

TAX PLANNING BULLETIN

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Introduction

Since our last Bulletin the Gordon Brown has departed to higher things and Mr Darling has been appointed as Chancellor of the Exchequer. With his predecessor now installed as his boss it is doubtful whether the new Chancellor will depart very far from the fiscal policies which have ruled for the last ten years; over complication, inaccurate legislation, misleading Revenue pronouncements and obfuscatory tax increases.

Readers will know that “Darling” is the surname of Wendy and her family in Peter Pan. Item A1 shows why HMRC’s guidance on the so-called ‘Capital Loss TAAR’ is simply fantasy from Never-Neverland. Item 6 contains yet another example of HMRC attempting to correct over-restrictive legislation by publishing an over-generous construction of the legislation in its guidance. For the first time the Government seems to be willing to defend this deleterious practice. In relation to the TAAR, Mr ‘Ed’ Balls told the Finance Committee that:-

“In the real world of tax policy making and in the real world of business, the best way to provide clarity is not always to make legislation more complex or restrictive. Indeed, adding such complexity can undermine the best efforts of both sides to find a sensible way forward. That is why consultation on guidance, rather than restriction of legislation, can often be a better way to proceed in tax policy making.”

This is a bare-faced attempt to justify a practice of which HMRC have, until now, had the grace to be ashamed. It marks a significant new stage in the Government’s progress towards a regime in which tax is levied by administrative fiat rather than by the law.

In this new regime advisers must take account of the law, of HMRC’s, often misleading, statements of the law and of the practical implications of reconciling them. In practice, the Revenue’s incorrect statements of the law may be of great use to the taxpayer but relying on those statements always requires care and exact analysis.

As always, we would like to help you find a practical answer to these problems of technical complexity and uncertainty. If you would like our help on any matter please contact us by telephone or by email.

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A. CAPITAL GAINS TAX

1. TAAR for Capital Losses

FA 2007, s.27 inserted a new s.16A into TCGA 1992 providing that a person's loss is not an allowable loss if:-

- “(a) It accrues to the person directly or indirectly in consequence of, or otherwise in connection with, any arrangements and,
- (b) The main purpose, or one of the main purposes, of the arrangements is to secure a tax advantage.¹”

'Arrangements' is widely defined as including “any agreement, understanding, scheme, transaction or series of transactions (whether or not legally enforceable).” The definition of a 'tax advantage,' which is based on that in ICTA 1988, s.709(1), is also very wide.

It will be noticed that the securing of a tax advantage does not have to be the main purpose of the arrangements but only a main purpose.

This legislation will deny loss relief to much ordinary tax planning.

Widespread Criticism

The legislation was first published in a draft on December 6, 2006 and it has been criticised by all of the major taxation bodies as denying loss relief to many ordinary tax planning transactions. HMRC has consistently denied that this is the case, issuing successive drafts of 'guidance' on the legislation (issued in a final form on July 19, 2007) which has itself been criticised as misleading and inaccurate.

On February 9, 2007, in a paper supported by STEP, The Law Society and the ICAEW's Tax Faculty, the CIOT endorsed the Government's declared policy of ensuring that those who deliberately and knowingly create capital losses by means of complex or convoluted schemes of transactions should not be enabled to claim relief but concluded:-

“ ... we have some serious reservations about the way in which the policy is being enacted. In our view it will affect a much wider range of transactions than is suggested in the guidance notes, and ... taxpayers ... undertaking what they consider to be 'standard' end of year tax planning will be caught.”

The paper went on to say that the:-

“... guidance does not reflect or explain the legislation. Indeed ... in some places the guidance contradicts the legislation ... New rules must be implemented by legislation and not by extra-statutory concession or guidance notes ... While guidance notes are helpful, they are not a substitute for proper legislation.”

The paper concluded:-

“In its unamended form, the legislation is likely to catch a range of transactions that most taxpayers would consider to be 'normal tax planning' rather than tax avoidance.

¹ TCGA 1992, s.16A(1): all references are to the TCGA 1992 unless otherwise stated

We do not think it is acceptable that taxpayers must rely simply on HMRC guidance to say that they are not caught...”

When the Finance Bill was published with the legislation unchanged the professional bodies made similar representations; and substantial criticisms were made by both main opposition parties in the Finance Bill Committee Debates. In spite of the overwhelming weight of informed opinion, the Government has enacted the provisions published in December 2006 without any change whatsoever.

Inaccurate Examples

The Guidance contains eighteen examples of how the legislation applies to various situations. Its analysis reaches the correct conclusion for the correct reasons in only five out of those eighteen examples. In four, it reaches the correct conclusion for the wrong reasons and in nine its conclusions are simply wrong. In those nine, the Guidance asserts that the legislation will not apply to circumstances where it does. Why is the Guidance so consistently wrong? On June 1, 2007, the CIOT commenting on the final draft of the Guidance, said:-

“In our view clause 27 of the Finance Bill (in its present form) is perfectly clear. Our difficulties are not with the meaning of the legislation, but with its width ... this is a clear case where the proposed guidance is likely to be ineffective because we believe that it is (improperly) attempting to concede by concession relief from losses which clause 27 has not granted.”

The paper identified the source of the Guidance’s errors:-

“You appear to be of the view that “main purpose” here is an objective test rather than a subjective one. You also appear to be of the view that, if the transaction is carried out in a straightforward way and/or has a genuine economic outcome, then the transaction cannot be said to have gaining a tax advantage as one of its main purposes.

We think that this view is fundamentally wrong.”

The Guidance’s Treatment of the Main Purpose Test

The Guidance nowhere says that the “main purpose test” is “objective” but the CIOT are certainly correct as to the paper’s methodology.

The Guidance says (at para 11):-

“The purpose of the arrangements is determined by the purpose of the participants in entering into the arrangements.”

