming *and* expensive. Moreover, it establishes a spirit of open and fair dealing between the parties that works very much in the client's interest in the efficient prosecution of the appeal. Whilst a tax dispute is nonetheless a dispute, savage "trench warfare" tactics serve to only alienate the representatives of the Taxation Authority and are usually cause more harm than good; especially these days when such behaviour is alien to the Civil Procedure Rules (CPR) used in the Higher Courts, which very much influence the Tribunal.

Witness Evidence

Again, the trick here is to ensure that as soon as a particular witness has been selected he or she commits as much detail as possible to writing: memories fade over time, so memory preservation is key. It is always as well to use Witness Statements in Tax Cases.

The first reason for this is that you will know exactly what the witness is going to say because that evidence is in a written form. Hopefully, it will be the product of careful research and it means that the risk of the witness "failing to come up to proof" or otherwise deviating from his story is reduced.

Second, it gives the witness something to read over before giving evidence to help refresh their memory and calm nerves. Although Witness Statements do not have to follow any particular formal style it is highly desirable that the first draft is the potential witness' own unaided work. Apart from the obvious difficulty of putting words into someone else's mouth and then expecting them to stand by it, it is a good way of starting the recollective process. Moreover, it enables witnesses to tell their own story in their own voice. Putting it bluntly, footballers should sound like footballers and not finance directors. If they do not it will not ring true and the witness's credibility will be lost.

After the first draft has been produced the advocate will need to look at the gaps in it, and there will usually be lots of them. There may be important side issues that will need to be expanded on; or the witness statement may use jargon and abbreviations which may need to be explained.

The best advice is to tell the witness to explain absolutely everything about the story being told because his audience will typically know nothing, or nothing much, about the particular circumstances; whereas the witness will know everything. It is therefore best to have as much detail - even if it is not central to the case.

As explained before, witnesses should also explain the provenance of the documents of which they have personal knowledge. They are proving the documents' role(s) in the particular transaction and using them as part of telling the story.

The Skeleton Argument

This is a very important document and, though its use is not compulsory in tax cases (unless there has been a direction from the Tribunal to that effect, which is quite common these days), it is nonetheless exceedingly good practice to use one. Since it is not a formal requirement of the procedural rules the advocate has a great deal of freedom in how to approach it. Some produce shortlists of bullet points and expand on them considerably when putting their case orally. Others go to the other extreme and have something resembling a script.

It is probably best to strike a balance between the two approaches - after all, it is the story telling that really matters and that takes place on the day of the hearing. One should use a Skeleton Argument as a means of allowing the Tribunal to become familiar with the arguments that it is about to hear (by lodging it with them ahead of the hearing) and also as a memory aid when it comes to produce its decision. But how you actually do it is a matter for you as advocate. If an external advocate is involved, it is good practice for the advocate to circulate it before it is served so that everyone involved is happy with it.

A well set out skeleton should weave the technical arguments into the particular facts of the case. It is useful to begin with a short outline of the point in dispute followed by an outline of the facts and then an outline of the law followed by expanding on the factors present in that case which mean the particular provision in the legislation or rule in a tax case applies (known as "submissions"). If the case is more concerned with the meaning of a particular provision than its factual application the way that the legal analysis should be set out in close detail.

Now, because the Skeleton Argument is a story telling aid it should follow the format the advocate or storyteller is most comfortable with. I use a series of headings - usually: Introduction; The Facts; The Law; Submissions and Conclusions. Under each of them I set out as much detail as I think I need. The first and last are short. 'The Facts' is a summary of the main events. 'The Law' is the relevant statutory rules plus short extracts from case law, and 'Submissions' consists of relating the first two to one another to show why my client should win.

If a Skeleton Argument can be produced decently ahead of time and the advocate is happy with it (and so is the rest of the team) then, as part of the process of persuading the Taxation Authority that the taxpayer's case is overwhelming, it should be served on it, together with any documents or evidence that have yet to be disclosed, ahead of the hearing. When I say ahead of the hearing I am thinking in terms of weeks rather than days so that the Taxation Authority's lawyers and policy makers have an opportunity to fully digest the impact of those documents and arguments on the taxpayer's case and, hopefully realise why that case is overwhelming.

