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TAXATION OF DAMAGES, COSTS AND INTEREST (1)[1]

Conrad McDonnell

VAT position on damages and interest

VAT is a tax on transactions which constitute economic activities (Articles 4 and 6, Sixth Directive[2]). The tax applies to supplies of goods or supplies of services. The liability to pay VAT is imposed on the *supplier*. The amount of the VAT is calculated by reference to the consideration for the supply. The "consideration" is everything obtained by the supplier for the supply (Article 11, Sixth Directive); consideration is obtained for a supply if there is a direct link between the two. In many commercial transactions, the agreed consideration is a certain sum "plus VAT"; or it may be agreed that the specified price is "exclusive of VAT" which amounts to the same thing. That means that, if the supply is a standard-rated supply, the contractual consideration actually agreed to be paid between the parties is 117.5% of the sum stipulated (*Hostgilt v. Megahart* [1999] STC 141). In such a case, the statutory obligation to account to Customs & Excise for the VAT of course remains with the supplier. If the contract is silent as to VAT (and if there is no implied term and no relevant custom and practice in the particular business sector concerned), or if there is no contract, then the price paid is inclusive of VAT; and it will be the obligation of the recipient of the consideration to account to C&E for VAT. It can be seen that if the parties to litigation fail to take VAT into

account, the burden of the VAT due on a sum representing damages or other fruits of the litigation is likely to fall on the recipient.

Where litigation relates to a commercial transaction, there are essentially two types of claim for the purposes of analysing the VAT position. The first type is a claim for unpaid contractual sums (or a claim for payment on a *quantum meruit* basis) for a transaction which *has* taken place. (A particular example might be a claim in a professional negligence matter; negligence is often raised as a defence and counter-claim to a claim for unpaid fees.) The second type is a claim for compensation in relation to a transaction which *did not* take place. A similar distinction is made in Customs & Excise' Press Notice 82/87 concerning the settlement of disputes.

In the first type of case, any sums recovered in the litigation are fundamentally "consideration obtained by the supplier" for the supply previously made, and are therefore subject to VAT. There may be difficult issues as to the timing of the VAT charge, in particular in the case of a supply of professional services which is a continuous supply over a long period. Substantial technical difficulties can arise where the supplier has ceased trading before the litigation is resolved, or where more than three years have elapsed (see below). In the specific example of a professional negligence matter raised as a defence to a claim for unpaid fees, the fact that damages for negligence may be set off against the fees due does not affect the position that VAT will be

due on the fees, since a service was in fact supplied (this is the case even where the fees are reduced to nil and a payment of damages is made, since even there the fees invoiced have produced some benefit for the negligent party namely to reduce the damages that would otherwise have been due). In some cases, however, it may be in dispute whether any service was in fact supplied, and if there was none then no VAT will be due. In the second type of case, because there was no underlying transaction, the compensation received is not subject to VAT: VAT applies only in relation to a supply of goods or a supply of services. Of course in some cases it may be in dispute whether a service was provided or not, in which case the VAT treatment of any damages will be extremely dependent on the precise outcome of the litigation.

The VAT system as implemented in the United Kingdom is subject to a general three-year time limit that is, claims for repayments of tax cannot be accepted more than three years after the end of the relevant VAT accounting period (see, however, *Marks and Spencer plc v. C&E Comrs* (Case C-62/00) [2002] STC 1036, ECJ in respect of retrospective application of that three year time limit). On the other hand, Customs & Excise do not normally have power to assess a taxpayer to unpaid VAT more than three years after the end of the accounting period. It can be the case that litigation is resolved more than three years after the event, in which case it may not be possible to make any adjustment to the parties' VAT position.

Interest on damages (either assessed interest included in a judgment award, or interest on a judgment debt) normally falls to be disregarded for VAT purposes (except, of course, where the underlying transaction was a loan or other provision of financial services). In *B A Z Bausystem AG v. Finanzamt München für Körperschaften* [1982] 3 CMLR 688, ECJ, Bausystem had sued a customer for payment for a supply of services, and had obtained judgment from the German court for a sum plus interest of 5%. The German revenue authorities sought VAT on the judgment sum and additionally on the interest. The ECJ concluded -

> Interest of the kind with which the present case is concerned has no connection with the supply or the receipt of the supply and does not constitute value in return for a commercial transaction. It is, rather, a mere reimbursement of expenses, in other words, an indemnity due because of lateness in payment.

VAT position on costs

Each party to litigation receives a supply of legal services from its lawyers. (Most minor disbursements would be regarded for VAT purposes as incidental to the principal supply of legal services, and thus disbursements normally receive no special VAT treatment.) Assuming that the lawyers' principal place of business is in the United Kingdom, or at least that the lawyers conduct this aspect of their business from a fixed establishment in the UK, then the VAT treatment of the supply of legal services is as follows. If the client belongs in the United Kingdom VAT is chargeable in the United Kingdom. If, however, the client belongs outside

the European Community no VAT is due, since it is not a UK supply. But if the client belongs in another EC member state, VAT is chargeable in the United Kingdom *unless* the client receives the supply for the purposes of a business carried on by him in that other member state. (Note that being a shareholder, or a holding company which merely passively holds shares in its subsidiaries, is not a "business" for VAT purposes[3].) "Belongs" here is to be interpreted according to s.9 Value Added Tax Act 1999. Essentially, in the case of a business, the test has regard to the business establishment or fixed establishment (including a branch or agency) most directly concerned with the supply. In the case of an individual who is not in business (or where the legal services do not relate to his business), he belongs where he has his usual place of residence.

Where Counsel is involved, it is a moot point whether, for VAT purposes, Counsel makes a supply of services to the professional client or to the lay client. The answer usually depends on whether the payment for Counsel's services is made out of the solicitor's office account (in which case it is probably a supply to the solicitor) or out of the client account as a disbursement (in which case it is probably a supply to the client). If the professional client is in the United Kingdom but the lay client is overseas, this will affect whether or not VAT is due on Counsel's fees.

Where VAT is due on legal fees, a party to litigation which is in business and is VAT registered may well be entitled to recover that VAT as "input tax",

assuming that the litigation relates to a business matter. (The normal mechanism for recovery is that input tax recoverable is deducted from output tax due, and only the difference is payable to Customs for each VAT accounting period. In some periods a person's input tax may exceed the output tax, in which case a net payment will be due from Customs to the taxpayer.) A notable exception is where the party makes exempt supplies, in which case he is an exempt trader or a partially exempt trader, and input tax will be irrecoverable or partially irrecoverable depending on the extent to which it is attributable to the exempt supplies. Common examples of traders making exempt supplies include: insurance companies, banks, stockbrokers, bookmakers, schools and universities, hospitals, doctors, dentists, nurses, opticians and other providers of health services, some landlords, and persons providing sporting or cultural services of various kinds.

A typical outcome of litigation is that the successful party receives a contribution towards its costs from the other party. For VAT purposes, the payment of costs is a "mere reimbursement of expenses" (*B A Z Bausystem AG v. Finanzamt München für Körperschaften*, supra[4]). Thus the VAT position of the successful party is essentially unaffected by that receipt: the successful party will still have received legal services from its lawyers, and may have a right to recover the VAT input tax shown on its lawyers' invoices, subject to the usual conditions as indicated above, despite that fact that it has received a contribution towards that cost from the other party. Accordingly, if the successful party to

litigation is a person who is entitled to recover input tax on his business inputs on the principles set out above, then the award of costs should be calculated on a net of VAT basis. If the successful party is not entitled to recover input tax (in particular, in the case of a private individual), then the award of costs should be calculated to include VAT. If the successful party is entitled to partial recovery of input tax then it seems fair that the award of costs should be calculated to include part of the VAT, although I am not aware of any authority for this view. The unsuccessful party paying the costs will not have a right to recover input tax on those costs, despite making a payment of an amount which includes VAT. This is simply because the supply of legal services in question was not a supply made to the unsuccessful party. A person cannot recover input tax for supplies received by some other person.

Interest

A receipt of interest will be subject to income tax or corporation tax under Schedule D Case III. (That relates to income with a source in the United Kingdom; different provisions may apply for foreign source income. For the source of the income in the case of a payment of interest, see *National Bank of Greece SA v. Westminster Bank* [1971] AC 945.) If the payer of 'yearly interest' is a company (except in the case of payments to a UK resident company) or local authority, or if the payee is resident outside the United Kingdom, then the interest must be paid net of tax: tax must be deducted in accordance with s.349 ICTA 1988. (There

are certain exceptions, in particular in the case of interest paid by banks in various circumstances: see s.349(3) ICTA 1988.)

The interest assessed and included in a judgment award (i.e., pursuant to the Court's jurisdiction under s.35A Supreme Court Act 1981) may or may not be regarded as a payment of interest for tax purposes. Normally, and in particular in a case where a sum was due to be paid by the defendant to the claimant at some earlier date (whether contractually or otherwise), the interest element of the judgment will represent "interest" for tax purposes with consequences for the recipient under Schedule D Case III and also consequences for the payer if s.349 ICTA 1988 applies (*Westminster Bank Ltd v. Riches* (1947) 28 TC 159, HL). Occasionally the 'interest' included in an award of damages is simply a means of calculating the present day value of some earlier loss or damage, for example in the case of damage to a capital asset (*Glenboig Union Fireclay Co Ltd v. CIR* 12 TC 427). The distinctions can be subtle, while the consequences of overlooking the application of s.349 ICTA 1988 can be severe, since the payer of interest may find itself liable to account to the Inland Revenue for tax on the interest, while unable to recover an equivalent sum from the amount already paid to the payee.

Interest on a judgment debt (Judgments Act 1838, s.17) is interest for tax purposes (and thus subject to tax under Schedule D Case III). It is not, however, considered to be "yearly interest" for the purposes of

s.349 ICTA 1988: *Re: Cooper* [1911] 2 KB 550. Interest on an arbitration award, which is equivalent to interest on a judgment debt and payable under section 20 Arbitration Act 1950, is similarly treated as not subject to s.349 ICTA 1988 (although the Revenue have not published their views on this, they have been prepared to confirm this view in writing in some cases).

Capital gains tax position when the ownership of an asset is in question

The beneficial ownership of an asset may be in dispute in many types of action. Obvious examples include trust matters (in particular where there is a constructive trust claim or a tracing claim), fraud cases (*A-G for Hong Kong v. Reid* [1994] AC 327), claims to have an equitable interest in property, disputes over title to property, many types of company law claims (for example, securities might not have been validly issued), and voidable transactions (including insolvency cases). Actions of this kind often result in a declaration that an asset or a certain share of an asset belongs to one party or the other, or that a prior transfer of assets was void. By their very nature, proceedings of this kind often concern capital assets[5]. Such cases can produce very difficult CGT[6] questions, such as:-

(a) Has the successful party to the litigation had the same beneficial interest in the asset all along, or has the beneficial interest been acquired at some point?

(b) What is the acquisition cost of the asset, for the purposes of applying CGT to an eventual disposal by the successful party?

(c) Does the order of the Court (or the agreement whereby the proceedings are settled) result in a disposal of the asset (or a share in it) by the unsuccessful party and an acquisition of it by the successful party?

(d) Where there is a disposal, what is the consideration for that disposal, and does the market value rule apply? (s.17 of the Taxation of Chargeable Gains Act 1992 ("TCGA 1992"))

The answers to these questions will, of course, depend on the precise circumstances.

Void and voidable transactions

At one extreme, a transaction which the Court finds to have been void will clearly have had no CGT effects. In that case, the unsuccessful party will not be making a CGT disposal of an asset as a result of the order of the Court since (as the Court will have found) he never owned that asset anyway. It is less clear what the CGT treatment of a voidable transaction should be. Such a transaction does have legal effect unless and until avoided by the order of the Court on the application of an interested party. But the effect of the order of the Court avoiding the transaction is to deem the transaction to have been void *ab initio*, and in that case the same tax

consequences would follow as if the transaction had been void. Where the parties settle the litigation without an order of the Court avoiding the transaction, the position may be different: in that case, the original transaction would not seem to have been avoided and thus it may have tax effects, even though the parties to the litigation (presumably the Inland Revenue is not a party) may have reached a position between themselves which is as if the transaction had been avoided. Some voidable transactions may be subsequently ratified, in which case all parties will certainly be treated for CGT purposes as if the transactions had been valid from the start.

Mortgaged property and sale by mortgagee

Mortgaged property is considered to belong to the mortgagor for CGT purposes, irrespective of the form of the mortgage or charge (s.26 TCGA 1992). If the mortgagee enforces the security and sells the asset, that is considered to be a sale by the mortgagor for CGT purposes and so it may give rise to CGT for the mortgagor even though it is an involuntary transaction.

Bare trusts, constructive trusts, co-ownership, disputed ownership

Capital gains tax disregards bare trusts and other trusts where the beneficial owner is absolutely beneficially entitled: in such cases, the beneficial owner is considered to be the owner of the asset for CGT purposes (s.60(1) TCGA 1992). In the case of an asset held for persons as beneficial tenants in common, CGT

applies as if each beneficial owner were the absolute owner of an asset consisting of a corresponding share in the actual asset. This treatment will apply in any situation where one or more beneficial owners have the absolute right to direct the trustees how to deal with the asset (*Saunders v. Vautier*; s.60(2) TCGA 1992). Section 60(2) TCGA 1992 provides:

> It is hereby declared that references in this Act to any asset held by a person as trustee for another person absolutely entitled as against the trustee are references to a case where that other person has the exclusive right, subject only to satisfying any outstanding charge, lien or other right of the trustees to resort to the asset for payment of duty, taxes, costs or other outgoings, to direct how that asset shall be dealt with.