Here, the Guidance is almost but not quite correct. In *Snell v Revenue & Customs Commissioners*,² which concerned the purposes of arrangements under TCGA 1992, s.137, the Court accepted that the purposes of the taxpayer who planned and undertook arrangements were the “relevant” information from which to determine the purposes of these arrangements. In the leading case on the purposes of trading expenditure, *Mallalieu v Drummond (Inspector of Taxes)*,³ Lord Brightman stated that:-

² *Snell v Revenue & Customs Commissioners* ChD [2006] EWHC 3350

³ *Mallalieu v Drummond (Inspector of Taxes)* HL [1983] STC 665

“The [relevant statutory tests did] not refer to ‘the purposes’ of the taxpayer ... They refer to ‘the purposes’ of the business which is a different concept, although the ‘purposes’ (i.e. the intentions or objects) of the taxpayer are fundamental to the application of the paragraph ... To ascertain whether the money was expended to serve the purposes of the taxpayer’s business it is necessary to discover the taxpayer’s ‘object’ in making the expenditure ... As the taxpayer’s ‘object’ in making expenditure has to be found, it inevitably follows that ... the Commissioners need to look into the taxpayer’s mind at the moment when the expenditure is made.”

Thus in determining the purposes of a transaction one looks at the objects of the person or persons who undertook that transaction and that involves determining the state of that person’s mind at the relevant time. It is thus a purely subjective test (see also *John Pimblett & Son’s Ltd v Customs & Excise Commissioners*⁴, *Vodafone Cellular Limited v Shaw*⁵ and *Coffee Republic v Commissioners of HMRC*⁶).

Para 11 goes on:-

“If any participant who has entered into the arrangements has done so with a main purpose of achieving a tax advantage, that will constitute a main purpose of the arrangements.”

This is an important error. As we have seen, one determines the purposes of arrangements from the objects of the participants. Because one participant has an object of avoiding taxation that does not, of itself, result in that being a main purpose of the arrangements if the participant’s involvement in the arrangements is peripheral. What is required is to determine whether a purpose of the arrangements is a main purpose, not whether an object of a participant is one of his main objects.

What is clear is that s.16A can apply where the tax avoidance purpose is that of a third party. In their February paper the CIOT gave the following example:-

“A (who is UK domiciled and resident) sells a non-UK situs asset at a loss to an unconnected person, B (who is UK resident but not domiciled). B – who could have purchased a similar UK situs asset instead – has a main purpose of enabling future gains to be taxed on a remittance basis. This purpose may be unknown to A.”

Here, were it not for s.16A, an allowable loss would have accrued to A. The sale is an arrangement within the statutory definition because it is a transaction. In considering the purpose of that arrangement one considers the objects of the persons who entered into it. B’s object in entering into the transaction must be of equal weight to A’s. Therefore B’s object of avoiding tax on future gains is a main purpose of the arrangement. One of the main purposes of the arrangements, therefore, is to secure a tax advantage. The result is that A does not realise an allowable loss.

At paragraph 12 the Guidance goes on to say:-

“There is no one factor that determines whether the obtaining of a tax advantage is a main purpose of an arrangement. All the circumstances in which the arrangements

⁴ *John Pimblett & Sons Ltd v Customs & Excise Commissioners* [1988] STC 358

⁵ *Vodafone Cellular Limited v Shaw* [1997] STC 734

⁶ *Coffee Republic plc v Commissioners for HMRC* [2007] LON/2006/0756

were entered into need to be taken into consideration. The circumstances might include:

- the overall economic objective: this should be considered not only from the perspective of individual participants in the arrangements, but also from any wider perspective, such as that of the settlor or beneficiaries of a settlement whose trustees were participants; for these purposes an economic objective does **not** include tax motivated reasons;
- whether this objective is one which the parties involved might ordinarily be expected to have, and which is genuinely being sought;
- whether the objective is being fulfilled in a straightforward way or whether the introduction of any additional, complex or costly steps would have taken place were it not for the tax advantage that could be obtained.”

Determining the purposes of arrangements from the objects of the participants in entering into the arrangements involves determining the state of the participants' minds at a particular time. That is an enquiry of fact to be determined upon evidence. The factors listed in paragraph 12 should be no more than examples of evidence which may be relevant to determining the state of the participants' minds at the relevant time. They are clearly not the only evidence which one might consider and in many cases one will have more direct and more relevant evidence. For example, one might have correspondence between a taxpayer and his advisers setting out why particular transactions or actions were to be adopted as was the case in *Snell v HMRC*. Nonetheless, if the factors set out in paragraph 12 are merely examples of the sort of evidence which HMRC will consider in determining participants' objects in entering into the arrangements then they are unobjectionable.

In fact, in the Guidance, they appear to be alternative or further tests in addition to, or in substitution for, the statutory purpose test.

The example in Boxes 1 and 2 reproduce Examples 4 and 15 in the Guidance although with my analysis rather than HMRC's. In relation to the example in Box 1 the Guidance says:-

“It is ... necessary to consider whether securing a tax advantage was a main purpose of those arrangements, and to do so it is necessary to take account of all the circumstances in which the arrangements were entered into, including the participants' overall economic objective, and whether that objective is being fulfilled in a straightforward way, or whether additional, complex or costly steps have been inserted. Mrs H's decision to acquire shares in S Plc was unconnected with Mr H's disposal of similar shares, and Mr H has simply taken advantage of the statutory relief for capital losses in section 2(2) in a straightforward way. Moreover, Mr H has incurred a real economic loss on a genuine disposal to a third party. Mrs H has made a genuine purchase on arm's-length terms. These factors suggest there was no main purpose of obtaining a tax advantage, so these transactions do not fall foul of the TAAR.”

It is not necessary to have regard to whether the participant's economic objective “has been fulfilled in a straightforward way, or whether additional complex or costly steps have been inserted” in this example because we are told as a fact that Mr H “sells shares in a company ... in order to crystallise a loss which can be set against his chargeable gains arising in a year.” His object in the transaction is to obtain a tax advantage. Whether that is done in a straightforward or complex way is simply not part of the statutory test.

Commenting on a similar example in a previous draft (which omitted the irrelevant information in relation to the wife's transactions) the CIOT commented:-⁷

“We cannot see why the new legislation, as drafted, does not apply here. Are there arrangements? Yes. There is a ‘transaction’ (the sale of the shares in [S] ... plc). Is there a ‘tax advantage’? Yes, [Mr H] obtains relief from tax. Is securing that relief one of the main purposes of the transaction? Yes, [Mr H] would not have sold the shares in [S] plc were it not for the ability to offset the loss.”