The Hearing

How to open a hearing

Except in dishonesty cases, the Taxpayer goes first. The Taxation Authority puts its case next and the Taxpayer has an opportunity to reply to the Taxation Authority's case. If it is a dishonesty case the order is reversed. This is on the basis that the party wishing to show something – that the assessment is excessive or that the taxpayer is a crook - must demonstrate it. The other side then tries to refute and the original party responds. The obligation to show something is so is referred to (in legal terms) as 'the burden' being on a particular side. This burden is generally evidential; that is to say, that party must provide evidence (facts) to demonstrate that its case is right.

The best way to begin the opening is to try and capture in a few sentences exactly what the case is all about. At this point one might say; 'why bother, considering all the trouble that has been gone to with the Skeleton Arguments, Witness Statements and so on.' There are two reasons. First, it is nice to begin with some easy sentence or two to get yourself comfortable - think of it as the equivalent of warming up in a sporting game. Second, the Tribunal is hearing your case today but, in the hour or so before the hearing started, it may have had to have look at administrative matters in relation to other cases, so it allows the Tribunal to focus its attention on the matter in hand, as well as being a warm up for the Tribunal as well as you. No one will criticise you for this and it provides a useful boost to the advocate's confidence because it allows for a pleasant and fluent start to the proceedings.

Having completed the first and easy bit, the next thing is to approach the technical arguments in more detail. Typically, it is best to begin with these since the Tribunal will want to know the legal framework in which to consider all of the facts.

The exception to this approach is if there is a Statement of Agreed Facts. Since such things will typically be short, rather than detailed, it is useful to go through that Statement as part of the warm up: the advocate's confidence can build up tremendously after a clear opening and reading out of the Statement of Agreed Facts.

When speaking to the Tribunal do keep an eye on the chairman's pen. It dictates the speed of the hearing. Speak slowly enough at critical points to let him get everything down on paper.

<u>Documentary evidence</u>

To set the case within its legal context it is generally useful to go through the Bundle of Documents before coming to the Witness Statements. It is not a process of referring to each and every page of the Bundle of Documents, but a process of picking out the important points - whether it be the effect of a whole agreement, *but* summarised by reference to one or two operative clauses; or a paragraph in a letter; or a series of board minutes.

Provided one goes through the Bundle of Documents economically rather than mechanically it should not be a daunting exercise. The advocate will often find it useful to make a number of comments tying in the legal submissions to particular documents at this point.

Witness evidence

Generally, the last thing one does in opening one's case is to put the witnesses before the Tribunal. If it is your witness, that witness will be giving evidence 'in chief'. As will be apparent by now, the witness evidence, unless it is very short, should be provided in the form of a Witness Statement.

There is an etiquette point to mention. The Special Commissioners generally do not require 'sworn evidence', but the VAT & Duties Tribunal usually does. If a witness is being 'sworn' (either giving the oath or making an affirmation) it is a solemn act, so respect this, stay silent and (preferably) motionless - to show you, too, appreciate the solemnity of what the witness is doing.

When giving evidence the witness should go into the witness box and, after being sworn (if it is done), you should ask them to state their name and home or professional address. If professional qualifications or status are relevant they should be dealt with at this point. Then the witness should be taken to their statement and asked if they recognise it, check it is complete (it is not unknown for pages to go astray in the photocopying process) and then confirm that it is true.

Even the most carefully prepared and thought out Witness Statement will usually need to be added to once the hearing is underway, as particular thoughts or issues occur to the advocate. This is perfectly acceptable; but only ask 'open questions,' never 'leading questions'. A leading question is a question that suggests its own answer; or, put another way, is usually answered with a yes or a no. When the witness has finished giving evidence in chief, the witness is offered to the other side for cross examination (if any).

In cross examination you must put your client's case to that witness with the ideal view of getting the witness to agree to your client's version of events. In a Tax case it is seldom as exciting as in the movies but cross examination can often elicit information from that is helpful. You absolutely must put your case to the other side's witnesses in cross examination, and their advocate must do the same to yours.

There is an opportunity to attempt to repair any damage done under cross examination in re-examination. This is where the advocate puts further questions to the witness. Again they must not be leading questions (as with evidence in chief) and they especially must not take the form of 'when you said '*x*' what you really meant was '*y'* wasn't it?'). And please do not use it as a chance to ask all of the questions from evidence in chief again.

Once all the taxpayer's witnesses have put their evidence the taxpayer will have 'opened' his case and it is then for the representative of the Taxation Authority to put his case.