It seems likely that the word “trustee”, in section 60, includes any kind of trustee and thus that it includes a constructive trustee. In the case of a declaration by the Court that a person has been trustee or constructive trustee of an asset at all times since its acquisition by that person, then there is no CGT disposal of that asset as a side-effect of the litigation: the true owner of the asset is considered to have acquired the asset at the time, and for the same consideration, as the trustee originally acquired it.

In some cases the claimant’s interest in an asset may have been acquired at a later time than the asset was originally acquired, or gradually over a long period. This would include the gradual acquisition of a beneficial interest in a house by a co-habitee (*Lloyds Bank v*

Rossett [1991] 1 AC 107): that must be considered to be, for CGT purposes, a series of transfers of small shares in the asset from one co-habitee to the other. In some cases the consideration given would be consideration in kind, as opposed to financial, which can sometimes give rise to the difficult problem of how to value that consideration. But in many cases the market value rule will apply (s.17 TCGA 1992): a transfer between connected persons or otherwise not at arm's length is treated as taking place at market value. Transfers of an asset or a share of an asset between husband and wife are deemed always to take place on a no-gain, no-loss basis (s.58 TCGA 1992), that is to say the transferee's acquisition cost will be equal to a corresponding share of the transferor's acquisition cost.

The important point is that where the order of the Court is declaratory, that is to say it establishes what the true position has always been, then the CGT position of the parties will reflect the past history of ownership of the asset as it has been found to be by the Court. In other cases, the order of the Court may be more than declaratory: the Court may order a transfer of assets from one party to another which results in a position different from the *status quo ante*. That will amount to a CGT disposal by the transferring party. For example, where the ownership of two assets is in dispute, one asset may be transferred to one party and one asset to the other party. For CGT purposes, that would amount to a disposal by each party of a one-half share in the asset not retained, if the *status quo ante* was that each held a one-half share in each asset. The position would be similar

where a partnership is dissolved and the partnership assets are partitioned between the partners (s.59 TCGA 1992 and Revenue Statement of Practice D12 provide for each partner to be treated, for CGT purposes, as if he owned a share in each partnership asset corresponding to his share of capital surplus on a dissolution of the partnership).

In some situations it can be extremely difficult to determine the consideration for the CGT disposal and acquisition of the asset (or share in the asset). If the transferee is ordered to give up an interest in other property in exchange for the property acquired, then the value of that other property will dictate the consideration. If there is no clear exchange of property then it may be necessary to value the rights that the transferee had against the transferor prior to the litigation. It may be suggested that the market value rule (s.17 TCGA 1992) should apply, on the basis that it is not a transaction at arm’s length: on the other hand, it could be argued that any transaction resulting from the order of the Court in hostile litigation is by its very nature an arm’s length transaction.

Specific performance

One feature of the CGT system that can occasionally cause problems in practice is that the date of a disposal, for CGT purposes, is the date of exchange of contracts. (This assumes that the contract is unconditional. In the case of a conditional contract, the disposal date is the date when the condition is satisfied and the contract becomes unconditional (s.28(2) TCGA

1992) and similarly in the case of an option to dispose of and acquire an asset, the disposal date is the date when the option is exercised (s.144 TCGA 1992).) Thus, between contract and completion the purchaser of the asset is considered to be the owner of that asset for CGT purposes. If the purchaser needs to go to the Court to obtain specific performance, that will not affect the CGT treatment: even though completion may be considerably delayed after the time specified in the contract, the purchaser is considered to have acquired the asset at the time of the contract. If an action for specific performance is unsuccessful, however (for example because in the interim the vendor has sold the asset to a bona fide purchaser without notice) then clearly the CGT treatment will not be as if the asset has been acquired, since the asset in question has in fact not been acquired: s.28 TCGA 1992 applies only to determine the time of acquisition where an asset is indeed acquired. Instead, the purchaser is considered to have acquired an asset consisting of the right to obtain the property (see also *Marren v Ingles*), and to have disposed of that asset for consideration equal to any deposit forfeited and any damages awarded by the Court (s.144(7) TCGA 1992). Thus, a forfeited deposit is always[7] subject to CGT; the costs of entering into the contract and the irrecoverable costs of any legal proceedings may be brought into account as part of the acquisition cost.

Income tax treatment of transactions set aside and constructive trusts

Income tax (and the equivalent for companies,

corporation tax) will in general apply by reference to the state of affairs following the Court's decision in civil litigation. At its most basic level, this is because the tax applies by reference to a person's income or profits, and those may be adjusted as a result of the Court's decision. In *Spence v. IRC* (1941) 24 TC 311, the House of Lords had set aside a sale of shares induced by fraudulent misrepresentation, and ordered the defendant to account to the plaintiff for the dividends he had received between the sale and the decision of the House of Lords. The Revenue repaid to the defendant the tax on those dividends. The Revenue sought to recover tax on the dividends from the plaintiff. The Court of Session (Inner House) dismissed the plaintiff's appeal against the tax assessment, saying: "From the date the contract was reduced [i.e., set aside], Mr Spence fell to be treated as having been throughout the proprietor of the shares and equally the person properly entitled to receive the dividends." *Spence* is to be distinguished from *Morley-Clarke v. Jones* [1986] Ch 311, where the Court varied an earlier order for maintenance payable to a wife so that the maintenance was payable directly to the child, with retrospective effect. In the latter case, Oliver LJ said -

> A retrospective order cannot, any more than a retrospective agreement, undo the past and convert something that has already happened, and to which legal consequences have already attached, into something else which never in fact did happen. … In Spence the restitutio in integrum represented by the court order obtained some years later did not so much reconstruct history as recognise and declare that which had all along been the legal position, although

> until the order the parties were in a state of some uncertainty as to what their rights were.

In a case where the Court finds that certain assets were received subject to a constructive trust in favour of some other party, the assets would not normally be regarded as "received" for tax purposes — and in the case of a payment of money, that would not normally be regarded for tax purposes as a payment to the constructive trustee. See, for example, *Hillsdown Holdings plc v. IRC* [1999] STC 561 where a pension fund, believing it was in surplus, paid the surplus to the employer. It later turned out that there was no surplus and therefore that the payment to the employer was in breach of the terms of the pension fund trust deed; accordingly, the employer held the payment on constructive trust for the fund. Arden J held that in those circumstances there was no payment out of the fund to the employer, for the purposes of s.601 Income and Corporation Taxes Act 1988 ("ICTA 1988") which imposes a charge to tax on such payments. Contrast *Venables v. Hornby* [2002] STC 1248, CA; [2002] EWCA Civ 1277[8], where a payment made to a member of the pension scheme in breach of trust was regarded as a payment for the purposes of s.600 ICTA 1988 which imposes a charge to tax on unauthorised payments to scheme members — even though there the scheme member to whom the payment was made was in fact an express trustee of the scheme.

Does it make a difference to the tax or VAT treatment if a claim is settled?

As has been seen above, the capital gains tax, income tax and VAT treatment, in general, reflects the transactions which have occurred, the income which has been received, and the supplies which have been made, in the case of all three taxes having regard to the proper legal analysis of what has taken place. In a normal case, although the existence of the claim may make it uncertain for a while what has in fact taken place, that uncertainty will be resolved by the decision of the Court, and the tax consequences will follow. Where a claim is settled, the uncertainty as to the correct legal analysis of the transactions which have taken place may remain unresolved. This will be the case in particular where a settlement is reached without any admission of liability. In that case, although the parties might not be agreed about the correct analysis of what has happened, each party must still assess its own tax treatment by reference to what is believed to have happened. A party's tax advisers may be called upon effectively to decide the issues raised in the litigation, merely so that the party's self-assessment tax return may be completed correctly. Counsel's Opinion as to the correct analysis of the situation in dispute may be very important here. In most cases (if the tax return is examined at all) it is likely that the Revenue will accept the evaluation of specialist Counsel involved in the litigation, rather than seeking, for example, to have the issues decided by the Special Commissioners or the VAT Tribunal. If each party submits a different tax treatment, however, then it is

possible that the Revenue will protect its position by assessing both parties to tax and leaving each party to resolve the position on appeal against that assessment: in that situation the appeals would normally be heard consecutively by the same Special Commissioners.

As for VAT, in *Reich v C&E Comrs* (1992) VAT Tribunal Decision no 9548, unreported, the taxpayer (who provided business introductions) had previously had a dispute with a customer as to whether any service had been supplied. The dispute had been settled on the basis that part of the fee claimed would be paid (presumably without any admission of liability). Customs assessed the taxpayer to VAT on the settlement sum, and the taxpayer appealed. The Tribunal held that VAT was not chargeable unless it was clearly established that the underlying supply had been made. The litigation had in fact been settled on the basis that a substantial sum, but not the whole sum claimed, was paid. As the Tribunal chairman said,

> This can only be because the parties placed on the claim an agreed estimate of its true worth as a claim, not because they recognised that consideration was being paid for a supply that had been made.

Sometimes when a claim is settled, specific provision may be made for one party's costs. That should be taken into account as a receipt in relation to the income tax or CGT treatment of the receiving party. But for VAT purposes it cannot be regarded as the consideration for any supply. As the Tribunal said in *Reich* -

> To take an obvious point, the sum paid in settlement was paid 'inclusive of costs'. The element attributable in the negotiation to costs, whatever it might be, has to be disregarded in arriving at the net sum receivable by the claimant.

The parties would be well advised to anticipate some of the tax difficulties through including appropriate provisions in the settlement agreement or draft order. If possible, any facts which have become uncontentious should be recited, in particular it will assist to determine the tax treatment if the parties state whether or not they consider that the original transaction properly took place, and whether or not goods or a service were supplied. In areas of doubt, it would be wise to include in the settlement agreement or draft order a provision as to which party is to bear the cost of the tax if tax in fact proves to be due: this might take the form of an indemnity. This is likely to be uncontentious where the position is such that if one party is liable to tax on a receipt of compensation then the other will be entitled to a tax deduction (see below).

Where litigation is settled by agreement, any payment of interest between the parties, whether provided for under the terms of the settlement agreement or otherwise, will not be interest on a judgment debt, and therefore it may well be 'yearly interest' subject to s.349 ICTA 1988. If the payer of the interest forgets this point, it may find itself liable to account for tax on the interest paid while unable to recover that tax from the payee. The position will be different in the case of litigation settled by way of a *Tomlin* order or other agreed order of the

Court, where any sum payable by one party to another will be a judgment debt and thus not subject to s.349 ICTA 1988.

The position of the payer of damages or compensation

A company or other business ordered to pay damages, or which settles litigation on the basis that compensation will be paid, will be concerned to know whether that sum will be tax deductible (in the case of a private individual, of course, it cannot be). That is, will the damages be deductible in computing the profits of the trade or profession under Schedule D Case I or Schedule D Case II (or in the case of a property business, the Schedule A profits)? The legal tests are first, whether the expense of a capital nature or an income nature, and second, whether it is

> "money wholly and exclusively laid out or expended for the purposes of the trade, profession or vocation" (s.74 Income and Corporation Taxes Act 1988, "ICTA 1988").

In applying these tests, regard must be had to the subject matter of the litigation, from the point of view of the payer of damages. That may not be obvious.

There is perhaps even a test before these two, that is, are the damages properly an expense of the business at all? For example, a partnership may be sued by an expelled partner, and ordered to pay damages: are those damages against the partners for breach of the partnership agreement, or are the damages an expense of

the partnership business? It depends on the nature of the claim. Damages and penalties which properly arise out of the conduct of the *proprietor* of the business or which relate to the proprietor's title to the business as a whole would not be a deductible expense of the business. This would encompass many partnership actions, and most actions between shareholders. In *IRC v. Alexander von Glehn & Co Ltd* [1920] 2 B 553, CA, a penalty was imposed on a company for exporting goods under the Customs (War Powers) Act 1915; the penalty was not for the purposes of the trade but because of a wrongful act on the part of the company. The same would apply to other similar types of penalty, for example fines under the Companies Acts, or fines imposed by professional bodies such as the Institute of Chartered Accountants. In contrast, if the action relates to the business' title to its assets, then damages incurred would be business expenses and deductible. In *Morgan v. Tate & Lyle Ltd* (1954) 35 TC 367, HL the company feared nationalisation of the sugar industry, that is to say compulsory acquisition of all or most of the assets of the business. The expenses incurred by the company in conducting a publicity campaign to prevent nationalisation were incurred to defend the company's title to its assets, and were held to be deductible. The distinctions in this area can be very fine. See, for example, *Hammond v. IRC* [1975] STC 334. A company indemnified its directors and certain shareholders against the costs of an action brought by a substantial shareholder claiming that certain shares of the company were not validly issued. Templeman J held that it was open to the Special Commissioners (who heard the tax

appeal at first instance) to decide, as a question of fact, either that the indemnities were granted and paid exclusively for the purposes of the trade, or that they were for other purposes such as securing the positions of the shareholders and directors personally. (It is possible that this case would have been decided differently today, in the light of the special position in relation to costs established in *Sheppard v. McKnight*, discussed below, but the general principle as to what constitutes an expense of the trade and what constitutes an expense of the proprietors remains valid.)