Similarly, in relation to the example in Box 2, the Guidance says:-

“To decide what J’s main purpose was in entering into these arrangements, it is necessary to consider the overall economic objective of the arrangements, and whether that objective is being fulfilled in a straightforward way, or whether additional, complex or costly steps have been inserted. J has made a real disposal of a capital asset in a straightforward way, and has incurred a genuine economic loss. There have been no additional, costly or complex steps inserted into the transactions. The fact that the disposal has been made with a view to using the proceeds to invest in shares which fall within the EIS tax regime does not mean that the arrangements have been entered into with a main purpose of securing a tax advantage, because the straightforward use of a statutory relief does not of itself bring arrangements within the TAAR. Hence the TAAR does not apply.”

In this example, we are told as a fact that J makes his investment “with a view to securing income tax relief”. That is plainly, therefore, a main purpose of the transaction and one does not need to look for further evidence as to the transaction’s purpose. The fact that the investment is straightforward does not mean that J has not made it with the object of obtaining Income Tax relief.

In commenting on the example when it first appeared in an earlier draft the CIOT agreed with the analysis I have given and said⁸:-

“Whilst we agree that it is right the legislation should not apply in these circumstances, again we cannot follow the logic ...

The conclusion that the transaction is not caught does not appear consistent with the explanation of when the legislation applies, given in paragraphs 7 to 14 of the revised guidance.

We would stress that we agree with the conclusion reached in Example 10 of the revised guidance that the loss should, as a matter of principle, be allowable, but on the basis of the actual legislation suggest it is not ...”

If HMRC had wanted the evidential categories in paragraph 12 of the Guidance to be part of the statutory test, the Government could have enacted the legislation in that form. Indeed, in Committee the Opposition put forward various amendments to restrict the scope of the section including amendments designed to restrict it to artificial or complex transactions. The Government rejected the amendments on the basis that they would allow some tax avoidance which they wished to be caught to escape the ambit of the section. It is clear that the

⁷ In a paper dated February 9, 2007 at para 6.2

⁸ In a paper dated April 2, 2007 at paras 24-26

Government have intentionally made a provision which will apply to much standard tax planning in order to ensure that it will catch all of the transactions which it considers objectionable. In the words of the CIOT the taxpayer is to be “taxed by law” but “untaxed by concession”. The Government refuses to acknowledge this. The Economic Secretary to the Treasury, “Ed” Balls said in Committee that “The Guidance is not concessionary, as alleged by the CIOT.” As we have seen the CIOT stuck to its guns saying on June 1, 2007:-

“in our view this is a clear case where the proposed guidance is likely to be ineffective because we believe that it is (improperly) attempting to concede by concession relief from losses which clause 27 has not granted.”

What Should Advisers Do?

What are taxpayers and their advisers to do where the Government deliberately publishes false guidance on the law? Can they rely on the Guidance? Unfortunately, it would be unsafe to do so.

There are a number of reasons for that.

First, the Guidance is rarely expressed with sufficient precision for a taxpayer to clearly show that he falls within its terms. For example it says⁹:-

“In particular it is unlikely that individuals with a normal portfolio of investments who make disposals in the ordinary course of managing their portfolio would be affected by these new rules ...”

It does not define what is meant by a “normal portfolio” or “disposals in the ordinary course of managing” that portfolio.

Secondly, the Guidance is hedged around with caveats. For example, paragraph 26 explains that:-

“Examples of how the legislation will apply in particular circumstances are set out below. These examples are intended to show how different factors will be taken into consideration in deciding whether or not the TAAR applies in a given set of circumstances. They are not designed as templates for deciding whether a loss is or is not caught by the TAAR in any particular case. That can be determined only in the light of all the actual facts and circumstances.”

So it would appear that even if a taxpayer’s situation exactly matches an example it would be possible for HMRC to reach a different conclusion on the application of s.16A.

Thirdly, as the CIOT has pointed out, it is inevitable that the examples will leave gaps allowing the legislation to be applied differently to cases involving facts differing only slightly from those in an example.

Even if the taxpayer were able to show that his circumstances were exactly covered by the Guidance, would HMRC be bound by it? The Guidance is not binding on the Special Commissioners or the Courts (see *Gaines-Cooper v HMRC*¹⁰).

⁹ HMRC Guidance at para 3

¹⁰ *Gaines-Cooper v Revenue & Customs Comrs* [2007] STC (SCD) 23

It is unlikely that the remedy of judicial review will be available. It is clear that the Revenue do have the power to make extra statutory concessions but only in:-

“...the interstices of the tax legislation, dealing pragmatically with minor or transitory anomalies, cases of hardship at the margins or cases in which a statutory rule is difficult to formulate or its enactment would take up a disproportionate amount of parliamentary time.”¹¹

It is the opinion of the professional bodies that s.27 is a provision of the widest possible application and that the Guidance purports to restrict its application radically. Even if the Court were to agree that HMRC had held itself out as applying a concessionary treatment it is likely to find that concessionary treatment to be ultra vires.

Even if it were possible for the taxpayer to enforce the application of the Guidance through judicial review that remedy is discretionary, highly uncertain, expensive and subject to onerous time limits.

In completing their self assessment returns, can taxpayers safely take advantage of losses which are disallowable in law under s.16A but which they suspect, on the basis of the Guidance, HMRC may be willing to allow?

It would be foolhardy to do so. *Jones v Garnett*¹² showed that HMRC are happy to reverse the practice of years in an attempt to establish a strained and artificial construction of taxation legislation where there is substantial tax at stake. How much more likely are they to reverse an overgenerous interpretation of this legislation?

One approach might be for the taxpayer to use the white space to disclose that he has taken advantage of a loss which is not allowable under the relevant tax legislation on the basis that it seems to be in accordance with the Revenue's published views in the Guidance. That might be an example of a rare occasion where a taxpayer's disclosure fulfils the criteria set out in the case of *Veltema v Langham*¹³ providing protection against the imposition of penalties under TMA 1970, s.95.