Typically, if there is any evidence to be provided by the Taxation Authority this will come next. However most tax cases do not involve the Taxation Authority putting forward witnesses. The exceptions to this are in investigation type cases where officers of the Taxation Authority will have carried out observations into how the taxpayer carries on his business and all cases which involve disputed expert evidence (for example, on a point of accountancy practice.)

The practitioner approaching cross examination of the Taxation Authority's witnesses should bear a few things in mind.

Leading questions are allowed but television style theatrics help no one. The best approach is to bear in mind the notion that if there is a dispute of fact you must put your client's case to the witness and invite the witness to agree or comment on what you say. Putting your case to the other side is both a requirement and, if borne in mind, enables an effective series of questions to be put. It is better to ask questions slowly rather than to gabble them since the Tribunal will have to take a note, generally in manuscript. It is also amazing what inspiration arrives if one bears the simple 'put your case' rule in mind.

If there is no evidence, or after it has put its own witness evidence forward, the Taxation Authority will make submissions on the law and how it wishes the Tribunal to apply it in a particular case.

After the Taxation Authority has finished putting its case all that remains is for the taxpayer's advocate to put points in reply. This can be as long or short as is thought desirable but again the best way of dealing with points in reply is to see where the Taxation Authority has put points effectively, so that the taxpayer's case looks weakened in particular areas or where the Tribunal and the Taxation Authority's representative had a detailed discussion and the Tribunal appeared impressed by the way that the Authority put its case.

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1 A longer version of this article appeared in the 2002-2003 Edition of TAXline published by the Tax Faculty of the Institute of Chartered Accountants in England and Wales.

TREATMENT OF TAX EQUALISATION PAYMENTS

Aparna Nathan

Introduction

Several international employers operate a policy of tax equalisation. The aim is to attempt to keep the employee in broadly the same position as that employee would have been in had he remained in the home country.

Whether a particular tax equalisation policy achieves this aim depends, among other things, on the formula applied in implementing the tax equalisation policy.

The following is a fairly standard formula used to tax equalise an employee: a notional amount of tax payable in the employee's home country by the employee whose salary is to be tax equalised is determined. Let us assume for these purposes that employee's tax liability in the home country is x%. That x% tax rate is then applied to the employee's salary to determine a notional net salary. The world-wide tax on his salary is borne by the employer. As a result of the tax equalisation arrangement the employee receives a sum which approximates to this notional net salary.

It must be noted that in most instances the employer does not guarantee a net of home country tax salary, i.e. there is no guarantee that the employee will receive the notional net salary.

Looked at from a non-legal standpoint, the employee receives broadly the same amount of after-tax cash as he would have received had he continued to work in his home country.

From a legal standpoint, however, the employee is not contractually entitled to receive a salary equal to the after-tax cash he would have received had he continued to work in his home country. He is simply contractually entitled to receive the amount arrived at using the relevant tax equalisation formula.

The Issue

Where a UK resident, non-ordinarily resident and non-domiciled employee performs duties partly inside and partly outside the UK, the employee's salary is taxable under Schedule E Case II.

Schedule E Case II applies in respect of "any emoluments from the chargeable period in respect of duties performed in the United Kingdom".

The remainder of the employee's emoluments (i.e. the emoluments that are not taxed under Schedule E Case II) will be chargeable in the UK under Schedule E Case III to the extent that they are received here.

The issue that arises is whether all amounts brought into the tax equalisation calculations in respect of UK taxes are UK source so that payment by the employer of such UK taxes is wholly a Schedule E emolument.

More specifically, the issue is whether payments by the employer of the employee's Schedule E Case II tax are "emoluments … in respect of duties performed in the United Kingdom" so that they are themselves within the charge to tax under Schedule E Case II.

In the past, major accountancy firms and the Revenue, discussed and disagreed on the correct tax treatment of tax equalisation payments in respect of Schedule E Case II tax. Over the course of the last twenty years, several compromise arrangements were operated but which left the principle undecided. The principle was decided in the Revenue's favour at Special Commissioners level in a recent case, Natalie Perro v. BC Mansworth ([2001] STI 1361[**]).

The Alternative Tax Treatments of Tax Equalisation Payments

There is no dispute between the Revenue and taxpayers that tax equalisation payments are emoluments for the purposes of Schedule E. Further it is not disputed that they are indistinguishable from any other emoluments paid to the employee by the employer. The Revenue, nevertheless, appear to treat tax equalisation payments made in respect of Schedule E Case II tax differently from other emoluments.