Of course, there are some types of civil claim where the damages (and costs) will almost always be deductible. That will be the case for most types of tortious claim, where the tort was committed in the conduct of the business. So, for example, in *Herald and Weekly Times Ltd v. Federal Commissioner* (1932) 48 CLR 113, the High Court of Australia decided that damages for defamation were deductible expenses of a newspaper business. An employer's liability for injury to employees would be deductible (and any corresponding insurance payment would be brought into account as a receipt, of course). Damages for professional negligence would be deductible. I would suggest a general principle that all these types of claims could be regarded as *normal risks* of the relevant trades or professions; the position might be different in the case of exceptional types of torts which are outside the normal scope of the business (similar to the approach in *Midland Bank v. Hett, Stubbs & Kemp* [1979] Ch 384 in the case of partners' liability for tort committed by another partner).

In intellectual property matters (breach of copyright, trademark or passing-off claims), damages payable by a defendant would normally be tax deductible, on the basis that they represent a cost relating to the previous (unlawful) exploitation of the intellectual property — that is to say, the exploitation would presumably itself have been a profitable endeavour (were it not for the subsequent intellectual property claim). From a tax point of view, the fact that a cost of this kind arises after the profits have been realised does not prevent it from being deductible, so long as it is a necessary incident of the earlier profitable activity.

Where there is litigation, it will presumably be uncertain whether or not damages will be paid: thus the damages are a contingent liability of some earlier business activity. A contingent expense of this kind may not be deductible for tax purposes until its amount is determined with some degree of reliability (*James Spencer & Co v. IRC* (1950) 32 TC 111, Ct of Sess; *Southern Railway of Peru Ltd v. Owen* [1957] AC 334, HL). The modern approach is to ascertain, "Would the contingent liability be recognised as an expense of the current year as a matter of commercial accountancy practice?" (*Herbert Smith (a firm) v. Honour* [1999] STC 173). Clearly very difficult issues can arise in this regard, and Counsel's Opinion as to the likelihood of recovery in the litigation, and the likely amount of damages, may well affect the tax treatment.

Capital or income expense?

As indicated above, only expenses of an income

nature are deductible when computing the profits of a trade or profession for tax purposes, although expenses of a capital nature may produce other tax benefits, for example they may increase the capital gains tax ("CGT") base cost. An expense will be of a capital nature if it secures an enduring benefit for the business. There is a distinction between expenses incurred to maintain the existing capital assets of a business without enhancing their value (income) and expenses incurred to improve an asset or to enhance the value of an asset (capital). If title to a capital asset is disputed, the expense of defending or improving title to the asset is a capital expense, since it tends to enhance the value of that asset. In contrast, if there is a general threat to the business whereby it may lose title to all its assets, then the cost of resisting that threat will be an income expense: that might include a winding up petition or other insolvency proceedings.

The expense of a business extricating itself from a contract, or damages resulting from breach of contract, are generally costs of an income nature, even though in one sense they could be set to result in benefits of an enduring nature: the distinction may be that in most of these cases no asset is acquired, but rather a liability is removed. For example, payments of damages to employees unlawfully dismissed are income expenses (and normally deductible). Exceptionally, where a contract stipulates for a capital sum to be paid, and there is a breach of that contract so that damages are paid instead, then those damages could be a capital expense: it may depend on whether or not a capital asset is in fact

acquired, so that if nothing is acquired then it may be an income expense.

In relation to capital expenses relating to a particular capital asset, these will be allowable when computing the gain on the eventual disposal of that asset. Section 37(1)(b) of the Taxation of Chargeable Gains Act 1992 ("TCGA 1992") provides for the deduction of -

> any expenditure wholly and exclusively incurred on the asset by him or on his behalf for the purpose of enhancing the value of the asset, being expenditure reflected in the state or nature of the asset at the time of the disposal, and any expenditure wholly and exclusively incurred by him in establishing, preserving or defending his title to, or to a right over, the asset.

That would include the costs of litigation, where for example title to an asset is disputed and the outcome of the litigation is favourable (even if the outcome is unfavourable, the costs of defending title would be an allowable expense for CGT purposes assuming that at least some interest in the asset is retained after the litigation). See also above for the situations in which the loss of title to an asset as a result of litigation amounts to a CGT disposal of that asset (in which case the costs of defending title would be an allowable expense in relation to that disposal).

Deductibility of costs incurred by successful and unsuccessful parties

There are cases in which costs are deductible even

though the underlying penalty or damages would not be. This was the issue considered in *McKnight v. Sheppard* [1999] STC 669, HL. Mr Sheppard was in business as a stockbroker; he had suffered disciplinary proceedings and been ordered to pay fines and suspended for 6 months. He incurred considerable legal costs in conducting an appeal which was partially successful: the order for suspension was set aside, although fines were still imposed. He claimed a tax deduction for the fines and the legal costs. The fines were not tax deductible, because they were in the nature of a penalty imposed upon Mr Sheppard personally (that is, they were an expense of the proprietor of the business: see above). Mr Sheppard's costs of conducting the appeal against the suspension were held to be deductible. In particular, Lord Hoffman was impressed by the point that if the allegations prove groundless then the costs should always be deductible business expenses because there has been *no* misconduct by the proprietor of the business. Lord Hoffman could see no policy reason for the costs of a successful defence and the costs of an unsuccessful defence to be treated differently for tax purposes. Accordingly, a successful party to litigation concerning a business matter would normally be able to deduct any irrecoverable costs as an expense of its trade or profession (the position would be different if the litigation relates to the acquisition of a capital asset, in which case the costs would be part of the acquisition cost of that asset for CGT purposes, in accordance with s.37(1)(b) TCGA 1992). An unsuccessful party to litigation would be entitled to deduct costs of litigation and the contribution to the other side's costs, so long as

the costs would have been deductible had the litigation been successful.

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[1] From a paper contributed by the author to a seminar of the Chancery Bar Association chaired by Park J, on 24th February 2003.
[2] EC Sixth Council Directive on the common system of valued added tax, Directive 77/388/EEC.
[3] *Polysar Investments v Inspecteur* (Case C-60/90) [1993] STC 222, ECJ.
[4] In that case the German revenue authorities did not even suggest that VAT was due on the costs award.
[5] It should be borne in mind that all forms of property, including, for example, the rights of a party under any contract (*Marren v Ingles* [1980] STC 500, HL), constitute assets for capital gains tax ("CGT") purposes. CGT applies to all disposals of assets, except in a case where the proceeds of disposal are subject to tax as income.
[6] "CGT" here will also refer to corporation tax on chargeable gains.
[7] Unless it is subject to income tax treatment: that would be the case for a business trading in property.
[8] Note that this decision is currently under appeal to the House of Lords.

TAXATION OF DAMAGES, COSTS AND INTEREST (2) [1]

Harvey McGregor[2]

Tax and Damages

It all began with *Gourley,* a case we all know, decided in late 1955. Before then little or no attention had been paid to whether damages should be reduced on account of taxation, though well before that time the Revenue had interested itself with the question of whether damages themselves were taxable. For *Gourley* to apply it was said two conditions must be satisfied, two factors must be present. At their simplest these two can be stated as -

(1) the loss compensated by the damages would have been subject to tax

(2) the damages would not be subject to tax,

and I shall refer to them simply as factor (1) and factor (2).

(I should say here, in parenthesis, that I am dealing, as was *Gourley,* with tax on income, whether income tax or corporation tax, with which nearly all the cases deal. Capital gains tax, and the difficult *Zim* case, is dealt with by John Walters.) This then is what I shall call pure *Gourley*; the loss compensated would have been taxed, the compensation will not be. However, a modified form of *Gourley* has made its appearance, particularly

noticeable in the course of the last 10 years, which is of great importance, particularly in the fields which are of concern to practitioners at the Chancery Bar. This is where factor (2), as stated, is inapplicable because the damages will be taxed, but they will be taxed at a lesser rate than the loss compensated would have been taxed. Should *Gourley* still apply, albeit in modified form? I shall deal with modified *Gourley* in due course but for the moment mainstream *Gourley* is my concern. This after all is where the vast majority of cases lies.

Gourley was of course dealing with personal injury and the Chancery Bar does not concern itself with such cases. Indeed the Chancery Bar does not concern itself with most of the types of case where pure *Gourley* has been applied over the years. Thus apart from being applied in relation to loss of earnings of one who has been physically injured, the rule already existed in relation to loss of dependency in Fatal Accident Act claims (*Zinovieff*, 1954), has been proposed, at House of Lords level, for claims for profits lost through injured reputations in defamation cases (*Lewis v. Daily Telegraph* [1964] AC 234) and had a number of contract applications in claims for wrongful dismissal (*Beach*, 1956, *Phipps*, 1958, *Shindler*, 1960) before special rules were brought in by statute to tax the damages. About the only cases which might have trespassed on to Chancery soil have concerned not damages but statutory compensation - which also follows the *Gourley* rule - and *Gourley* was applied in two cases because the Revenue happily said that the compensation would not be taxable (*West Suffolk County Council v. Rought*

[1957] AC 403; *McGhie v. British Transport Commission* [1963] 1 QB 125; and in one because the Court just got it wrong, mistakenly assuming that the Revenue would not seek to tax the compensation *Pennine Raceway v. Kirklees Metropolitan Council (No.2)* [1989] STC 122).

The reason that, outside these fields, applications of pure *Gourley* do not tend to occur is that so often where the loss compensated would have been taxable the damages likewise will be taxable, and where the damages will not be taxable the loss compensated would not have been taxable: the two run in parallel. In the first case factor (2) is inapplicable, and the fact that factor (1) is present makes no difference; in the second case factor (1) is inapplicable, and the fact that factor (2) is present makes no difference. Let us look at these two situations separately.

The inapplicability of factor (1) can be dealt with briefly. That it is inapplicable is obvious in relation to many items of damages. This is true of all non-pecuniary losses, and it is true of all negative losses by way of expense. Only where there is a positive loss by way of a loss of assets or a loss of profits does the question of applicability or inapplicability arise, and the answer in short will be that factor (1) is inapplicable where the loss is of a capital item – it will be recalled that I am dealing only with tax on income and not on capital gains, and factor (1) will only be applicable where the loss is of income from trading, investment or employment. Thus in *Hall v. Pearlberg* [1956] 1 WLR 244, where the

defendant had taken unlawful possession of the claimant's farm, which depreciated through the defendant's bad husbandry, the damages representing diminished value were awarded in full.

The inapplicability of factor (2) is a more difficult matter. One reason for this is what is called the "source doctrine" – the rule that to constitute taxable income or profit the sum in question must be traceable to a source. Types of income are classified by reference to the source from which they come, and from this it has been held, in a variety of cases, that if the taxpayer has ceased to possess a source of income he could not be taxed upon delayed receipts from that source. This is why damages paid to a wrongfully dismissed employee were held not taxable – before statute intervened – because the source, which was the employment, had *ex hypothesi* gone before the damages were awarded. Some cases are reasonably straightforward, and I can cite a whole raft of authorities holding damages to be taxable, and therefore factor (2) inapplicable. For example, where in *Diamond v. Campbell Jones* [1961] Ch 22 a dealer in real estate bought a house from a seller who repudiated, damages for the lost profit were awarded without tax deduction as they would be liable to tax as part of the profits of the dealer's business. But there are cases which are more difficult. *Deeny v. Gooda Walker* is one – an episode in the extensive litigation initiated by Lloyd's Names against their managing and underwriting agents for subjecting their syndicates to excessive exposure to risk by failure to arrange reinsurance cover to protect them against losses. In this episode, the matter went as far as

the Lords on the question of whether the damages were subject to tax: [1996] 1 WLR 426, HL as John Walters explains. All I would add here, by way of postscript to this issue, is that very occasionally, as in a very recent case, pure *Gourley* falls to be applied where the damages were not to be taxable, not on any ground of principle, but simply because the defendant had become insolvent (*Finley v. Connell Associates* [2002] Lloyd's Rep PN 62).

A most interesting aspect of this whole subject, as the law has developed, has been to deal with the situation where the loss for which you are getting damages would have been taxable and the damages are also taxable but at a different, generally lower, level. Strictly speaking, factor (1) applies but factor (2) does not, and that should be an end of it. This was the approach originally taken. The first case was *Praet v. Poland* [1962]1 Lloyds Rep 566, and it was unusual in two respects which in combination may have influenced the decision: the tax in question was foreign and the tax rates involved were very small. The loss in question was of insurance premiums which, if received, would have been subject to tax at a two per cent rate in Belgium. When however it appeared that the damages themselves would be subject to tax in Belgium, albeit at an amount well below the two per cent figure, that was held to be an end of the matter. "Once it is agreed . . . . that the damages awarded will be subject to tax, the court enquires no further", said Mocatta J. *Gourley* did not apply. This decision was soon after approved by the Court of Appeal in *Parsons v. B.N.M. Laboratories* [1964] 1 QB 95, a decision which

has had much influence, and where the members of the Court of Appeal laid down in no uncertain terms that if the damages would be taxed, at whatever level, *Gourley* had no application. That this was the decision to cement the rule of no *Gourley* where there was to be some degree of tax on the damages, is somewhat ironic, as *Gourley* was in fact applied in that case. It involved wrongful dismissal and golden handshakes, and the Court held that, the first £5,000 of any payment being exempt from tax, *Gourley* must apply to a payment of only £1,200.

The courts soon moved away, in wrongful dismissal cases, from the *Parsons* view that *Gourley* could not apply where the damages were partly taxable. They did so the moment a case appeared where the damages awarded exceeded the £5,000 threshold. Otherwise there would have been a terrible disparity between cases where the award was just under and cases where it was just over £5,000. The cases which followed (*Stewart*, 1963, *Bold*,1964, *Shove*, 1984) concerned themselves only with the method of working out the statutory tax on the damages, a task made horrendous by the infinitely complex formula imposed by the legislation, a formula which mercifully disappeared in 1988. But the developments were not thought necessarily to place in doubt the validity of the general rule applied in *Praet* and approved in *Parsons* – the wrongful dismissal cases could be regarded as exceptional because of the dividing line between damages below and damages above the exempt threshold – and what was said in both cases, especially *Parsons*, and in the

following wrongful dismissal cases continued to be extensively cited in the cases to which I shall now turn.