In its submission on June 1, 2007 the CIOT said:-

“... we ought also to put on record that we are considering whether the proposed guidance might be challenged by judicial review. We are at an early stage of our thinking on this front, but our initial thinking is that it may be appropriate to bring early judicial review proceedings to clarify the status and effectiveness of the guidance.”

Although that would put the CIOT in the uncomfortable position of asking the Courts to restrain HMRC from applying concessionary practices favouring the taxpayer, the application should proceed. The present situation leaves taxpayers and their advisers in an unacceptable position of uncertainty.

In any event, Tax Advisers will require the independent guidance of their own professional bodies as to how they should deal with the contradictions between the actual content of s.16A and the view of it taken in HMRC's Guidance.

¹¹ *R (on the application of Wilkinson) v Inland Revenue Commissioners* [2005] UKHL 30

¹² *Jones v Garnett (Inspector of Taxes)* [2007] All ER (D) 390

¹³ *Veltema v Langham CA* [2004] STC 544

Box 1 – Sale of shares to realise a capital loss

The Facts

Mr H sells shares in a company, S Plc, in order to crystallise a loss which can be set against his chargeable gains arising in the year. Unbeknown to Mr H, his wife Mrs H, buys shares of the same class in S Plc a few days later, at the same price as Mr H sold the original holding.

The Correct Analysis

Mr H has obtained a tax advantage because he has obtained a relief from tax. His disposal of the shares constitutes arrangements because ‘arrangements’ include “any... transaction”. The loss resulting from the disposal falls within the new s.16A(1)(a) because it accrues to Mr H “directly ... in consequence of ... [the] ... arrangements.”

Section 16A applies and Mr H’s loss is therefore not an allowable loss.

His wife’s transactions would only be of any relevance to the matter if they provided evidence as to Mr H’s purpose in making his disposal. As Mr H is ignorant of his wife’s transactions they do not do so.

Box 2 – Investment in EIS Shares

The Facts

An individual, J, invests in shares under the Enterprise Investment Scheme with a view to securing Income Tax relief. In order to fund the purchase of the shares J sells the capital assets which are standing at a loss to a third party.

The Correct Analysis

The sale of the shares and the purchase of the Enterprise Investment Scheme shares are clearly arrangements because they are a series of transactions planned and undertaken by reference to each other. We are told as a fact that the purpose of J’s investment in the EIS shares was to secure Income Tax relief. A main purpose of the arrangements is therefore to secure a tax advantage. What would otherwise be an allowable capital loss accrues to J “directly ... in consequence of ... [the] ... arrangements.” Section 16A therefore prevents J’s capital loss from being an allowable loss.

2. Offshore Trusts: Capital Payments

Herman and another v HMRC: The issue

Amounts were transferred to a husband and wife from a personal settlement. The question was whether those amounts were received by the taxpayers indirectly from the trustees of a family settlement for the purposes of TCGA 1992 s.97(5)(a).

The facts

The taxpayers were a husband and wife ('H and W'). In 1990 H created a non-resident settlement of which he and his family were beneficiaries (the "non-resident trust"). By 1998 the 'stockpiled gains' of the family settlement were some £2m. On 4th February 2002 H created a UK resident settlement of which he and W were beneficiaries and trustees; a UK solicitor was the third trustee (the "UK trust").

In February 2002 the trustees of the non-resident trust, having borrowed money and purchased a holding of Treasury stock, appointed the Treasury stock and the cash and the benefit of an unsecured loan from H to the trustees of the UK trust. In March 2002 the trustees of the UK trust appointed all of the trust assets to H and W in equal shares absolutely.

An issue arose whether the trust gains for the year 2001/02 (which included the stockpiled gains of some £2m) were to be treated as chargeable gains accruing to H and W in that year. That depended on the application of TCGA 1992 s.87(4) which would apply with that effect if H and W, as beneficiaries of the non-resident trust had received '*capital payments*'; for that purpose a capital payment was regarded as received by the person in question from the non-resident trustees '*... if he receives it from them directly or indirectly*' (s97(5)). HMRC argued that the amounts received by each of H and W in March 2002 were to be regarded as received from the trustees of the non-resident trust. H and W contended that ss.87(4) and 97(5) did not, properly construed and in the circumstances of the case, produce that result. It was common ground that the transactions were carried out in order to implement a CGT avoidance scheme known as a 'Mark II flip-flop'.

Prior to the amendments introduced by FA 2000, where property was transferred from a non-resident to a resident settlement, s.90 applied to carry over the realised gains of the non-resident trustees to the resident trustees. But it did not apply to gains realised by the non-resident trustees after the transfer. That gave rise to arrangements known as 'flip-flop' schemes. Under a 'Mark I' flip-flop scheme, for example, the trustees of a non-resident settlement held assets worth £1m. The assets had a CGT base cost of £0.5m. The trustees borrowed £1m and advanced it by way of resettlement on the trusts of a resident settlement for the benefit of beneficiaries of the non-resident settlement. The non-resident trustees sold the assets and discharged the borrowings. Because s.90 did not apply to the post-advancement gains, they were left in the (now redundant) non-UK resident settlement.

FA 2000 enacted two new schedules, TCGA 1992 Schs 4B and 4C which applied where there were transfers between settlements 'linked to trustee borrowings'. Those provisions were effective to counter Mark I schemes. But at the same time a new s.90(5) was inserted which paved the way for Mark II flip-flop schemes designed for cases where there were pre-existing stockpiled gains. The scheme was used where the settlement carrying out the transfer of value had already disposed of all or most of its assets, but the gains had not yet been attributed to beneficiaries. The transfer of value to another settlement triggered a deemed

disposal of the settlement's assets, but the settlement had few if any unrealised assets so there were few if any gains to go into the Sch 4C gains pool. Since the legislation only required gains created by the deemed disposal to go into the pool, any existing unattributed gains remained in the transferor settlement and it was claimed that the capital from the transfer of value could then be paid out to beneficiaries by the trustees of the transferee settlement without triggering a CGT charge.

H and W appealed against adjustments to their self-assessment returns for 2001/02.