What lies at the heart of the issue is whether, as required by s.19 ICTA 1988, these emoluments, i.e. the tax equalisation payments are only "in respect of duties performed in the United Kingdom" and, therefore, in their entirety chargeable under Schedule E Case II.

It is the Revenue's view that they are so chargeable. The Revenue position is simply put. It is their view that tax equalisation payments in respect of a Schedule E Case II tax liability only arise because the employee works in the United Kingdom and therefore the payments constitute emoluments "in respect of duties performed in the United Kingdom".

It is maintained on behalf of taxpayers, however, that whether or not any emoluments (including tax equalisation payments) are "in respect of duties performed in the United Kingdom" is a question of fact. This requires an analysis of the rights that exist between the employer and the employee. These rights are enshrined in the contract of employment. It is the contract of employment that provides the legal basis for the employer/employee relationship. It defines the relationship. Consequently, it is to the contract of employment that one must look in determining the rights that exist between employer and employee.

Where the contract of employment between the employer and the employee attributes emoluments to particular duties, then those emoluments are quite clearly in respect of those duties – e.g. if part of the emoluments are attributed to duties performed in the

UK, those emoluments are quite clearly in respect of duties performed in the UK.

If, however, the contract of employment is silent on this point, it must be determined whether, as a question of fact, it can be said that the emoluments are in respect of duties performed within the UK. If, as is quite common, international employees have a single contract of employment that covers all their duties wherever they are performed and in respect of which the employees are entitled to a single global salary, it may be somewhat difficult to say, as a matter of fact, that a particular portion of that salary is attributed to duties performed in the UK.

This, however, does not progress matters any further for the purposes of Schedule E Case II because some form of apportionment is clearly required by that Schedule. It is arguable that, in the absence of any clear indication in the contract of employment or on the facts that particular emoluments are earned in respect of duties performed in the UK, apportionment should be on a time basis. The Revenue provide in Statement of Practice SP5/84 that the apportionment is based on the number of working days spent by an employee in the UK.

The Special Commissioner in Natalie Perro v. Mansworth accepted that there was no specific reference to UK tax within the Appellant's contract of employment. He was, however, unwilling to accept that tax equalisation payments in the Appellant's case were not impliedly or in fact "in respect of" duties performed in the UK. He stated:

> "It is an inescapable fact that the tax is only payable because of the performance of duties in the United Kingdom and the amount of the tax depended on the proportion of her emoluments attributable to those duties. She went to work in the UK on the basis that as a UK resident she would be liable to Case II tax on emoluments for her duties. That was the law. Her employer undertook to pay or reimburse that tax. Whether it was implied that tax "in respect of" her UK duties would be paid or whether it was merely so paid in fact matters not. It was still "in respect of" the performance of those duties."

He later went on to state that he could see no logical basis for drawing a distinction between payments to enable duties to be performed in the UK and payments resulting from the performance of duties in the UK. So saying, he found for the Revenue.

Implications of the Revenue Position

It is the author's view that the Revenue position, approved by the Special Commissioner, leaves several matters unaddressed. If one starts from the premise that tax equalisation payments are emoluments for the purposes of Schedule E which are indistinguishable from any other payments made by the employer, then one has to ask the following question: what is so special about tax equalisation payments made in respect of Schedule E Case II tax that requires them to be treated differently from other emoluments? Does the "Englishness" of the tax make the tax equalisation payments English-source and, therefore, chargeable within the UK? Alternatively, is it the basis upon which the charge to tax under Schedule E Case II arises that renders tax equalisation payments made in respect of Schedule E Case II tax wholly chargeable within the UK?

Generally, tax equalisation payments are payable in respect of foreign taxes irrespective of the basis on which the tax is charged. As long as the tax is charged (on whatever basis), an employee is entitled to a tax equalisation payment.

Schedule E Case II specifically talks of "duties performed" in the UK. There are, however, other UK taxes that do not depend on the performance of duties at all – for instance, Schedule E Case III. It is worth considering how tax equalisation payments aimed at reimbursing such taxes will be treated by the Revenue.

Example 1

Assume that there is a Schedule E Case III employee who remits some foreign income and so incurs a Schedule E Case III charge. A tax equalisation payment would be due to that employee under his tax equalisation policy.