It would of course simplify the position if the courts could adopt the rough and ready assumption that the effects of taxation cancel out, but the facts of a particular case may make such an assumption entirely unjustified. The most obvious cause of tax on damages being lower than tax on loss is falling tax rates between the time of the loss and the time of the award. This was the position in *Amstrad plc v. Seagate Technology Incorporated*, 1998, a forwarding-looking decision, which, despite its importance, is ill-reported: all I know is 86 Building Law Reports 34 and [1998] Masons CLR Reports 1. Damages had been awarded for the loss of profits which would have been made from the sale in 1989 and 1990 of some 50,000 computers. The tax on the damages when received would be at a rate of 33 per cent. but the tax on the profits had they been received at the proper times would have been at rates of 34 and 35 percent. Judge Humphrey Lloyd held that the damages, as he put it, "should be adjusted to take into account the incidence of taxation". In other words *Gourley* was applied to the difference between the tax rates which, although small as a matter of rates, was large as a matter of amount, making a difference of about £1 million to the claimants. Here was a sensible shift away from the *Praet* and *Parsons* approach; indeed the five reasons which Pearson L J had propounded in *Parsons* for the rule there approved are all neatly and fully answered in the extensive judgment. Logic and justice had triumphed over expediency and pragmatism.

But things went differently in *Deeny v. Gooda Walker*. While the principal question there was whether the damages were taxable, there was a second question, but at first instance only ([1995] STC 439), which was whether, if it were decided that the damages were taxable, there should still be taken into account the fact that the damages would be taxed at a lower rate than would have been the losses for which compensation was given. The reason for this was that many of the Names would have been able to set off losses on other income against tax at a higher rate than the rate applicable to the award at the date of recovery. Potter J was not prepared to depart from what he called the traditional approach of simply regarding the effects of taxation as cancelling out because of the complexity of examining the different tax positions of over 3,000 individuals, particularly when the whole approach to the case had been on a group syndicate basis. The case may therefore be considered somewhat special, but there is no doubt that here expediency and pragmatism won out over logic and justice. Moreover, if the *Amstrad* line is adopted, it should follow that, if the rates of tax have been increasing rather than reducing over the relevant years, so that the tax on the damages would be greater than that on the lost profits, the damages should be adjusted upwards. This would be *Gourle*y, in truth modified *Gourley*, in reverse. It is true that in the *Tate & Lyle* case, dealt with below, Forbes J refused to adjust the damages upwards on account of the rate of corporation tax having risen between cause of action and judgment, but it was early days when *Tate & Lyle* was decided, and

in any event Forbes J was, as we shall see, being innovative enough.

Something needs to be said on the burden of proof. Does the claimant have to prove that factor (1) is not present or the defendant prove that it is? Similarly, does the claimant have to prove that factor (2) is not present or the defendant prove that it is? There was for long little clarity on this, but eventually the Court of Appeal in *Stoke-on-Trent City Council v. Wood Mitchell* [1980] 1 WLR 254 held that it was the defendant's onus to show that factor (2) is satisfied, so that his failure to do so ousts the *Gourley* rule. It must be "clear beyond a peradventure" that the damages are not to be taxable in the claimant's hands; otherwise the dangers of double taxation are too great. Indeed it is of some concern that the courts do not always get the position right. Thus in *Pennine* (above) the compensation was held to be payable net of tax on the basis that it would not be taxable in the claimant company's hands, and, after the time of appealing this decision had run out, the Revenue turned round and demanded tax. Fortunately, faced with this double taxation the claimant company was able to obtain an extension of time for requiring a case to be stated and the decision was changed. But none of this would have happened if the onus had firmly been on the defendant to show that factor (2) applied. These considerations suggest that it may be wise in some cases to try to join the Revenue. It was said by the Court of Appeal in *Deeny* that they had been told that it was the first time that the Revenue had been joined by consent to argue the tax issue before the trial judge (Potter J) in

relation to a dispute over damages, not being a tax appeal ([1996] LRLR 109, CA, at 111, col.1). As for factor (1) there is likely to be far less difficulty with proof, but I would think that the onus should be also on the defendant here. There seems little point in splitting the onus between the two factors, and in any event it might be said that there should be no issue of taxation until a defendant raises it.

A few points should be made on the calculation of the tax. (1) The first is that the Lords made it plain in *Gourley* itself that mathematical exactness and accuracy are not necessary. "An estimate", said Earl Jowitt there, "will be none the worse if its formed on broad lines." This has continued to be the accepted position. (2) The assessment of tax liability falls to be based upon present rates of tax and present rates of reliefs and allowances, of course taking into account any changes that have occurred between cause of action and judgment. In *Daniel v. Jones* [1961] 1 WLR 1103, a fatal case, the Court of Appeal properly took into account the substantial tax reliefs on earned income proposed in the Budget of the day though there was no certainty at the time of judgment that the proposals would become law. In *Amstrad* Judge Humphrey Lloyd went further and, in the context of ascertaining the tax not on the lost profits or earnings but on the damages, ordered that no judgment should be entered until after it was known whether the imminent Budget statement brought in a change in the rate of corporation tax. In *Beach v. Reed Corrugated Cases* [1956] 1 WLR 807 the Court accepted evidence that the claimant intended to take steps in the

near future to minimise his tax exposure. (3) Though there have been varying decisions, it is clearly correct that the sum to which the *Gourley* rule is to be applied is to be regarded as the top slice of an individual claimant's income.

Finally, let me say something about the impact of tax not on the damages themselves but on the interest awarded upon the damages, a development stemming from the innovative and important decision in *Tate & Lyle Food and Distribution v. Greater London Council* [1982] 1 WLR 149 at first instance. Dredging costs necessitated by the defendant's nuisance were deducted by the claimants for a number of years in arriving at their trading profits for corporation tax purposes; subsequently these costs were recovered as damages and interest was claimed in the usual way. Forbes J held that the claimants must bring into the interest computation the amount of corporation tax that they had saved over the years until tax became payable on the costs when received as damages. Now *Tate & Lyle* has been applied by Philips J in a further episode of the *Deeny v Gooda Walker* saga. Just as Potter J was asked to reduce the damages because the tax on the damages would be less than the tax on the losses compensated ([1995] STC 439), Philips J was asked similarly to refuse to reduce the interest he would award by ignoring the tax element ([1996] LRLR 168). What applied to tax, it was argued, should apply equally to interest. This argument was happily not accepted by Philips J, despite having been cogently advanced by our most learned Chairman of this evening. He distinguished between loss of use of money

and loss of cash flow. The fact that you shared the damages money with the Revenue and would have similarly shared the money had you received it in the normal way was one thing, but the suggestion that you should be entitled to interest on the part that you would have shared with the Revenue was another. Moreover, there is a Court of Appeal decision in *O'Sullivan v. Management Agency and Music* [1985] QB 428 which is supportive of Philips J's approach (though he did not think so). And further Philips J was unprepared to accept the pragmatic argument that exceedingly complex calculations would be required to ascertain the effect that taxation would have on the cashflow of, again, over 3,000 claimants. If the Court proceeded on the artificial basis that the claimants had been deprived of the whole of their damages, this would provide them with a large unjustified windfall at the defendants' expense. Detailed investigations of the claimants' tax positions could nonetheless be avoided, and in the result interest on only 75 per cent of the damages to which the group claimants had been held entitled was awarded. This is interestingly to be contrasted with Potter J's decision on the main tax issue. How far defendants have taken advantage of Philips J's wise decision over the last eight years it would be interesting to know.

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[1] From a paper contributed by the author to a seminar of the Chancery Bar Association, chaired by Park J, on 24th February 2003.
[2] Harvey McGregor QC is a former member of Gray's Inn Tax Chambers, now practising at 4 Paper Buildings. He has kindly agreed to be a guest contributor to this issue of the *Review*. Ed.

TAX AND THE PROCEEDS OF CRIME

Nicola Shaw

The phenomenon of money laundering has arisen because of the combination of two factors: offshore tax havens and electronic banking transactions. In respect of the first of these factors, the problem is magnified by the fact that such a large proportion of the world's money is held in offshore centres. Whilst initially the offshore centres acted as means of reducing tax liabilities, they are now also regarded, to an extent, as black holes hiding criminals from investigation by offering relaxed nominee company rules, banking confidentiality and less regulation (although, it has to be said, the offshore centres themselves object strongly to this view of their activities). In respect of the second of these factors, the ever-advancing possibilities of modern technology means that cash paid into a bank account can be easily transferred around the world with very few questions asked and in such a way as to destroy any audit trail. Responses to the problem of money laundering have come in a variety of forms – the Vienna Convention, the Council of Europe Convention and national legislation.

The UK government's most recent response is in the form of the Proceeds of Crime Act 2002 ("PCA"). The PCA provides the courts with a new set of powers to inquire into and restrain a person's assets and income where it is suspected that they are the "proceeds of crime". The legislation is drafted extremely widely indeed. In addition to creating offences, its main objective is to facilitate the recovery of both laundered

and unlaundered illegally obtained property. It effectively provides a mechanism for the State to obtain restitution from criminals on a broad basis.

A central distinction of the legislation is the divide between confiscation and money laundering investigations (which fall exclusively within the jurisdiction of the Crown Court) and the new civil recovery investigations (where jurisdiction is reserved to the High Court).

In a tax setting, the PCA gives rise to two implications. First, tax crimes will act as a trigger to liability. Secondly, the wide ranging armoury of remedies includes "revenue powers". I deal with each of these implications in my analysis of the criminal and civil regimes under the PCA. But before I do, it is worth mentioning that the PCA also establishes an administrative body (the Assets Recovery Agency) to conduct confiscation and civil recovery investigations. It effectively establishes a body of financial private investigators. At the head of this agency is the Director, who is responsible for fulfilling the functions of the legislation.

Criminal regime

There are two types of offences which will trigger liability under the criminal regime within the PCA. The first type of offence is obtaining a benefit from criminal conduct. The second type of offence is money laundering.

Obtaining a benefit by Criminal Conduct:

Where an individual has been convicted of an offence in the Crown Court from which he has received a benefit from his criminal conduct, the Director may request that the Crown Court makes a confiscation order equal to the amount of the benefit. The standard of proof in establishing the obtaining of such a benefit is the civil standard (the balance of probabilities)[1]. The individual will then be required by the confiscation order to pay the amount of the benefit to the Director. A person benefits from criminal conduct where he obtains property or a pecuniary advantage[2] as a result of or in connection with the criminal conduct. In a tax context, where an individual has been found guilty of carrying out a fraud on the Inland Revenue which causes an evasion of tax, the amount of the unpaid tax will be treated as a pecuniary advantage[3].

This, of course, then invites the question: "what is the actual value of such a pecuniary advantage?". On the basis that the tax which has been evaded will be a debt owed by the individual to the Revenue, is the value of the pecuniary advantage to be assessed by reference to the value of the unpaid tax debt or the amount of the tax evaded[4]? One might argue that as a matter of logic it ought to be the value of the unpaid debt. However, in my view, the authority of *R v. Dimsey and Allen*[5] and indeed the legislation itself, indicates that the value of the pecuniary advantage will be the amount of the tax evaded. It is also worth noting that under this heading, offences of attempting, conspiring or inciting, aiding and

abetting, counselling or procuring an offence will result in the same consequences under the PCA as apply to the substantive offence. Thus, an adviser who is guilty of, say, procuring the evasion of tax by a client will be liable under the PCA and any benefits received in the course of that procurement (e.g. fees) will be subject to the powers of the Act.

Money Laundering

Central to the money laundering offences created by the PCA[6] is the concept of "criminal property". The term "criminal property" carries with it the mental element of the offences. However, the question of who carried out the underlying criminal offence or who primarily benefited from it are irrelevant to the determination of whether or not property is "criminal property"[7]. These provisions essentially make it an offence to conceal, disguise, convert, transfer or remove criminal property from England and Wales. Furthermore, the use or possession of criminal property is also an offence. In the context of tax evasion, this is unlikely to materialise in practice, for the simple reason that it is extremely difficult to launder a tax liability. If the "criminal property" in such a case is the amount of tax evaded, unless there is a clear allocation of funds to meet that liability which have not in fact been so used, it is extremely difficult to see how it might be established that any particular fund of money constitutes the tax liability.

The maximum term for money laundering offences is 14 years.

Civil Regime

The advantage of proceeding under the civil regime is that no criminal conviction is required in the first instance in order to trigger the liability. The standard of proof with regard to all matters is thus always the balance of probabilities. Under the civil regime, the Director may bring an action for an order to recover property obtained through unlawful conduct[8]. "Unlawful conduct" is defined by reference to criminal law[9]. Whilst determining the criminal law of England and Wales will be relatively straightforward, determining the criminal law of a foreign jurisdiction will be more difficult – it is a question of fact for the court[10] to be determined by evidence from experts within that foreign jurisdiction.