The decision: SpC (Sir Stephen Oliver QC)

Unless there was anything in a wider context that precluded it, the correct approach was to apply the statutory test contained in the words in s.97(5)(a) and work back to find the indirect source of the undisputed receipts. The underlying aim of the particular code was to attribute trust gains to beneficiaries according to any benefits they received in a form that was not subject to income tax. That was the framework created by ss.87 and 97. Moreover, it was implicit in the arguments for the taxpayers that, had the relevant arrangements been entered into prior to FA 2000, a charge to CGT would have arisen in respect of the payments they had received.

The right approach was to make an enquiry, using whatever signposts appropriate to the circumstances were available, and to determine whether the taxpayers' receipts could properly be linked to the disposition from the family settlement as their indirect source. An obvious signpost would be the existence of a plan. In the present circumstances the appointment by the trustees of the non-resident trust was in pursuance of the Mark II flip-flop scheme. If the relevant receipt resulted by accident or on account of circumstances not envisaged by the scheme, then the linkage might not be there. The second signpost was to analyse the trust law and determine whether the UK trust was a vehicle to receive and continue the act of bounty effected by the trustees of the non-resident trust. The precise means by which the scheme was implemented would be relevant to whether there was sufficient linkage to make the payments 'indirectly' receipts from the trustees of the non-resident trust.

It was clear from the evidence that the plan involved almost the entire contents of the non-resident trust, as at February 2002, being transferred to the trustees of the UK trust and then on to H and W, free of all charges to CGT. In particular the plan was designed to leave the trust gains of the non-resident trust stranded off-shore; and to avoid the impact of any corrective legislation the scheme had to be completed before the 2002 Budget. The implementation of the scheme went beyond looking after the interests of the non-resident trust. As far as the trusts were concerned, every step in the implementation of the plan was related. The transfer from the trustees of the non-resident trust to the UK trust was in process of a properly exercised power for the benefit of the two beneficiaries, H and W as the intended recipients of the amounts transferred.

H and W were aware of the plan and were specifically consulted as to its purpose and means of implementation. They kept their options open as to whether and when the UK trust should be closed. Nevertheless they agreed to the adoption and implementation of the plan at every stage. The outcome was intended, though not necessarily preordained. That outcome was the release of the funds originating from the non-resident trust to H and W absolutely. To conclude otherwise would be shutting one's eyes to the obvious. The appeal was dismissed.

(Herman and another v HMRC SpC 609 26.3.07 reported at CCH Weekly Tax News Issue 450 21.5.07 p450)

Comment

FA 2003 s.163 effectively countered the avoidance arrangement employed in this case.

What might the Special Commissioner have decided had the trustees of the UK trust not advanced out the capital to H and W – in particular, if they had simply paid income to H and W from the invested funds, on which an income tax liability would have arisen? Presumably then there would have been no ‘capital payment’.

We wait to see whether there will be an appeal from this decision. What would be interesting to see in any decision from a higher Court is the Court’s ruling on the approach of Sir Stephen Oliver QC which, in finding whether there was a ‘capital payment’, does not require two events to be ‘preordained’ within the classic *Ramsay* doctrine. It is enough if they were “intended by the parties”.

B. INHERITANCE TAX

3. Family Home: *Phizackerley* case

Context

It is a commonplace that, on the first death of spouses or civil partners, full use should be made of the nil-rate band (NRB) in passing assets to other than the survivor. Failure to do so, for 2007/08, is to lose, in broad terms, a potential IHT saving of up to £120,000 (40% of £300,000). In circumstances where suitable assets do not readily present themselves to constitute the NRB, it has for very many years now been accepted professional practice to make it up by either a debt owed by the survivor or (more specifically an undertaking given by the survivor to the personal representatives, which should be effective to mitigate SDLT) or a charge, typically an equitable charge, imposed by the personal representatives over the deceased's share in the house subject to which they assent that share to the survivor.

The arrangement is simply stated, but a number of both fiscal and practical issues need to be carefully watched. The particular issue in this case, decided by the Special Commissioner is the potential trap posed by FA 1986 s.103.

Phizackerley v HMRC: The facts

On his retirement in 1992 Dr Phizackerley and his wife bought a house in North Oxford as joint tenants for £150,000 (with a £30,000 mortgage which was repaid in 1994), funded entirely by Dr Phizackerley. In 1996 the joint tenancy was severed so that husband and wife together held the property as beneficial tenants in common in equal shares.

Mrs Phizackerley died in April 2000, with an estate not exceeding £210,000 (the NRB then being, incidentally, £234,000). Under her Will made in 1996 she left a nil-rate sum on discretionary trusts with residue to her husband absolutely.

On 28th December 2000 Dr Phizackerley, Stephanie Phizackerley and John Phizackerley made a deed of assent, of retirement and appointment and of agreement under which Dr Phizackerley assented to himself an undivided half-share of the house and promised to pay £150,000 (subject to indexation) to the trustees of his late wife's Will trust. Dr Phizackerley died in July 2002 with an estate valued at £529,654 ignoring a disputed liability (stated variously as £153,222.99 and £156,013).

A deduction for the liability was denied by HMRC on the grounds that, within the meaning of s.103, consideration given for the debt consisted of 'property derived from the deceased'. Dr Phizackerley had made to his wife a gift of £75,000 to acquire the house in 1992 (on the footing also that he alone paid the interest and repaid the capital on the mortgage) and one must infer from the decision that the whole of the debt was abated because the value of the half-share had increased to £150,000 in 2000. This would be through application of the difficult words in s.103(1) '*... that liability shall be subject to abatement to an extent proportionate to the value of any of the consideration given for the debt or encumbrance which consisted of – (a) property derived from the deceased ...*'.

The argument for the appellant

James Kessler QC argued that a way of escape was provided by IHTA 1984 s.11 (dispositions for maintenance of family). Under s.103(4) a disposition is not taken into account for purposes of s.103 if it is not a transfer of value (and is not part of specified associated operations). Section 11 provides that a disposition is not a transfer of value if it is made by one party to a marriage in favour of the other party and is for the maintenance of the other party. James Kessler argued that the provision of a half-share in the house constituted a disposition for Mrs Phizackerley's maintenance. Special Commissioner Dr John Avery Jones found for HMRC on this point: while there are circumstances in which the transfer of an asset to a spouse could be maintenance, the ordinary meaning of the word has a flavour of meeting recurring expenses. He noted the evidence of Dr Phizackerley's daughter that her father had felt it appropriate that the house be acquired jointly so that her mother would enjoy the security of joint ownership.