Will this tax equalisation payment made to discharge the employee's Schedule E Case III liability be apportioned under the SP5/84 treatment that applies to other emoluments or will the Revenue treat this tax equalisation payment as an emolument falling within Schedule E Case II?

It seems to be the Revenue position that tax equalisation payments made to meet Schedule E Case II tax (which tax is chargeable in respect of duties performed in the UK) must, therefore, also be emoluments in respect of duties performed in the UK.

If the tax equalisation payments are paid to meet a tax liability that does not depend on the performance of duties in the UK, such as the Schedule E Case III liability of the employee in this example, then based on the Revenue view, those emoluments are not in respect of duties performed in the UK and are, therefore, outside the charge to Schedule E Case II tax. The tax equalisation payments ought, therefore, to be apportioned in the same was as other emoluments under SP 5/84.

If this is extrapolation of the Revenue's current position is accurate, the Revenue seem to be applying one rule for emoluments that discharge a liability to one type of UK tax, namely Schedule E Case II tax, and another rule for emoluments used to discharge another type of UK tax.

Issues also arise in respect of other UK taxes, for instance, capital gains tax on disposals in the UK; or a s.776 ICTA 1988 liability in respect of artificial transactions in land; or a liability to tax in respect of UK bank interest. All of these tax liabilities are, in theory, capable of being tax equalised under a tax equalisation policy. Would such tax equalisation payments be apportioned under SP5/84 or would they somehow be treated as being "in respect of duties performed in the UK"?

Further, the Revenue's position raises intriguing questions in the context of reimbursements of non-UK taxes. Assume, for instance, that an employee is tax equalised in respect of US tax, three alternative analyses can apply: first, the tax equalisation payment is in respect of US tax and is, therefore, US source and consequently outside the charge to UK Schedule E tax entirely; secondly, the tax equalisation payment is chargeable in the same way as other emoluments and apportioned under SP5/84; thirdly, the tax equalisation payment is somehow brought within the ambit of Schedule E Case II tax and taxed entirely within the UK.

If, as the Revenue claim, UK Schedule E Case II tax is a UK tax so that a tax equalisation payment in respect of it is wholly chargeable to UK tax under Schedule E Case II, then, arguably, a tax equalisation payment in respect of US taxes ought also to be exclusively chargeable to US tax in the US. It is doubtful whether this view will be accepted by the Revenue but, in the author's view, it seems to be a logical outcome of the Revenue position.

Another anomaly that is created by the Revenue position can, perhaps, be demonstrated by the following example:

Example 2

Assume that an employer operates the tax equalisation policy by estimating all anticipated foreign taxes and then adding that amount to the employee's annual salary. The employee receives a monthly salary of an amount that includes a sum representing the estimated tax equalisation payment.

How would the Revenue treat this monthly salary? Assuming that they overcome the problems of identifying which part of the monthly salary comprises the tax equalisation element, how would the Revenue seek to distinguish the extra cash representing the tax equalisation element from the rest of the monthly salary?

Perhaps the Revenue might seek to identify what part of that extra cash was calculated to cover estimated Schedule E Case II liabilities so that that part would, in line with the Revenue's current position, be exclusively taxable in the UK.

If that were true, how would the Revenue claim that the amount allocated to the estimated Schedule E Case II tax was paid "in respect of duties performed in the UK"? That extra cash would be paid to the employee whether or not the employee performed any duties in the UK. Indeed, even if the employee performed fewer or greater duties in the UK than had been anticipated in calculating the estimated extra cash amount, that estimated extra cash would remain unaltered and would continue to form part of that employee's monthly salary.

Consequently, the Revenue's method of seeking to tax payments made to discharge Schedule E Case II tax could, arguably, be avoided by the simple expedient of including payments to discharge estimated tax liabilities as part of the monthly salary.

Conclusion

It is the author's view that the Revenue's treatment of tax equalisation payments made in respect of Schedule E Case II tax creates a special category of emolument. The author fails to see why this particular form of emoluments ought to be treated in any way differently to other emoluments paid to an employee. No adequate reason for this special treatment was, in the author's view, given in Natalie Perro v. Mansworth. It will be interesting to see how the Revenue deal with the various anomalous situations created by their tax treatment of tax equalisation payments.

[**] Full transcript available on Gray's Inn Tax Chambers website: www.taxbar.com

RECENT RUMBLINGS OF THE EUROPEAN COURT: WHAT REMAINS OF *BACHMANN*?