These powers are exerciseable whether or not criminal proceedings are brought in respect of the criminal activity and regardless of the outcome of any such criminal proceedings as might be brought[11]. However, if a confiscation order has already been made under the criminal regime in respect of the property, the Director cannot achieve double recovery

Property recoverable under this regime includes all forms of property (such as things in action and other intangible property). As far as tax evasion is concerned, it is submitted that the unpaid tax will again amount to "property" for these purposes, with the value of the property being determined by reference to the amount of tax evaded. It is briefly worth noting that the civil regime provides a legislative mechanism whereby the Director can trace property into the hands of another person or

into new property as if he had a proprietary interest in the property[12]. All the Director must show is that the property was obtained by the unlawful conduct of one person. The recipient may be entirely ignorant of such conduct and yet the property may still be traced into his hands. It should also be noted that the usual shortcomings of tracing property under the common law (namely, the inability to trace into a mixed fund) and in equity (namely, the requirement for the wrongdoer to be in breach of a fiduciary duty) are sidestepped by the PCA. These statutory rules enable property to be traced into a mixed fund and a proportion of that fund recovered[13]. The statutory rules do, however, still preserve a defence against the tracing of property for equity's darling, the bona fide purchaser[14]. However, as noted above with regard to the money laundering offences, it will only be in exceptional cases that this remedy is relevant in a case of tax evasion, as ordinarily it will not be possible to show the movement of a tax liability.

Revenue Powers

The general purpose of the PCA is to provide as many powers for the recovery of the proceeds of criminal conduct as possible. Clearly confiscation, forfeiture and civil recovery are the most direct methods of achieving that purpose. However, one of the most innovative remedial powers is the creation of "revenue powers". This novel remedy is perhaps an acknowledgement that there may be situations where the evidential thresholds required for exercising the

alternative remedial powers[15] may be unachievable, but the investigation has uncovered substantial income which an individual has not declared for tax purposes.

Part 6 of the PCA permits the Director to take over the functions normally exercised by the Commissoners of Inland Revenue in respect of a person's tax affairs over a specified period. Indeed, the Revenue have a statutory duty to co-operate with the Director in the exercise of his functions[16]. The qualifying conditions for the Director to acquire revenue powers are that the criminal conduct has given rise to income, chargeable gains or profits[17]. There are also provisions which provide for inheritance tax where the value transferred is attributable to criminal property or where criminal property is settled[18]. When the qualifying conditions are met, the Director may serve a notice on the Revenue, which automatically vests in the Director all the Revenue's functions, save as to the PAYE and NICs requirements of a company, for the specified period[19]. In exercising his Revenue powers, the Director must interpret the law in accordance with any published concession or treatment of the Revenue[20]. However, to assist him in recovering tax due from income or gains obtained from criminal activity, the Director is not required to prove the source of any income, unlike the Revenue[21]. As long as he can show that income was received by the individual he may raise an assessment in respect of it.

The underlying rationale for this provision is that if the source of the profits can be ascertained the Director

is likely to simply use the ordinary civil recovery remedies. It is precisely the situation where the Director can prove that profits have been received but their source is unknown that he is likely to want to use his revenue powers. Appeals from the Director's exercise of revenue powers lies to the Special Commissioners[22]. One interesting feature of these appeals will be the interaction of the Human Rights Act within such appeals. The Director will presumably be required to show the criminal conduct underlying the assessment and it remains to be seen whether such an allegation will be construed as a criminal charge within the meaning of the Convention.

Conclusion

The PCA introduces powerful machinery for the State to collect the ill-gotten gains of criminals. In particular, the remedial powers contained therein are ground-breaking and create a mechanism whereby the State can recoup lost tax on the proceeds of crime arising within the black economy which might otherwise never be subjected to tax.

It will be interesting to see how often the Director invokes his revenue powers in practice and indeed the attitude of the Revenue towards the usurpation of their jurisdiction.

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[1] See s.6(4)(c) of the PCA..
[2] See s.76(4) of the PCA..
[3] See *R. v. Dimsey and Allen* [2001] Cr. App. R (S) 497.

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[4] The quantum of the benefit is dealt with in sections 78 to 81 of the PCA..
[5] [2001] Cr.App.R (S) 497.
[6] See sections 327 to 330 of the PCA..
[7] See s.340(4) of the PCA..
[8] See s.240 of the PCA.
[9] See s.241 of the PCA..
[10] See s.15 of the AJA 1920.
[11] See s.240(2) of the PCA..
[12]See s.304(2) and (3) of the PCA..
[13]See s.306 of the PCA..
[14]Query the applicability of other restitutionary defences, such as change of position.
[15]For example, where the criminal property has been dissipated and it is not possible to trace it into the hands of another or into any replacement property.
[16]See s.4 of the PCA. Other organisations responsible for the investigation or prosecution of offences have the same duty e.g. the Police, the Crown Prosecution Service and Customs & Excise.
[17] See s.317(1) of the PCA..
[18] See ss.321 and 322 of the PCA.
[19] See s.317(3) of the PCA.
[20] See s.324 of the PCA.
[21] See s.319(1) of the PCA.
[22] See s.320 of the PCA.

THE INFLUENCE OF THE EUROPEAN COURT - RECENT AND FORTHCOMING TAX CASES[1]

Claire Simpson

Introduction

The European Court of Justice ("the Court" or "ECJ") has long been known for its instrumental role in the development of Community law. It is only however in relatively recent times that it has really had the opportunity of flexing its muscles in the fiscal arena. If the Court can be seen as arm-wrestling the governments of the Member States, then it is currently winning hands down. I mention below a number of recent and forthcoming ECJ cases in relation to companies and individuals. To me the cases demonstrate an ever-increasing boldness on the part of the taxpayer in attacking a broad range of fiscal measures and the continuing failure of national governments in defending them. In these circumstances, the reader is of course always at the mercy of the selection of the author, as in when one receives a box of chocolates chosen by a friend. But I hope that in the selection I have made there will be something of interest to everyone.

Recent ECJ Tax Cases

Case C-136/00 Danner[2]

This case sounded the final death knell for the famous, or infamous, *Bachmann* 'fiscal cohesion' defence[3]. It will be recalled that Mr Bachmann was a

German national, resident and employed in Belgium. The provisions of Belgian income tax law made the deductibility of Mr Bachmann's pension and life assurance contributions conditional upon them being paid "in Belgium"- *i.e.* to a Belgian resident undertaking. The ECJ ruled that such provisions amounted to discrimination on the grounds of nationality – on the basis of the residence of the undertaking - and contravened Articles 39 and 49 EC (free movement of workers and freedom to provide services). However, the Court held that such provisions could be justified by the need to safeguard the 'cohesion' of the Belgian tax system. The ECJ reached this conclusion on the basis that there was a connection between the deductibility of the contributions and the liability to tax of the sums eventually paid out under the pension insurance contracts. The loss of revenue from the deduction was thus offset by taxation at a later stage.

The decision was widely criticised – not least because the Court failed to take the Belgium-Germany double taxation convention into account, and the ambit of the defence was reduced in later cases. In Case C-80/94 *Wielockx* the Court ruled that cohesion was in any event secured at the level of the relevant double tax treaty (and was not something to be assessed purely by reference to the national tax system), and in Case C-35/98 *Verkooijen* the Court added the requirement that there be a 'direct link', a 'symmetry', between the granting of the tax advantage and the offsetting of that advantage by a fiscal levy. As a consequence, and despite being consistently invoked by Member States to

justify a myriad of measures, the ‘cohesion’ defence has not met with success in any subsequent case.

Danner, however, removes any practical possibility of relying on the defence. The facts of the case were on all fours with *Bachmann*: Finnish tax law provisions precluded or restricted the deductibility for income tax purposes of pension insurance contributions paid to institutions established in other Member States (here, Germany). The Court ruled that the legislation restricted the freedom to provide services, contrary to Article 49 EC. It refused however to apply the ‘cohesion’ defence. It did so on the basis that there was no “direct link” between deductibility and taxation and that fiscal coherence was secured by Finland’s bilateral convention with Germany. It also rejected arguments that the provisions could be justified by the need to ensure the effectiveness of fiscal controls, since this could be secured by less restrictive means or, by the need to protect the integrity of the tax base.

Two observations can be made. First, a trawl through the relevant provisions governing the deductibility of pension, life assurance or other contributions paid to institutions established in other Member States, to ascertain those which fall foul of *Danner* (or of other Treaty provisions), may pay dividends. If the deductibility of the contributions is conditional upon the institution being established in a certain Member State, this will almost certainly be prohibited[4]. I very much expect this to be the result of the forthcoming case of C-288/01 *Thomsen*. Second, the

debate may in future shift to a consideration not simply of whether there is a prohibition on the deductibility of contributions paid to foreign schemes, but whether the resident and non-resident schemes are sufficiently similar that the differential treatment amounts to unlawful discrimination. We can already see this happening in Case C-422/01 *Skandia*, where the Swedish court referred the question of whether UK, German or Danish insurance undertakings, which, though not established in Sweden, meet all Swedish requirements, can be treated less favourably than otherwise identical Swedish undertakings. The ECJ is yet to rule on the case. Therefore, instead of Member States seeking to invoke 'legal' justifications such as 'cohesion', we may see a shift to a more practical approach, with Member States seeking to justify discriminatory treatment by drawing out as many factual differences as possible between national schemes and the foreign scheme in question.

Case C-324/00 Lankhorst-Hohorst GmbH v Finanzamt Steinfurt

I think it is not going too far to describe this case as a landmark decision. Tax advisers have long been aware that certain measures are incompatible with Community law but, for one reason or another, they have not been challenged. In *Lankhorst*, however, the taxpayer successfully challenged the German thin capitalisation legislation. The ECJ ruled that such legislation was incompatible with Article 43 EC (freedom of establishment). Under the relevant legislation (the German law on corporation tax), interest payments made

by a German undertaking to a shareholder not entitled to a German corporation tax credit were recharacterised as a non-deductible dividend (a covert distribution of profits), if the loan capital represented more than three times the shareholder's proportional equity capital. The legislation did not however bite if (i) the company could have obtained the loan capital from a third party under similar circumstances, or (ii) the loan constituted borrowing to finance normal banking transactions. The only groups of shareholders *not* entitled to corporation tax credit, and therefore subject to the thin capitalisation rules, were non-resident shareholders and a very limited class of corporations governed by German law and exempt from corporation tax.

In ruling that the legislation was incompatible with Community law, the Court held that it could *not* be justified on the basis that it was aimed at combating tax evasion – i.e. the extraction of profits from high tax jurisdictions. Nor was it necessary to ensure fiscal 'cohesion'. In this regard the German, Danish and UK governments raised not only *Bachmann*, but Article 9 of the OECD Model Convention as support for the existence of thin capitalisation rules. Broadly speaking, the Court (and more particularly the Advocate General) dismissed the relevance of the Model Convention on the basis that the objectives of the OECD differed from those of the EU. Thin capitalisation rules lead to discrimination on the grounds of nationality, constitute a restriction within the single market and are therefore prohibited.

As an aside, it is interesting to note that Advocate General Mischo considered that Article 5 of Directive 90/435/EC (the Parent-Subsidiary Directive) applied to the German rules. The Article provides that profits distributed by a subsidiary to a parent shall be exempt from withholding tax. However the ECJ did not address this point.

The case is interestingly in direct contrast to recent moves by the US administration to tighten up the equivalent US rules on 'earnings stripping'. In the context of the EU, the case will undoubtedly have an impact on similar tax legislation in many Member States and is a serious blow to national tax authorities as the amounts of tax at stake are potentially huge. It will lend encouragement to those planning equally bold challenges, for example to Controlled-Foreign-Company legislation. Anyone considering mounting a CFC challenge needs to be aware that the matter has been considered by the French and Finnish national courts. In Re *Société Schneider Electric*, the Conseil d'Etat, Paris, by judgment of 28 June 2002, held that Article 7(1) of the France-Switzerland double taxation convention prevented the French authorities applying CFC legislation in respect of the Swiss subsidiary of a French company. Obviously, this case did not consider the application of Community law. In contrast, the Finnish Supreme Administrative Court, Helsinki, held in its judgment of 20 March 2002, in the case of *Re A OY AB*, that the Finland-Belgium double taxation convention did not prevent the application of Finnish CFC rules. It also held that the rules did not amount to a restriction on the

freedom of establishment within Article 43 EC or on the free movement of capital within Article 56 EC. The conclusion of the Finnish court on Community law is particularly unconvincing, and it is a pity that the matter was not referred to the ECJ. However, the case may yet end up before the Court: the taxpayer company (Partek Oy) refused to be defeated and has lodged a complaint before the Commission in mid-February, asking the Commission to take Finland to the ECJ under Article 226 EC. I understand that the Commission is interested in pursuing it; perhaps we shall see results later next year.

Case C-436/00 X and Y v Riksskatteverket

In this case, Swedish legislation prevented a transferor of shares at undervalue obtaining a deferral of capital gains tax (akin to roll-over relief) on those shares, where the transfer was made to a foreign legal entity in which the transferor had a direct or indirect holding, or to a Swedish company which was a branch or subsidiary of such a foreign entity. On the facts of the case, X and Y were Swedish resident individuals who, together with a Maltese company, held shares in a Swedish company. These shares were to be transferred, as part of a re-organisation, to another Swedish company, a subsidiary of a Belgian company, again owned by X, Y and M. X and Y applied for an advance ruling from the Swedish authorities as to the treatment of the planned re-organisation, and were informed that no roll-over relief or deferral would be available.

The Court ruled on a reference from the Swedish

court that the legislation contravened the freedom of establishment and the free movement of capital – Articles 43 and 56 EC. Again, as in the other cases mentioned above, the ECJ refused to find that the rules could be justified, and rejected arguments based on possible abuse of freedom of establishment, on prevention of a reduction in tax revenue, on the 'cohesion' of the tax system, on the risk of tax evasion, on the effectiveness of fiscal supervision and on the provisions of Article 58 EC (which allow distinctions based on residence, but not where they amount to discrimination). What is interesting here is that the ECJ noted that the Swedish tax treatment resulted in a cash-flow disadvantage. This rationale could be applied to challenge other types of fiscal measures, where their application results not simply in the outright unavailability of a relief, but merely its postponement or deferral.