Commentary

The decision is unsurprising and uncontentious. Comment in the non-professional press was somewhat emotive, in arguing for the 'unfairness' of the provision – especially when the good late doctor had devoted his professional life to caring for children! But that of course is beside the point. The only technical issue is whether or not, within the meaning of the statute, the deceased had provided property to his wife as consideration given for the debt which he had undertaken to her Will trustees following her death. We must confess to a long-standing difficulty with the statutory wording, albeit clearly not one shared either by HMRC or by the Special Commissioner.

Indeed, the final sentence of the decision is '*The fact that the joint tenancy was severed four years after the purchase at the time their Wills were made indicates that inheritance tax planning took place in 1996 and the gift was not made with reference etc to the giving of the consideration of the debt*'. That therefore assumes that the concept of consideration for these purposes is not the familiar contract one and that there need be no connection between the gift and the subsequent debt. In this case there was an elapse of four years. But the gap may be very much longer than that. The only limitation in s.103 is that the debt or encumbrance arises on or after 18th March 1986, the commencement date for the reservation of benefit (GWR) code. The offending gift might have been made many years before that.

Section 103 may of course be regarded as 'the other side of the coin' of the principal GWR provision of s.102. Without it, for example, a father might make a gift to his daughter and then his daughter makes a loan back to her father with which, for example, he purchases a house to live in which he stills owns and does not repay the debt by the time of his death very much later. Section 103 will deny a deduction for the debt to the extent of the amount of the gift on the father's death – and it matters not whether the loan by the daughter to her father was at a commercial rate of interest.

It is very often in husband and wife cases that s.103 rears its ugly head: there is no let-out for inter-spouse transactions, which, albeit exempt, are still transfers of value. Nor is there any *de minimis* exception. Its scope must therefore be considered carefully in the case where, both when making the Wills and, following the first death, administering the Will of the first to die, there is evidence of more than insubstantial gifts by the surviving spouse to the deceased. If so, the debt route should be avoided at all costs, assuming of course that it is the donor spouse who survives – but one can never be sure in advance of the order of deaths. The major difficulty with s.103 is knowing quite how far the concept of '*property derived from the deceased*' goes in terms of lifetime gifts. While income gifts for maintenance would clearly be

excluded as not being transfers of value (the James Kessler argument), any gifts of capital would seem to be vulnerable.

Some commentators have expressed themselves surprised that no account was taken of the equitable rights in the family home and other property built up by a 'financially poor' spouse in the course of the marriage. This is of course a principle well-established in matrimonial cases as evidenced by a series of well-publicised decisions in the higher Courts. We understand, however, that these rights are not actual property rights during the marriage, whether under the general law or specifically for IHT purposes (as they might be for example under certain European matrimonial property regimes).

The major problem of course in terms of inter-spouse gifts is that of evidence. The facts of *Phizackerley* were unusual in that the first matrimonial home was bought only on retirement. Where, more usually, the first home is bought following or before the marriage and there is then over the years a series of 'tradings-up' with the benefit of interim capital appreciation, it will remain the case that if say a half-share in the first house was provided by one spouse to the other that will always remain vulnerable to s.103 if a simple debt scheme is adopted on the first death of the donee. While James Kessler's argument based on s.11 was rejected by the Special Commissioner, James has, in a posting on the Trusts Discussion Forum on 18th April 2007, affirmed his view that even after the decision the provision of mortgage repayments are exempt under s.11. Clearly, if it can be shown that the original donee spouse provided the mortgage repayment, that is provision by that spouse.

The charge route

A straightforward alternative, though perhaps slightly more complex to administer is the charge route. Assuming that the house was owned by the couple as tenants in common in equal shares, the legal estate (held as joint tenants) will pass to the survivor by survivorship and so the deceased will be left with only an equitable interest. Therefore any charge imposed by the personal representatives will be an equitable, rather than a legal, charge, not that that matters. Because the charge as an encumbrance is imposed by the personal representatives s.103 presents no difficulty on the second death. Similarly, if any indebtedness on the second death is a liability not of the surviving donor spouse but of trustees of a Will trust established by the first to die.

Conclusion

While the outcome of the case will have given little comfort to the appellant, its reporting is a salutary reminder to professionals that, however much a particular strategy might be 'accepted wisdom', its implementation in particular cases should always be adopted with care. This is certainly the case here. Further, all advisers should remember to emphasise to their clients that advice given, both at the time of drafting the Will and of executing it on the first death is provided on the basis of the law at the relevant time, that the law might always change in future and so any arrangements should be kept under careful review.

4. Pre-Owned Assets: Electing into Reservation of Benefit

HMRC have released a version of form IHT 500 which can be filled in onscreen.

Further HMRC comment

The following paragraph appears in HMRC's IHT Newsletter (April 2007).

“The third change proposed is to the Pre-Owned Assets legislation to allow us to accept a late election. The normal filing date for an election will continue to apply (i.e. 31 January in the tax year following the year of assessment concerned); and there is no change to the date to withdraw an election. This measure is aimed at people who may have been unaware that they were liable to the POA charge. Provided they elect into IHT as soon as practical after discovering they were liable to the POA charge, we will normally be able to accept a late election.”

Comment

No regulations, draft or final, have yet been issued pursuant to which Form IHT 500 should be promulgated – so it is hard to see that the election is made ‘in the prescribed manner’ as is required by FA 2004, Sch 15 para 21.

5. FA 2006 Schedule 20: Pre-existing Interests in Possession and Related Matters

Context

HMRC have responded to a joint letter from STEP/CIOT on a number of outstanding issues largely relating to the definition of an interest in possession. This is set out below.