Claire Simpson

Background

Member States' tax measures in the field of direct taxation may contravene Community law for a variety of reasons. For example, they may breach Articles 39 (free movement of workers), 43 (freedom of establishment) or 49 (freedom to provide services) EC[1] by discriminating, directly or indirectly, between taxpayers on account of the nationality of the taxpayer or the place where the taxpayer is resident or established.

Over the years, Member States have advanced a range of justifications before the European Court of Justice ("the Court") for their discriminatory tax measures. The following are examples of those which have failed:

- the risk of tax avoidance/loss of tax revenue;

- the need for progressivity of the tax system;

- the existence of lower tax rates in other Member States;

- that harmonisation of direct tax law has not been achieved;

- the effectiveness of fiscal supervision/administrative difficulties;
- the absence of reciprocal treatment under a double tax treaty;
- the discrimination is diminished by the effects of a double tax treaty;
- other advantages are enjoyed by the person suffering the discrimination.

Bachmann

The most famous, or perhaps infamous, justification was that which arose in the case of *Bachmann*[2]. Mr Bachmann was a German national, resident and employed in Belgium. Belgian income tax law made the deductibility of sickness and invalidity contributions or pension and life assurance contributions conditional upon the contributions being paid "in Belgium". Mr Bachmann was therefore precluded from deducting voluntary sickness, invalidity insurance and life assurance contributions made to a German company.

The Court ruled that the Belgian legislation contravened Articles 39 and 49 EC. However, it decided that the above condition could be justified by the need to safeguard the cohesion of the Belgian tax system. Under the Belgian rules there existed a connection between the deductibility of contributions and the liability to tax of sums payable by insurers under pension and life assurance contracts. The loss of revenue from the deduction was thus offset by taxation at a later stage. However, if Belgium were to allow the deduction of contributions paid to the German company, there was no guarantee that it would be able to tax the sums later paid by that company. Accordingly the Belgian legislation was in the circumstances the least restrictive measure for ensuring the cohesion of the tax system, and could be justified.

The Demise of the Bachmann Defence

The *Bachmann* decision was widely criticised. In subsequent decisions the Court took steps to reduce the ambit of the cohesion defence.

In *Wielockx*[3], the Court held that a Dutch rule which denied a non-resident Belgian self-employed person the right, granted to residents, to deduct from taxable income a provision made to a pension reserve was contrary to Article 43 EC. The Dutch government sought to justify the denial by reference to the fiscal cohesion defence. The Court dismissed this on the basis that fiscal cohesion was secured by the Netherlands-Belgium tax treaty. In other words, as the Netherlands had surrendered the right to tax pension benefits received in Belgium (even where they derived from contributions paid in the Netherlands) in its tax treaty, it could hardly claim that it was not obliged to grant a deduction where it was unable to tax the benefits.

The large majority of Member States' tax treaties follow the same principle of residence taxation. The

Court's reasoning in *Wielockx* thus applies to almost all similar cases.

In later cases the Court further stressed that Member States may rely upon the need to preserve fiscal cohesion only if there is a *direct* link, a 'symmetry' between the grant of a tax advantage and the offsetting of that advantage by a fiscal levy (both of which relate to the same tax and taxpayer). See, for example, Case C-35/98 *Verkooijen* [2001] ECR I-nyr, paragraphs 56-58.

The scope of the *Bachmann* defence was thus reduced to the extent that it has not met with success in any of the later cases in which it has been raised.

Case C-136/00 Danner

Danner concerns the compatibility with the freedom to provide services (Article 49 EC) of Finnish tax law provisions which preclude or restrict the deductibility for income tax purposes of voluntary pension insurance contributions paid to pension insurance institutions established in other Member States. The case is very similar to *Bachmann* and provides an excellent opportunity to see how the principles established in that case have evolved over the last decade.

At present, only Advocate General Jacobs' Opinion, delivered on 21 March 2002, is available. The Opinion is however well-reasoned and I would be very surprised if the Court did not adopt a similar approach.

It was not contested by any of the parties that the Finnish tax rules constituted a restriction on the freedom to provide services. The rules were also overtly discriminatory on the grounds of the nationality of the service provider and thus contravened Article 49 EC.

The Finnish Government sought to justify the rules on four grounds: the need to ensure the cohesion or 'coherence' of the Finnish tax system; the effectiveness of fiscal controls; the need to prevent tax evasion; and the need to protect the integrity of the tax base.

