

## ‘NO BENEFIT. NO TAX’ – TRUE OR FALSE?

By Michael Flesch QC

Consider the following scenario: X, a UK resident, is a beneficiary under a discretionary trust created by his late father. The trustees are resident in Jersey. In June 2016 the trustees lend X five million euros (€5m) to help him to purchase a villa in Portugal for fifteen million euros (€15m). The loan is for a fixed five year term, secured on the property with the interest compounded/rolled up half yearly. The (compounded) interest is to be paid, together with repayment of principal, at the end of the fixed term. You may assume, that the terms of the loan and in particular the rate of interest, are such that it constitutes a fair bargain such as might reasonably have been entered into by persons acting at arm’s length<sup>1</sup>. You may also assume that the trust is awash with ITA 2007, section 733 “relevant income”.

I would have been prepared to advise, in June 2016, that on the basis of the above facts X did not receive a taxable “benefit” for the purposes of ITA 2007, section 731 *et seq* when the loan was made to him. At worst, any such benefit would have been relatively insignificant. And the position would have been the same for capital gains tax purposes: see TCGA 1992, section 97(4), as in force in June 2016.

The question that now arises is whether, and if so how, the above conclusion is affected by the enactment of Schedule 9 to the F(No 2)A 2017. In what follows I shall focus on the ‘transfer of assets abroad’ provisions in section 731 *et seq*. But the analysis should in principle be equally applicable for capital gains tax purposes.

Para 2 of Sch 9 inserted new provisions into the ITA 2007, as follows:

**“742B Value of certain benefits**

*Sections 742C to 742E apply where it is necessary, for the purpose of calculating a charge to income tax under the preceding provisions of this Chapter, to determine the value of a benefit provided to a person by way of –*

*(a) a payment by way of loan (see section 742C)...*

**742C Value of benefit provided by a payment by way of loan**

*(1) The value of the benefit provided to a person (P) by a payment by way of a loan to P is, for each tax year the loan is outstanding, the amount (if any) by which*

*(a) the amount of interest that would have been payable in that year on the loan at the official rate, exceeds*

*(b) the amount of interest (if any) actually paid by P in that year on the loan.”*

Since X will not actually be paying any interest on the loan until it matures in June 2021 it might appear that these new provisions impose a charge on him under section 731 *et seq.*<sup>2</sup> Given HMRC’s well-known distaste for ‘rolled up interest’ loans in this context, it is reasonable to assume that these new provisions were intended to apply to such loans. But do they apply to the loan made to X?

It is in my view clear, as a matter of construction, that sections 742B and 742C only apply where the loan in question actually constitutes a “benefit” to the borrower. If the loan does not confer a “benefit” on the borrower then the new provisions should not apply. There must be an actual “benefit” before one is required to value anything. That, on any fair reading, is what sections 742B and 742C say. Accordingly, if the terms of the loan made to X in 2016 were such that there was no “benefit” to him, he should not in my view be caught by the new provisions.

I am fortified in this view by the absence of a provision corresponding to the recently inserted section 173(1A)(a) of

ITEPA 2003<sup>3</sup>. Section 173(1A)(a) is intended to, and does, tax the so-called “benefit” of employer-related ‘rolled up interest’ loans which do not actually confer any benefit. The draftsman recognised the ‘no benefit’ problem and circumvented it by providing that where you have an employer-related loan “*the loan is a benefit for the purposes of this Chapter (and accordingly it is immaterial whether the terms of the loan constitute a fair bargain)...*” Job done! But, as I say, there is no corresponding provision in the context of the new sections 742B and 742C.

I recognise, of course, that HMRC might very well challenge the view expressed above as to how sections 742B and 742C apply (or don’t apply) and I recognise further that, in the current climate, a Tribunal/Court might very well side with HMRC. Anyone contemplating making a new ‘rolled up interest’ loan today has been warned! But on my reading, sections 742B and 742C should not apply in the absence of an actual “benefit”.