The STEP/CIOT letter

“We are writing about a number of situations (set out in the questions below) where a person (A) was beneficially entitled to an interest in possession in settled property before 22nd March 2006. Doubt has been expressed as to whether IHTA 1984 s.49(1) will continue to apply in the future, notwithstanding that A will throughout be entitled to the income of the settled property. We consider that, in all those situations, s.49(1) will continue to apply, notwithstanding s.49(1A) which (with exceptions) disapplies that subsection where the interest in possession is one to which a person becomes beneficially entitled on or after 22nd March 2006.

It has been suggested that A will, after that date, become entitled to a different proprietary interest in the settled property. As HMRC argued in *Pearson v IRC* [1981] AC 753, and all the members of the House of Lords appear to have accepted, for IHT purposes the expression ‘interest in possession’ must be construed as a single phrase. *Pearson* decided that it means a present right to present enjoyment of the settled property, i.e. the right to the income from that property as it arises. And in each of the relevant situations, A became entitled to that right before 22nd March 2006. Section 49(1A) does not, therefore, in our view, apply.

If we are right about this, then it means that the IHT treatment of the relevant situations will not depend on the accident of the particular drafting technique adopted, with settlements being treated differently notwithstanding that A’s rights are the same and without any possible policy justification that we have been able to identify.

We would emphasise that, in each of the examples below, the trustees have not exercised any dispositive powers post-March 2006: the interest taken by A remains throughout merely an entitlement to income and, moreover, an entitlement which is defined under the terms of the settlement prior to March 2006.

We hope that you will be able to confirm that s.49(1) will continue to apply and, therefore, that the same pre-Budget interest in possession will continue to subsist in each of the following examples.

Example 1

- (1) Settled property is held on trust to pay the income to A for life contingently on A attaining the age of 25. The trust carries the intermediate income.
- (2) A attained the age of 18 on 1st January 2006 and thereupon became entitled to an interest in possession by virtue of Trustee Act 1925 s.31. Section 49(1) applies.
- (3) In our view, it will continue to apply after age 25, when the express trust to pay income to him comes into effect. On any footing, A has only one interest, being the present right to present enjoyment, brought into possession earlier than would otherwise be the case by s.31.

Question 1 – do HMRC agree?

HMRC Answer to Question 1 – yes

Example 2

- (1) Under a pre-Budget 2006 trust, A is entitled to capital contingently on attaining the age of 25 years. The clause goes on to provide that the trusts carry the intermediate income and Trustee Act 1925 s.31 is to apply.
- (2) The same clause provides that the capital should not vest absolutely on A attaining the age of 25 but should be retained on trust:-
 - (a) to pay the income to A for life, and then
 - (b) for A's children after A's death,
- (3) A attained the age of 18 on 1st January 2006. Section 49(1) applies.
- (4) In our view, s.49(1) will continue to apply after A attains the age of 25 on 1st January 2013, when the 'engrafted' trust to pay income to A comes into effect.

Question 2 – do HMRC agree?

HMRC Answer to Question 2 – yes

Example 3

The facts are the same as Example 3, except that the engrafted trusts are contained in a separate clause. In our view, the position is the same, and s.49(1) will continue to apply after A attains the age of 25.

Question 3 – do HMRC agree?

HMRC Answer to Question 3 – yes

Example 4

- (1) A became entitled to income at 25 in January 2006 and s.49(1) applies.
- (2) A is contingently entitled to capital at the age of 35, but the trustees retain overriding powers of appointment exercisable during his lifetime. He therefore attains only a defeasible interest in capital in 2016, and the capital remains settled property until his death.
- (3) In our view, s.49(1) will continue to apply after A attains the age of 35, notwithstanding that his contingent interest in capital is replaced by a vested but defeasible interest in capital.

Question 4 – do HMRC agree?

HMRC Answer to question 4 – yes

Example 5

Presumably, where a transitional serial interest (TSI) arose after 21st March 2006 but before 6th April 2008 (e.g. a pre-22nd March 2006 Budget life tenant's interest was ended in 2007 and A the new life tenant takes an immediate interest in possession and capital at 35 but that capital entitlement is defeasible being subject to any exercise of the overriding powers), HMRC would agree that s.49C continues to apply to A after he attains the age of 35 for the same reasons, i.e. that his TSI entitlement continues following his 35th birthday.

Question 5 – do HMRC agree?

HMRC Answer to Question 5 – yes

In all the above examples, A's interest arises under the terms of the Settlement, and not from the exercise of the trustees' powers. We think these examples can be distinguished from the case where a beneficiary is absolutely entitled to capital on reaching a specified age and the trustees positively exercise their powers to defer that absolute entitlement and maintain the interest in possession, where we understand that different issues may arise as set out in the previous reply to queries on Sch 20 – see questions revised in April 2007 and in particular Question 6.

HMRC Answer - agreed

Interest in possession which continues after death of life tenant

In some circumstances, an interest in possession may continue after the death of the person entitled to the interest up until their death. HMRC have confirmed that a lifetime assignment of an interest in possession will qualify as a TSI (assuming the other requirements are satisfied - Question 10 of Sch 20 letter) on the basis that the interest in possession will have 'come to an end' within the meaning of s.49C(3), presumably on the basis of IHTA 1984 s.51(1). There is no equivalent provision to s.51(1) in relation to transfers on death of an autre vie, but the entitlement of the prior beneficiary who is holding an interest pur autre vie will have come to an end, even though the interest itself will not have done so. This may arise, for example, where the Will of the deceased life

tenant leaves their residuary estate, which would include their remaining entitlement to the interest pur autre vie, to their surviving spouse.

Question 6

Do HMRC consider that, when a pre-Budget interest in possession beneficiary who holds the pur autre vie dies, any interest in possession in such property then taken by his spouse (or any other person if that occurs before 6th April 2008) will qualify as a TSI?

HMRC Answer to Question 6 - Yes. In the circumstances outlined, it would seem that the death of the beneficiary holding a pur autre vie interest must bring 'the prior interest' within the terms of IHTA 1984 s.49C to an end.

IHTA 1984 section 46B

We should be grateful if you would confirm your view in relation to pre-Budget 2006 settled life policies, where a policy is held on s.71 A&M trusts and the trusts are then converted into trusts within IHTA 1984 s.71D. Insurance premiums continue to be paid on the policy.