As readers with a European law background will be aware, none of these grounds is expressly mentioned in the Treaty – thus they will only be recognised as possible justifications if they amount to 'overriding requirements in the general interest'. The main line of cases of the Court (from which it has never expressly departed) has established that overtly discriminatory rules (such as those at issue in *Danner*) may only be justified on the basis of *express* justifications such as those contained in Articles 45 and 46 EC. However, in a separate line of authority, the Court has avoided assessing whether the rules in question were overtly discriminatory (such as in *Bachmann*, where arguably the rules were indeed directly discriminatory), and has examined justifications not expressly provided for in the Treaty. The Advocate General called for clarification of the Court's case law on this point, adding that in his view it was not proper to draw a rigid distinction between the grounds of justification for directly and indirectly discriminatory measures. Accordingly, he addressed the four grounds raised by the Finnish government.

In the Advocate General’s opinion, none of the grounds invoked could justify the contested measures. What is interesting in this context is his dismissal of the cohesion defence.

First, he considered that, unlike the symmetrical system which the Court “assumed” to exist in *Bachmann*, there was no “direct link” between deductibility and taxation. The pension received by Mr Danner from the German company would be subject to Finnish income tax despite the fact that he could not deduct the contributions paid to that company. The Finnish system was “asymmetric”.

Second, he applied the Court’s reasoning in *Wielockx*. Fiscal coherence was secured by Finland’s bilateral convention with Germany[4].

Third and in any event, he considered that the Finnish measures were not the least restrictive means of securing the coherence of the system. All persons paying contributions to foreign insurance undertakings could not be prohibited from deducting those contributions merely because some of those persons might leave the country. A mechanism providing for some form of ‘claw back’ from departing taxpayers would be less restrictive than such a general prohibition.

The Implications of Danner

Two broad points can be made.

First, while no two cases are ever alike, *Bachmann* and *Danner* are close enough that *Danner* provides a strong indicator of how *Bachmann* would be decided today. If the Court follows the approach of the Advocate General, it will be the closest it has ever come to saying that the *Bachmann* cohesion defence can no longer be relied upon – even in *Bachmann*-type factual situations. It becomes harder and harder to envisage circumstances in which the defence might ever be successful.

Second, a trawl through the United Kingdom provisions governing the deductibility of pension contributions paid to institutions established in other Member States, to ascertain those which fall foul of *Danner* (or of other Treaty provisions), would not go amiss.

This is particularly so since the Commission has indicated in its recent Communication on the elimination of tax obstacles to the cross-border provision of occupational pensions[5] that:

> "national rules denying equal treatment to pension schemes operated by pension institutions established in other Member States are in breach of the Treaty. Member States must ensure that they grant the same tax deductions for contributions to domestic pension institutions and those

> established in other Member States. Equal treatment must similarly be granted in relation to any yield tax and in relation to the tax treatment of benefits. The Commission will monitor Member States' national rules and take the necessary steps to ensure effective compliance with the fundamental freedoms of the EC Treaty, including bringing the matter before the Court of Justice on the basis of Article 226 of the EC Treaty."

What constitutes "equal treatment" is of course a matter for discussion. Where tax advantages only attach to pension schemes based in the United Kingdom which possess certain characteristics, Community law should not require the granting of such advantages to foreign schemes which do not, simply because they happen to be based in other Member States.

It may be that where the tax treatment of foreign pension schemes is challenged in future, the debate will shift to a consideration of whether the resident and non-resident pension schemes are sufficiently similar that the differential treatment amounts to unlawful discrimination.

One thing is certain: considerably more movement can be expected in this area of tax law over the next few years.

[1] Formerly Articles 48, 52 and 59 respectively, before the EC Treaty was renumbered by the Treaty of Amsterdam.
[2] Case C-204/90 *Bachmann v Belgian State* [1992] ECR I-249.
[3] Case C-80/94 *Wielockx v Inspecteur der Directe Belastingen* [1995] ECR I-2493.
[4] Interestingly, the Advocate General considered that the *Wielockx* rationale applies, even in the absence of a double taxation convention in any particular case, by virtue of the existence of the general network of double taxation conventions to which Member States are parties: see paragraphs 55 and 56 of his Opinion.
[5] O.J. 08/06/01 C 165/03.

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