Case C-385/00 De Groot v Staatssecretaris van Financiën

I mention this case in passing, because it forms part of the ongoing stream of cases concerning the personal tax advantages or allowances of those whose occupations or professions lead them to work in a number of Member States. Mr De Groot was a Dutch national who had worked in France, the United Kingdom and Germany. As a consequence of this, he forfeited, in the calculation of income tax in the Netherlands, his state of residence, part of his personal tax advantages, on the grounds that he had also received income in other Member States

which had been taxed without taking his personal and family circumstances into account. The ECJ ruled that Article 39 EC (the free movement of workers) precluded such rules, whether in national legislation or as a consequence of double taxation conventions.

Case C-208/00 Überseering BV v Nordic Construction Company GmbH

While not a tax case, Überseering is interesting because it looks at the link between company residence and national rules on legal capacity. Überseering was incorporated in the Netherlands. It was deemed under German law to have moved its actual centre of administration to Germany, because its shareholders were resident there and its activities took place in Germany. Nevertheless, German law required Überseering to be reincorporated in Germany before it could have the capacity to bring legal proceedings there. The ECJ ruled that in such circumstances Articles 43 and 48 EC (freedom of establishment) precluded Germany from denying Überseering legal capacity and thus the capacity to bring legal proceedings in Germany. This makes sense, because the requirement of reincorporation in Germany in order to bring legal proceedings amounts to the outright negation of the right of a company to establish itself in another Member State.

Pending ECJ Tax Cases

There are a number of pending cases – those in which an Advocate General has given his or her opinion, but the Court has yet to deliver its ruling. In most cases,

the ECJ agrees with the Advocate General (although usually with a more broad brush, or sometimes frankly unintelligible, approach to the case), so the following cases provide a good guide to what is likely to come out of the ECJ next.

Case C-168/01 Bosal Holding BV v Staatssecretaris van Financiën

(Opinion of Advocate General Alber of 24 September 2002)

This case concerns the deductibility in computing the profits of a parent company of charges relating to the holding of its subsidiaries. Bosal Holding BV, resident in the Netherlands, had subsidiaries in the Netherlands, in other EU Member States and outside the EU. Dutch legislation permitted Bosal to deduct any charges relating to the holding of its subsidiaries, but only if such charges assisted indirectly in generating taxable profits in the Netherlands. In reality, in order to generate such profits, the subsidiary would have to be resident in the Netherlands or have branches there. The Dutch court referred the question of whether such legislation was compatible with Articles 43 and 48 EC (freedom of establishment) and Directive 90/435/EC (the Parent-Subsidiary Directive).

The Advocate General found that the legislation was contrary to the freedom of establishment, because it made it less attractive for Dutch parent companies to have subsidiaries in other Member States. He went on to determine that the legislation could *not* be justified by

Article 4, paragraph 2, of the Directive. While that Article granted Member States the option of refusing to allow parent companies a deduction of charges related to their holdings, if they did so, they had to apply the same régime to all shareholdings. There could therefore be no discrimination between holdings in Netherlands subsidiaries and those in subsidiaries in other Member States. In addition, he found that the legislation could not be justified by (i) the need for 'cohesion' of the tax system, (ii) the principle of fiscal territoriality or (iii) the need to prevent the reduction of tax revenues.

If the ECJ reaches a similar conclusion – and I would expect a judgment any day now – this case will not only have serious consequences for the Dutch revenue authorities, but is likely to impact on similar regimes in a number of Member States.

Case C-58/01 Océ van der Grinten NV v Inland Revenue Commissioners

(Opinion of Advocate General Tizzano of 23 January 2003)

In this case, a UK company, Océ, paid dividends to its Dutch parent. On making the distribution it paid advance corporation tax ("ACT") to the UK Inland Revenue. The dividends carried a tax credit on the basis of the ACT paid. The final value of the tax credit was however reached by deducting from it a 'charge' equal to 5% of the aggregate of the dividend and the tax credit. This 'charge' was levied under Article 10(3)(a) of the UK-Netherlands double taxation convention. The

national court referred the question of whether this 'charge' was compatible with Article 5(1) of Directive 90/435, the Parent-Subsidiary Directive, which prohibits the levying of withholding taxes on the distribution of profits by a subsidiary to its parent.

The Advocate General found that the 5% charge had to be considered separately in relation to its application to the dividend and the tax credit. The 5% levy on the dividend clearly amounted to a "withholding tax" within the meaning of Article 5 of the Directive. However, it fell within the exemption provided by Article 7(2), because its application was designed to lessen the double economic taxation of dividends (the Netherlands parent being given credit for the 5% charge by the Dutch authorities). The 5% levy on the tax credit did not however amount to a withholding tax, because it was in effect just a step in the calculation of the final tax credit (a calculation which was described by the Advocate General as of "baroque complexity").

This case follows on from Case C-397/98 *Metallgesellschaft Ltd and Others v IRC*, also known as "*Hoechst*". In that case, the Court ruled that UK legislation which permitted UK subsidiaries to pay ACT-free dividends to UK parents, but not to parent companies resident in other Member States, was contrary to Article 43 EC, the freedom of establishment.

Case C-364/01 Barbier v Inspecteur van de Belastingdienst Particulieren

(Opinion of Advocate General Mischo of 12 December 2002)

This case concerned inheritance tax – not something one would ordinarily expect to fall under the scrutiny of Community law. Nevertheless, according to Advocate General Mischo, certain provisions of Dutch inheritance tax legislation need to be amended in the near future. The Dutch legislation provided that, for the purposes of calculating inheritance tax, those administering the estate of a non-resident could only deduct debts such as mortgages from the value of the deceased's real property situated in the Netherlands. The legislation applied in particular where the deceased had transferred the economic ownership of the property to another person. Perhaps not surprisingly, deductions were not so limited in the case of resident deceased persons.

The factual matrix we have here – with Mr Barbier owning the legal title to Dutch property, but the economic or equitable title being held through a Dutch resident company – derives from a stamp duty or transfer tax avoidance scheme. Mr Barbier had agreed in time to transfer the legal title to the resident company, but this obligation was *not* secured by way of mortgage. In these circumstances the effect of the legislation was that the full market value of Mr Barbier's property in the Netherlands was included in his estate. Had Mr Barbier been resident in the Netherlands, the taxable amount

would have been reduced by the unsecured obligation to transfer the legal title.

The Advocate General found that the legislation was discriminatory on grounds of residence and contravened not only the free movement of capital (Mr Barbier having bought the Netherlands properties once he had moved to Belgium) but also Article 39 EC (the free movement of workers). The principle to be drawn from the Advocate General's Opinion is that where a non-resident is taxed in the same way as a resident in respect of particular assets, the non-resident should be entitled to the same deductions and reliefs as the resident (especially where similar reliefs are unavailable to the non-resident in his Member State of residence). The Advocate General's view was that once a Member State treats a resident and non-resident in the same way for the purposes of taxation, it effectively admits that there are no objective differences between them and therefore cannot rely on pretended differences to deny a non-resident relief. This approach could clearly be applied in other fiscal areas.

Interestingly, at the same date as the Advocate General's Opinion was delivered, the Dutch court ruled that legislation deeming Dutch nationals who have emigrated to be resident for the purposes of inheritance tax in the ten years following their departure is discrimination based on nationality.

Two Forthcoming Tax Cases

The Advocate General delivered his opinion in the

first of these cases on 13th March; the other, while still at the time of writing before the national court, may yet end up in Luxembourg.

Case C-9/02 De Lasteyrie

(Opinion of Advocate General Mischo)

Under Article 167 *bis* of the French Code Général des Impôts, a capital gains tax exit charge is levied on individuals leaving France and becoming resident in, for our purposes, another Member State. The charge can be avoided, but only after a series of burdensome administrative requirements are met and guarantees given. If the charge is levied, it is only repaid after a period of five years and then only if certain conditions are met.

A challenge was brought to this legislation under Article 43 EC (freedom of establishment). The Advocate General held that the legislation was clearly a restriction on this freedom. The question was whether the restriction could be justified. Four justifications were advanced – the erosion of the tax base, the fight against tax avoidance and the efficiency of fiscal controls, the cohesion of the tax system and the distribution of the power to tax between the Member State of departure and that of destination. None of the justifications was accepted by the Advocate General. In particular, he found that there were less restrictive means of combating tax avoidance. The Opinion, although brief, is well-reasoned, and I shall be surprised if the Court does not adopt a similar approach. If this happens, the case is

likely to have a huge impact on exit taxes levied by Member States on, for example, the emigration of trusts or companies – such as the deemed disposal of trust assets on emigration, which arises under UK capital gains tax legislation. If therefore one is involved in planning in this area prior to the Court's judgment, and wishes at least to have the possibility of relying on this case, it will be wise to ensure that the country to which the individual, trust or company emigrates is within the EU. Jersey, Guernsey and the Isle of Man would therefore be out, but Cyprus and Gibraltar remain a possibility.

Marks and Spencer v Halsey (Inspector of Taxes)

This case is currently at national level (coming before the High Court in April), and has not yet been referred to the ECJ. It concerns a challenge to the UK group relief provisions for corporation tax. It raises interesting issues in relation to differences in the treatment of non-resident branches and subsidiaries and is certainly one to watch.

State Aid Cases

State aid has recently become a hot topic in the tax world. Following a more aggressive approach by the Commission – hand in hand with the Code of Conduct on Direct Business Taxation - the rules are being applied in a wide range of situations in which certain undertakings are taxed differently from their competitors - whether by means of a difference in tax rates, tax exemptions, concessions, deferrals or reliefs.

For Article 87 EC, to apply, there are five requirements:

(i) there must be an aid,

(ii) granted by Member State/through State resources,

(iii) which distorts competition/threatens to distort competition,

(iv) by favouring certain undertakings/the production of certain goods,

(v) and actually/potentially affects trade between Member States.

In the fiscal arena we have recently seen aid measures being struck down in a wide range of cases - such as in respect of the Gibraltar Exempt and Qualifying Company regimes (T-195/01, T-207/01). We can expect to see the State aid rules playing an ever-increasing role in the control of Member States' tax systems. It is therefore more than worth bearing not only the four freedoms in mind when considering challenging national tax legislation, but also the State Aid provisions – Articles 87 and 88 EC.

Conclusion

There is little doubt that the tax systems of the Member States are being attacked, albeit in a rather random, haphazard way, on all sides – and that this

attack is being spearheaded by the taxpayer. There remains however a vast, multi-layered web of rules – at the national, European and international level – within which many difficulties and inconsistencies remain ensnared. To disentangle and simplify this web is a truly Augean task, which falls largely on the shoulders of the Court. It is up to us to ensure that it is properly guided. The future of our tax systems is at stake.

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[1] From a paper contributed by the author to an International Tax Planning Association conference held in Cannes in March 2003.

[2] The Advocate General's Opinion in this case was considered in an earlier edition of the *Review* (May 2002).

[3] Case 204/90 *Bachmann v Belgian State* [1992] ECR I-249.

[4] See also the recent Commission Communication on the elimination of tax obstacles to the cross-border provision of occupational pensions (O.J. 08/06/01 C 165/03).

PRACTICAL INHERITANCE TAX PLANNING: AN OVERVIEW

by Michael Thomas

Introduction

The recent property boom has increased the importance of inheritance tax ("IHT") for a great many people. Accordingly, IHT planning is probably more important now than ever before. Good tax planning should be simple. IHT primarily operates to charge the value of a person's estate on death, so the best planning is to give away all your wealth and hope that you survive for another seven years (in order to avoid the deathbed gifts rule). The nil rate band allows £250,000 per person or £500,000 per married couple to be retained until death, free of IHT.

The Problem (for Most People)

Unfortunately most people cannot simply give away their wealth in excess of the value of the nil rate band because they need houses to live in and investments to live off! Another reason why people might not be able to simply give away assets is because they are pregnant with chargeable gain and a gift will trigger a capital gains tax ("CGT") charge; this is commonly the case with investment properties. It is worth noting at this point that IHT operates unfairly because the very rich can more easily avoid it by giving surplus wealth away whereas the middle class will need all or most of their wealth to live off. For example, a person worth £100

million can give the vast majority of her wealth away and live very comfortably indeed. Whereas a person worth £1 million living in a house worth half that has much less scope for making gifts.

Maximising Use of the Nil Rate Band

It is important that married couples plan to take advantage of both nil rate bands rather than only a £250,000 exemption on the second death. If the surviving spouse will require all the assets then a nil rate band will trust might be used. Care will need to be taken to ensure that the surviving spouse is not treated as having an interest in possession in the assets subject to the will trust. Various techniques are used in order to try and achieve this.

More Sophisticated Planning

If the clients have given away what they wish to and, in the case of a married couple, suitable nil rate band planning is in place, then more sophisticated planning might be considered to further mitigate IHT. Unfortunately, there are a number of problems and no magic solution. The good news is that there is usually something that can be done if the clients wish to pursue it.

The major obstacle is the gifts with reservation ("GWR") rules contained in the Finance Act 1986 (as amended). These are designed to prevent people giving assets away whilst continuing to benefit from them free of IHT. Those who have encountered these rules will

know that they are complicated and that they have been amended to counter the effect of earlier planning. Most planning continues to focus on the family home. Property law concepts are used to allow taxpayers to retain ownership of the property during their lifetimes but to reduce its value for IHT. Unfortunately, the GWR rules have been amended to focus on exactly this sort of planning with the result that it is ever more difficult. I shall now introduce some of the current planning ideas.