Even if I am wrong on the ‘absence of benefit’ point, X has a further argument as to why the new provisions do not apply to the loan made to him in June 2016. Para 3 of Schedule 9 to the F(No2) A) 2017 provides that: “*The amendments made by this Schedule*” – i.e. the insertion of sections 742B and 742C – “*have effect in relation to... benefits received in the tax year 2017-18 and subsequent tax years.*”

In my view any “benefit” received by X was received in June 2016 when the loan was made. Accordingly, the new provisions should not be in point.

Let us test it in this way. Suppose the five year term loan made to X in June 2016 was expressed to be interest free. Clearly X would have received a “benefit” when the loan was made, and the benefit would have been taxed under section 731 *et seq* in 2016-17. I hope that no one – not even HMRC – would seriously suggest that X received further taxable benefits in the five succeeding years, by virtue of sections 742B and 742C<sup>4</sup>.

Now let us suppose that it transpires that the loan actually made to X in June 2016 contained a small element of benefit, because the agreed rate of rolled up interest was marginally too low to constitute a 'fair bargain'. Again, any such benefit should have been taxed in 2016/17 and should not be taxed again in subsequent years. That being so, it surely cannot be right in X's actual case – where his loan was a 'fair bargain' and did not confer any 'Day 1 benefit' – that he should be taxed by virtue of the new provisions. X's 'benefit' – or non-benefit – must equally have been received before 2017-18.

Again, I believe this argument to be correct. But, again, one should not be too surprised if, on some basis or another, it was successfully challenged by HMRC.

That leaves the question of what X should do. Realistically, he has only two options. First, X might take his chance that at least one of the arguments outlined above would be upheld, so that sections 742B and 742C do not apply to his loan. If this course is adopted it would be sensible for X to make full disclosure to HMRC. Alternatively, X could renegotiate the terms of his loan and pay interest each year at (at least) the official rate<sup>5</sup>.

If this latter course is adopted one has to consider whether X is obliged to deduct, and account for, income tax at the basic rate when making the payment of interest: see ITA 2007, section 874(1)(d)<sup>6</sup>. This depends on whether or not the interest has a UK 'source'. The recent Upper Tribunal decision in *Ardmore Construction Ltd v HMRC* [2016] STC 1044, which purports to follow the House of Lords decision in *Westminster Bank v National Bank of Greece SA* [1971] AC 945, tells us that in determining source, one must apply "a multifactorial test"; this apparently requires a consideration of three factors, namely (i) the residence of the debtor; (ii) the location of the security; and (iii) the ultimate or substantive source of discharge of the debtor's obligation, i.e. where the funds used to pay interest and principal have come from.

In X's case, factor (i) suggests a UK source, factor (ii) suggests a non-UK (i.e. Portuguese) source and factor (iii) suggests a non-UK source (Portuguese or Jersey), on the basis that the payment of principal and interest will either be funded from a sale of the property or by a further loan from the trust. Precisely where this leaves us, when it comes to applying the multifactorial test, is anyone's guess. But Ardmore is due to be heard in the Court of Appeal in March this year so we should, or may, soon be a little wiser<sup>7</sup>. But don't hold your breath.

A tax adviser's lot is today not a happy one!

### ***Endnotes***

1. I recognise that HMRC might take issue on this point.
2. The House of Lords decision in *Paton (as Fenton's Trustee) v IRC* 21 TC 626 establishes that where interest is compounded/rolled up in a year it is not "actually paid" in that year.
3. Section 173(1A)(a) was inserted by section 7(8) of the FA 2016.
4. See *Billingham v Cooper* [2000] STC 122, at p.129h and p.134a.
5. By the time this article is read it may be too late to pay interest in 2017-18.
6. Typically, the loan agreement will provide that if the borrower is required by law to deduct income tax he must in effect 'make good' the deduction and pay the full gross amount to the lender.
7. This article was written in February 2018