Eversden Arrangements

The GWR rules do not apply to gifts between spouses. Accordingly, if I gift property into a life interest trust for my wife then the GWR rules do not apply The gift of the reversion is immaterial, because reversionary interests are ignored to IHT purposes. If my wife's life interest is subsequently terminated by the trustees in favour of the children (or a trust in their favour) then that is not a *gift* by her, and accordingly the GWR rules do not apply to that transaction. The result is that we can give away our house to the children and continue to live in it free of IHT. Lightman J recently approved this type of planning in *IRC v. Eversden* [2002] STC 1109. It is the current "hot" planning idea. The Revenue are appealing the decision. Should they lose, or possibly in this year's Finance Act anyway, the Revenue will undoubtedly enact legislation to prevent these structures being used. Importantly, this arrangement can also be used to put investments into a discretionary trust, in which the husband or wife or both of them may be interested. The terms of the trust may make the

arrangement effectively reversible should the Court of Appeal find for the Revenue or the structure's effect is counteracted by retrospective legislation.

Home Loan Schemes

This is a very popular scheme. Essentially, the transferor sells her house to a trust in which she has an interest in possession in exchange for a loan note redemption of which is deferred. The loan note is then given away. The house remains in her estate by virtue of s.49, but the value of the estate is reduced by the value of the loan note. Although these transactions are quite artificial, in my view they do work – but the tax analysis is very complicated. Meanwhile the Revenue are understood to be preparing a test case to challenge them. That is not of itself a reason not to use this structure, because if the Revenue lose in the courts then any anti-avoidance legislation is unlikely to be retrospective. Home loan schemes also raise a CGT problem because the *loan note increases in value* as its date for payment approaches. This might be overcome with careful planning, although it does raise further complications.

Reversionary Lease

This is the opposite of the scheme which was approved by the House of Lords in *IRC v. Ingram* [1999] STC 37 but subsequently countered by the enactment of s.102A FA 1986. In this version, the taxpayer retains the freehold but gives away a long (999 year) lease to take effect within 21 years. Only the rapidly diminishing value of the freehold is then left in the taxpayer's estate.

However, again this scheme raises a CGT problem which arises from the low base cost of the lease.

Lease for Full Value

This is a good scheme for elderly clients with surplus cash. Leases bought for full market value are not caught by the GWR rules. Accordingly, an elderly client can give away her house, buy back a lease for life for a premium and continue living there IHT free. The downside is that income tax is payable on the premium, although no IHT will be payable on it if she dies within 7 years because it is a payment for the lease rather than a gift.

Utilising The CGT Holdover Relief In Section 260 Taxation of Chargeable Gains Act 1992 To Give Away Assets Pregnant With Chargeable Gains

Lifetime transfers chargeable to IHT benefit from CGT holdover relief under s.260 TCGA. Although the transfers are chargeable to IHT, none is actually payable if sufficient nil rate band is available. So, for example, if a person gives away an investment property worth £240,000 into a discretionary trust this can be done with neither a CGT nor an IHT charge.

A scheme was available to allow property in excess of the value of the nil rate band to be placed into discretionary trust without an IHT charge. The Court of Appeal upheld this in *IRC v. Melville* [2001] STC 1271. Legislation was enacted in the 2002 Finance Act to reverse the effectiveness of that decision (the new s.55A

Inheritance Tax Act 1984). Although this is a relatively recent decision, practitioners have developed ways of overcoming the restrictions imposed by s.55A, by utilising fixed interests rather than powers.

Conclusion

I hope that the above gives some flavour of the IHT planning that is available. Unfortunately, there are no magic solutions. Accordingly, what planning, if any, is appropriate will depend upon the particular client's situation. None of the structures are guaranteed successes and each has downsides. On the other hand there are potentially some very large savings to be made with little or no downside if the planning does not work. In my experience the decisive factor is how concerned the individual client is to save IHT. There is usually something that can be done, but the owner of the assets will decide whether or not it is worth the effort, depending how concerned he is to benefit other people free of IHT.

TAXATION OF DAMAGES, COSTS AND INTEREST (3)[1]

John Walters

In this paper, I consider three aspects of this matter. First, the decision in *Deeny v. Gooda Walker*; second, issues of capital gains tax and damages (*Zim Properties* and Concession D33); and third, the question of joining the Inland Revenue in private litigation.

Deeny v. Gooda Walker[2]

The issue in this case was whether damages awarded to Lloyd's Names as compensation for losses caused by negligent conduct of their underwriting businesses by their underwriting agents are taxable receipts of the Names' underwriting businesses. The Courts at every stage held that they were, but the agents obtained a dissent in the Court of Appeal from Savile LJ (and leave from the Court of Appeal to appeal to the House of Lords). The agents' case that the damages were *not* taxable receipts of the Names' businesses – and so ought to be computed on a net-of-tax basis following *Gourley* – was that the Names' underwriting businesses consisted of underwriting risks at Lloyd's and were to be distinguished from the apparatus which enabled the Names to carry on their businesses – and the relationships of the Names and their agents was part of that apparatus. Thus damages arising from breach of duty by the agents would not compensate for lost profits of the business (although it would be computed in that way), but would instead be damages for the negligent

conduct of that apparatus underlying the underwriting business.

This distinction between the underwriting business and the apparatus underlying it was unanimously rejected by the House of Lords, and the arrangements between the Names and their agents were held to be part of their underwriting business for tax purposes, so as to make the damages taxable as receipts of the trade – albeit receipts received in unusual circumstances. Thus, the actual decision of the House of Lords was that the damages were taxable because they arose from a contract made in the course of the Names' underwriting business.

However, an interesting – at least to me – aspect of the case was that the Names (for whom I appeared, led by Geoffrey Vos QC) put forward an additional argument based on first principles, on the nature of receipts of a trade. We said that whether or not the agreement between the Names and the agents was a contract made in the course of the Names' underwriting business – *ie.* even assuming it was *external* to the business, as the agents argued – the damages would still be taxable as trading receipts because they compensated the Names for trading receipts which had not been received – or trading losses which had been incurred – because of the agents' negligence. This was called the "wider" argument, and it was based on Diplock LJ's well-known formulation in *London and Thames Haven Oil Wharves Ltd. v. Attwooll* [1967] Ch. 712, 815, which we said was a correct exposition of the law. That formulation is as follows:-

> Where, pursuant to a legal right, a trader receives from another person compensation for the trader's failure to receive a sum of money which, if it had been received, would have been credited to the amount of profits (if any) arising in any year from the trade carried on by him at the time when the compensation is so received, the compensation is to be treated for income tax purposes in the same way as that sum of money would have been treated if it had been received, instead of the compensation.

The principle applies also to compensation received for a trader's liability to pay a sum of money which was a deductible revenue expense (*Donald Fisher (Ealing) Ltd v. Spencer* [1989] STC 256).

We argued that this compensation principle dealt with all cases – and did not simply show how an income receipt was to be distinguished from a capital receipt, because we thought that if a receipt arose *from* a trade it must *necessarily* be of an income rather than a capital nature. It seemed to us to be illogical to suppose that a capital receipt could arise from a trade, because a trade is itself a capital asset which can produce only income profits. If a capital profit arose, it could not be *from* the trade; it could only be from a disposal or part disposal of the trade itself or a capital asset employed in the trade. Lord Hoffmann accepted this argument and Lord Goff expressed no opinion on it – but it was rejected by the other three law lords, who evidently thought that a receipt of a trade could be of a capital or an income nature, so that in order to test the taxability of damages you do not simply apply Diplock LJ's formulation, but you have to ask two questions: (1) was the receipt a

receipt of the trade? and, if so, (2) was it of a revenue or capital nature?

Capital gains tax and damages: *Zim Properties* and Concession D33

Zim Properties v. Procter [1985] STC 90; 58 TC 371 is an extraordinary case. It took 20 months for the Commissioners to state a Case for the High Court, and a further 2½ years after the Case had been stated to get to a High Court hearing. It established (as the Revenue had argued) that rights to take court action are an asset for capital gains tax (CGT) purposes, such that the compensation, or damages – including settlement proceeds – can attract CGT as a capital sum derived from that asset.

Having won *Zim*, the Revenue (four years later – at the end of 1988) issued what is now Extra-Statutory Concession (ESC) D33 on CGT on compensation and damages, promulgating a practice that almost entirely nullifies the effect of the *Zim* decision. The taxpayer in *Zim* had unsuccessfully argued that the settlement proceeds in issue related not to a separate asset, being the right to sue, but were instead proceeds of a part disposal of the underlying asset about which the negligent advice had been given and the original proceedings brought. The Court's decision that this was wrong affected the base cost which could be deducted from the compensation figure, and also the availability of reliefs to shelter the resultant gain – e.g. indexation relief (now taper relief for an individual), rollover relief, etc.

The ESC, however, while setting out the strict position as established in *Zim*, goes on to give relief by concession, which can be summed up as follows. Where the right of action relates to an *underlying asset* – for example, a property in the case of an action against an estate agent for negligent advice on sale – the compensation can be treated as proceeds on a disposal, or more likely a part disposal, of the underlying asset – i.e. the property, with the allocation of base cost and availability of reliefs and exemptions appropriate to such a disposal or part disposal. On the other hand, where there is *no underlying asset* – no asset in relation to which the right of action arises (for example a claim against advisers for negligent financial, including tax, advice), the Revenue grant exemption from CGT for any gain arising on the disposal of the right of action.

Sometimes it is not easy to establish whether there is an underlying asset, and if there is one, what it is. I had a case recently concerning a partnership of surveyors, who carried on a normal professional surveying business, but also looked for investment opportunities. When two partners found an investment opportunity, but did not invite the other partners to participate in it on terms reflecting their profit sharing ratios, the other partners sued for breach of the partnership agreement (which was not in writing) and claimed that the two defendant partners were constructive trustees of the property concerned for the firm. The defendants denied that they were constructive trustees, and the action was settled on the basis of substantial compensation paid to the claimant partners

and an agreement that the two defendant partners were not and had never been constructive trustees of the property. In these circumstances, what, if anything, was the underlying asset relative to the compensation received? I thought it was arguably the partnership goodwill, and that the compensation should be treated under the ESC as proceeds of a part-disposal of the goodwill.

The thinking behind the underlying asset approach in the ESC also confirms (as is recognized in the ESC) that any compensation received in respect of a right of action for personal injury or defamation, or unfair or unlawful discrimination suffered in the person, is exempt from CGT, because of the specific provision (s.51(2) TCGA 1992) that sums obtained by way of compensation or damages for any wrong or injury suffered by an individual in his person or in his profession or vocation are not chargeable to CGT.

Joining the Inland Revenue in private litigation

By RSC Ord. 77, rule 8A (Schedule 1 to the Civil Procedure Rules 1998 SI 1998/3132) reads -

> Nothing in CPR rule 19.3 shall be construed as enabling the Commissioners of Inland Revenue to be added as a party to any proceedings except with their consent signified in writing or in such manner as may be authorised.

The Commissioners may, however, themselves apply to be joined as a party. In practice, therefore, it is up to the

Revenue, whether they decide to be joined, and their decision seems to be taken on a case-by case basis.

In my own recent experience, the Revenue consented to be joined in two cases, *Lloyds UDT v. Standard Chartered Finance Trust Holdings plc and Others*[3], and *Toronto-Dominion Bank v. Oberoi and Another*[4]. They also, of course, consented to be joined in *Deeny v. Gooda Walker*. The first case (*Lloyds UDT*) was in reality about the proper construction of a tax provision – s.35(2) CAA 1990 and one can immediately see the Revenue's interest in being there. This was also the position in *Deeny*, where the tax consequences of an award of damages to a trader was in issue. But the second case, *Toronto-Dominion Bank*, was a rectification action, which had tax consequences because the Bank sought rectification of a lease, which was in terms a lease for an upfront payment of rent, saying that it should be rectified to show the payment as a premium, and not rent. This had Schedule E implications because the lease was a lease of accommodation provided for the Bank's employee. The Revenue unsuccessfully opposed the grant of rectification. The Revenue's decision to be joined in this action was more unexpected. They had not sought to be joined in the last reported tax-related rectification action (where rectification was refused, despite their not being there) – *Racal Group Services Limited v. Ashmore* (1995) 68 TC 86. I am inclined to see a change in policy over the period since 1995, and suggest that the Revenue are more likely than they were previously to want to be joined in private litigation which raises a tax point.

Against this, I notice that in *Abacus Trust Co (Isle of Man) Ltd v. NSPCC*[5], a case heard in July 2001, where Patten J applied the principle in *Re Hastings-Bass*[6] to declare void *ab initio* a trustees' appointment which had been made in disregard of tax advice and which had calamitous tax consequences, the Revenue refused either to be joined in the proceedings or to be bound by the Court's decision – reached, inevitably, in their absence. In these circumstances, the judge expressly stated that he was satisfied that Counsel had put before the Court all matters relevant and necessary for a proper decision in the case.

Where the actual tax consequences of a transaction could not be affected by the result of the case, there will usually be no occasion to join the Revenue, even where the proper construction of a tax provision is in issue. A recent example is *Grimm v. Newman*[7], a negligence action concerned with the proper application of the remittance basis. The Revenue were not there, even though this was apparently a matter of regret to the Court of Appeal, because on the facts Mr. Grimm's case had been settled with the Revenue and he was suing his accountant in the light of that settlement. Where, on the other hand, the tax consequences of a transaction are in issue, the Court will usually suggest that the Revenue are given the opportunity to consent to be joined, if the parties have not approached them themselves, and even if they object to doing so. Where the Revenue are joined, they may propose that they bear their own costs in any event and are not liable for any other party's costs in any event. This was the position in *Lloyds UDT*.

There was no such proposal in *Toronto-Dominion Bank*, with the result that the Revenue ended up with a liability for the other party's costs.

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[1] From a paper contributed by the author to a seminar of the Chancery Bar Association chaired by Park J, on 24th February 2003.
[2] [1996] STC 299 (HL).
[3] [2001] STC 1652 (Ch D); [2002] STC 956 (CA).
[4] Digested in [2003] STI 171.
[5] [2001] STC 1344.
[6] [1974] STC 211; [1975] Ch 25.
[7] [2002] STC 84 (Ch D); [2002] STC 1388 (CA).

EMPLOYEE BENEFIT TRUSTS – RIP?

Patrick Way

Background

2002 was the year in which the employee benefit trust ("EBT") regime reached a great but, very short-lived, height. This zenith occurred on 3rd September 2002, when the Special Commissioners found for *Dextra Accessories Limited*[1] to the effect that an EBT which had provided many millions of pounds of benefits to six principal beneficiaries and others had been successful; the company was entitled to a significant deduction, and the beneficiaries escaped income tax. The countervailing nadir (some might say the revenge) occurred on 27th November 2002, when the Inland Revenue introduced new provisions to widen significantly s.43 Finance Act 1989, with the effect that, broadly speaking, no sponsoring company may thenceforth obtain a deduction for a contribution to an EBT until benefits have been paid out to beneficiaries. The effect of denying a deduction can be well described by referring to the prescient words of the Special Commissioners in the *Dextra* case. They said (at paragraph 19 of that case) –

> "[The facts] show that the company and the directors were strongly influenced by tax considerations, but this is not surprising when dealing with an EBT which would not be much of a benefit if the employer could not obtain a deduction …"

How did we get here?

EBTs began to be popular prior to the 1980 changes to the corporate buy-back rules, as they could operate as a market for the shares of companies which could not be repurchased by the company. They took the form of discretionary settlements which were intended to incentivise staff on the basis that the company would pay sums into an EBT and in due course benefits would be made available by the trustees to the staff. In order to encourage the use of EBTs, generous tax benefits flowed. By s.86 of the Inheritance Tax Act 1984, EBTs were relieved from the ten-year charge otherwise applicable to discretionary trusts; through s.13 (subject to the involvement of participators) the creation of an EBT did not amount to a transfer of value; under s.12 there was no transfer of value, in any event, where the company's contribution to the EBT obtained the benefit of a tax deduction for the purposes of corporation tax.

But it was the asymmetry of EBTs which appealed to companies and tax planners alike and which, no doubt, offended the Inland Revenue. At paragraph 17 of the *Dextra* case the Special Commissioners said as follows –

> "We quite understand the Revenue not liking the asymmetry of the companies obtaining an immediate deduction for payments into trust without any charge to tax on the employee except perhaps a charge to tax on interest-free loans at the official rate, and not even that if the official rate is paid … However, it is in the nature of employee benefit schemes that the employer should obtain a deduction having paid away money to such a trust. The reason why the

> employees are not taxed on funds in the EBT is simply that they do not belong to the employees. The [employees] may have carried this to extremes by not taking any significant remuneration in cash but their position is entirely different from what it would have been if they had.

If this asymmetry were not unpalatable enough, what probably discomforted the Inland Revenue more was the fact that EBTs were increasingly being used as vehicles for fairly extravagant tax planning. In due course, the Inland Revenue began to devote great energies in investigating EBTs, such that the Special Compliance Office became involved and would raise typically a number of points, which I now consider in turn. As can be seen, the majority of these were raised in the *Dextra* case.

Urgent Issues Task Force Abstract 13 – "UITF 13"

The Inland Revenue used to argue that UITF 13 had application to EBTs (the company and the EBT are effectively one single arrangement), with the consequence (so the Revenue contended) that an EBT's assets should be treated, in effect, as remaining in the company's balance sheet, and no deduction should be given to the company until those assets passed out to a beneficiary. This view always struck me as hopeless. Indeed, it is perhaps noteworthy that it was not even raised in *Dextra*, although by the time of the hearing UITF 13 had been superseded by UITF 32 and UITF 32 effectively threw (extremely) cold water on the UITF 13

arguments anyway. Be that as it may, UITF 13 was concerned principally with ESOP trusts which are run in tandem with sponsoring companies rather than what one might call “normal” trusts, exemplified by EBTs which are quite separate, as a matter of law, from sponsoring companies. More particularly, the trustees of an EBT were independent from the sponsoring company, and they acted in accordance with their own constitution as applied by those trustees. It is unlikely that any trust lawyer would ever consider that the assets of a trust belonged to the settlor company in these circumstances. To be fair to the Inland Revenue, many EBT trustees did seem to be in thrall, to say the least, to the sponsoring companies, leading to an unhealthy relationship which fuelled the Revenue’s general concerns no doubt: indeed, in *Dextra*, the Revenue argued *Ramsay* forcefully on the basis that the companies and the EBT were so interlinked as to amount to a single vehicle producing guaranteed emoluments or benefits as part of a tax avoidance arrangement. (This Revenue view failed, as to which see later).

Another counter to UITF 13 applying was that had it done so it would have produced both bizarre and misleading effects. For example, assume that an EBT, over time, has acquired more than half of the shares of its own sponsoring company (perhaps even 75% of those shares). By virtue of the UITF 13 argument advanced by the Revenue, the position would be that even though as much as 75% of the company’s shares were owned by the EBT, nevertheless, the correct accounting treatment (apparently) would be (somehow) to record those assets

as on the company's own balance sheet. Or, assume that a company has transferred £1m. of cash to an EBT, which has been invested by the trustees, and assume also that in due course the sponsoring company goes into liquidation without any assets. The UITF 13 stance shows the £1m. as an asset of the company. A creditor of the company owed, say, £1m. might not be "best pleased" to find that the accounts of the sponsoring company were "misleading", in suggesting that the company retained £1m. of assets. There is little doubt that a liquidator would not have access to those assets and certainly could not claim that they remained in the ownership of the company.

I should say that it is my view that the new UITF abstract 32 should still not catch EBTs, provided that the sponsoring company can show that it does not control the EBT as more fully set out in paragraph 10 of that abstract.

Section 43 Finance 1989

The provisions of s.43 FA 1989 were debated in *Dextra*. Section 43 provides, in essence, that where relevant emoluments or potential emoluments are transferred to an intermediary, with a view to their becoming actual emoluments in due course, no deduction occurs until (again in broad terms) emoluments representing that intermediate payment are paid out. The Revenue maintained that their view – to the effect that s.43(11) applied in the circumstances – produced the necessary and desirable symmetry between the deductibility of the companies on the one hand and

the taxability of the employees on the other. By contrast, the taxpayer argued (successfully as it turned out) that payments made to an EBT were neither relevant emoluments nor potential emoluments, since there was no guarantee that they would be transferred out in due course as emoluments: they might take the form of loans or other benefits. And in *Dextra* very significant interest-bearing loans had been made to beneficiaries. Further, if the Inland Revenue's argument was correct, this would mean that there would never be a deduction and that was an indication of the fallacy in their approach. The Commissioners preferred the taxpayer's argument (s.43 was not in point) and it was largely as a result of this (one assumes) that the new draft Schedule, widening s.43, was introduced on 27th November 2002.

As a footnote to the above, I might add that the Inland Revenue have appealed *Dextra* to the High Court exclusively by reference to s.43, so it is understood. This would seem to be a difficult argument to sustain given the Inland Revenue have separately given instructions to the Parliamentary draftsman that s.43 needed to be widened: why request that legislation be fixed if it is not broken?

Benefits in kind

The second main argument which the Inland Revenue ran in *Dextra* was one which had concerned a great many tax advisers previously. The Dextra trustees (as one might call them) had created sub-funds for the benefit of particular beneficiaries, and, so the Inland Revenue argued, this created a benefit in kind taxable

under the general provisions of taxing benefits in s.154 of the 1988 Act.

By contrast, the taxpayer argued (successfully again, as it turned out) that the specific charging provisions in s.154 required actual benefits to be received rather than potential benefits being available. Having regard to *Templeton v. Jacobs*[2], the position is that "no benefit is provided for the purposes of s.154(1) until the benefit in question becomes available to be enjoyed by the taxpayer". The Commissioners agreed: an interest in a trust could not produce an availability for trust assets to be enjoyed – that would involve another step such as an appointment to the employee out of the trust. So there was no benefit in kind in relation to a sub-fund.

Templeton v. Jacobs is an increasingly important case in the area of employee benefits. The case concerned an individual who, whilst working for a firm of solicitors, accepted a job with a client company, which job was to take effect subsequently. In the meantime, the client company agreed to pay for a loft conversion to the individual's house (from which he would work for the company), and the company paid for the cost of that loft conversion immediately (at a time when the individual was still in employment with the solicitors). The taxpayer argued that this sequence of events meant that he was not subject to tax on the benefit in kind representing the loft conversion, because at the time when payment for the loft conversion had been made he was not employed by the client company:

payment for a benefit was synonymous with *provision* of that benefit. However, as stated, the High Court held that the relevant time for taxation purposes was when the benefit itself became available, being the time when the loft was completed. By this time Mr. Jacobs *was* working for the company, having left the firm of solicitors, and therefore he was taxed on the benefit in kind which was made available at a time when he was in employment with the employer in question.

The ratio of *Templeton v. Jacobs*, therefore, is that provision of a benefit occurs only when it is received. This rule enabled Dextra to win the benefit in kind argument, and, as an aside, it means that tax advantages may follow if benefits in kind are provided to employees *after* retirement: the provision of the benefit will occur when no "charging" employment exists.

The *Ramsay* argument

The final argument which the Inland Revenue ran in *Dextra* was in relation to *Ramsay*. The argument was that there was a single pre-ordained plan involving the companies and the trustees by which plan the six principal beneficiaries would receive (or be entitled to) remuneration (in some form) in a guaranteed fashion: the EBT was a conduit artificially inserted into the process of remuneration. The Commissioners dismissed this contention, since, having regard to the particular facts, it was not the case that there was an inevitable result which would produce cash in the hands of employees. Thus it could not be said, adopting a commercial approach to the relevant statutory concepts, that in the circumstances

there was a payment of emoluments or earnings by reason of the particular arrangements involving the EBT. The Commissioners even went so far as to say that they did not categorise the EBT as an artificial tax avoidance scheme.

27th November Changes

Probably in reaction to the *Dextra* case in general (which had originally been intended to be an anonymised case, but which, by contrast, was very widely trumpeted in the Press) and perhaps specifically by reference to the Commissioners' finding that no artificial tax avoidance was involved, the Inland Revenue introduced the new wording, already mentioned in this article, widening s.43. The definite consequence is, in the writer's view, that there is little point in companies setting up EBTs from the 27th November 2002 onwards, because, of course, contributions will no longer produce a deduction for the companies unless and until the EBT itself transfers to beneficiaries the cash or assets representing the contributions. This is likely to make EBTs prohibitively expensive.

The future

By way of conclusion, therefore, it can be said that the future for new EBTs is bleak but the future for existing EBTs is, if anything, enhanced. This is because *Dextra* gives good authority for the proposition that interest-bearing loans may be made to beneficiaries (the Commissioners accepted that these were not emoluments or taxable benefits in kind) without causing a tax charge,

and sub-funds may be created without giving rise to a benefit in kind or deemed emolument.

Otherwise, tax practitioners will have to look at other techniques for remunerating staff in an efficient manner without the use of an EBT, and these might include the following –

(a) a transfer of deferred shares so that the taxation charge occurs early and any subsequent growth occurs income tax-free in the hands of the employee;

(b) the use of s.140A Taxes Act 1988, which allows shares to be transferred on a conditional basis without an immediate charge to tax occurring;

(c) the use of options where s.135 Taxes Act 1988 has no application so that one is thrown back onto the old *Abbott v. Philbin*[3] analysis that options are taxable when granted and subsequent benefits are ignored for income tax;

(d) the use of options under the Enterprise Management Incentives (EMI) legislation;

(e) the use of soft currency loans (if one wishes to be aggressive); and

(f) a reinvestigation of post-retirement benefits, particularly because *Templeton v.*

> *Jacobs* as confirmed by the *Dextra* case (to the extent that a Special Commissioners case may do this) does seem to show, as described in this article, that – with care – benefits in kind may be paid tax-free to individuals once those individuals have ceased employment.

Caveat

As with my previous articles, my intention has been to stimulate thought. If readers wish to proceed on the basis of this article they should do so with care.

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[1] SpC 331 – [2002] STC (SCD) 413.
[2] [1996] STC 991.
[3] 39 TC 82.

Members of Chambers

Milton Grundy (Head of Chambers)
Michael Flesch QC
David Goldberg QC
David Goy QC
John Walters QC
Philip Baker QC
Patrick Soares
Felicity Cullen
Barrie Akin
Patrick Way
Hugh McKay
Aparna Nathan
Conrad McDonnell
Nicola Shaw
Claire Simpson
Michael Thomas

Senior Clerk: Chris Broom
GRAY'S INN TAX CHAMBERS
Gray's Inn Chambers, 3rd Floor, Gray's Inn,
London WC1R 5JA
Tel: 020 7242 2642 Fax: 020 7831 9017
e-mail: clerks@taxbar.com