It is clear that the continued payment of the insurance premiums will be potentially exempt transfers under s.46B(5).

Question 7

Are the added rights arising from the payment of the premiums settled property within s.71D, or are they separate settled property which is within the relevant property regime?

There is no equivalent provision in relation to s.71D trusts to s.46B(2), which applies for s.71 trusts where premiums continue to be paid on or after 22nd March 2006. Section 46B(2) provides that the rights arising by reference to the payment of the further premiums shall also be within s.71 if they would be but for s.71(1A).

The rights arising from the payment of premiums on policies held on trusts where the payments are made after such trust has been converted to s.71D status do not appear to be strictly within s.71D(3), which is necessary for those rights to be held on trusts within s.71D. Section 46B(1) in relation to s.71 trusts refers to ss.46B(2) and (5), but s.46B(3) in relation to s.71D trusts only refers to s.46B(5).

Do HMRC accept that the policy held on s.71D trusts is, in reality, the same asset as that previously held on s.71 trusts and that, in effect, no new rights become comprised in the settlement so that all the policy and its proceeds would be within s.71D?

We would be grateful for HMRC's views on this.

HMRC Answer to question 7 – we do accept that any added rights from the payment of additional premiums would constitute settled property within s.71D. If a premium paid once the policy has become property to which s.71D applies gives rise to an addition to the settled property the addition will, in our view, automatically become property to which s.71D applies.

Section 200

Finally, we note that, under s.200(1)(c), a person with a non-qualifying interest in possession can become personally liable for the tax charged on death, with his liability limited only by reference to the value of the settled property (not the value of his actuarial interest). This seems a somewhat draconian provision, given that the beneficiary is no longer treated as beneficially entitled to the capital. Surely the liability should be limited to the property or income he actually receives? Similarly, in s.201(1)(b), the liability seems anomalous, given that most interests in possession will now be non-qualifying. Why should a beneficiary with a non-qualifying interest in possession have a greater personal liability than a discretionary beneficiary? Can we press for these sections to be reviewed?

HMRC Answer – we do not accept that there is an anomaly here. Although an IIP holder whose interest arose before 22nd March 2006 has been regarded as owning the underlying property for IHT purposes, in reality he has only ever owned a limited interest. The FA 2006 changes do not alter the IIP owner’s real position.”

Comment

These responses from HMRC are helpful. We do not propose to go through them in detail, but merely to observe that the time-honoured definition of an interest in possession as a *‘present right to present enjoyment’* (as held by the House of Lords in *Pearson and others v CIR* [1980] STC 318) tends to underlie the analysis. That is, generally, so long as the right to income continues, it matters not that there may be slight changes in the underlying basis for that interest. So, if, in a case within Example 1 or 2, A reached the specified age between 22nd March 2006 and 6th April 2008, the express interest in possession under the Deed would be the same interest and not a TSI – and therefore it would be open to the trustees to replace A’s interest with a TSI. Equally, a successive life interest for a surviving spouse on A’s death after 5th April 2008 would also be a TSI. And, in those examples A attaining the specified age after 5th April 2008, the s.49 regime simply continues.

However, apart from the rather grudging response given by HMRC to the question on s.200 (which is hardly likely to arise in practice), we must take issue with HMRC’s answer to Question 5. This goes back to their response to Question 6 of the 43 Questions put by CIOT/STEP: merely because the trustees exercise their powers to advance capital on continuing trusts, it is hard to see that the interest in possession thereafter should be a different one.

6. FA 2006 Schedule 20: The impact on Trusts for Children – HMRC Guidance

Guidance has been agreed with HMRC which outlines the way in which HMRC interpret IHTA 1984 ss. 71 and 71D-H. It should not be regarded as a comprehensive explanation covering all aspects of these sections.

There are three particular areas of concern, namely:

1. the meaning of "B" in the legislation;
2. the class closing rules;
3. the scope of settled powers of advancement.

“1. The meaning of “B” or “bereaved minor” in the legislation

Both s.71A and s.71D are drafted by reference to a single beneficiary (in s.71 D called “B” and in s.71A called the “bereaved minor”). However, HMRC consider that it is possible to pluralise B or the bereaved minor to include all beneficiaries within the relevant class provided they are alive at the date the s.71A or s.71D trust takes effect and are under the specified age.

Accordingly a Will trust in the following terms can qualify as a s.71A trust:

“to such of my children alive at my death as attain the age of 18 years and if more than one in such shares as the trustees shall from time to time by deed or deeds revocable or irrevocable appoint and in default of such appointment in equal shares absolutely at 18 provided that no such appointment shall be made and no such appointment shall be revoked so as to either diminish or to increase the share (or the accumulations of income forming part of the share) of or give a new share (or new accumulations of income) to a child who at the date of such appointment or revocation has reached the age of 18 nor to benefit a child who has been excluded from benefit as a result of the exercise of the power.”

Note the following:

- 1.1 It is not necessary to fix the shares in which each child takes income and capital while they are all under 18. Hence it is possible to pay out income and capital to the minor children in unequal shares.
- 1.2 The power of selection must not be capable of being exercised so as to vary the share of a child who has already reached 18. Assume three beneficiaries B1, B2 and B3. It is possible to specify at any time before the eldest (B1) reaches 18 the share he is to take but once he reaches 18 any further power of selection can only be exercised between B2 and B3. B1 ceases to be within the definition of “B” in these circumstances.
- 1.3 If the power of selection is exercised revocably then it is not possible by revoking that exercise to benefit someone who has been wholly excluded from benefit albeit revocably. If, for example, the whole relevant share is appointed revocably to B3 (but on terms that the appointment could be revoked to confer benefits on B1 or B2) then even though B1 and B2 are under 18 the trust ceases to qualify for s71A status. HMRC consider that it is not possible under the s71A regime for someone who is not currently benefiting to become entitled in the future. Practitioners will therefore need to be careful before exercising any power of appointment revocably.
- 1.4 HMRC do not consider that s.71A is breached merely because a power of appointment might be exercised in this way. Nor is it a problem if, in the above example, the power of appointment is exercised revocably so as to give B1 5%, B2 5% and B3 90%. Since B1 and B2 are not wholly excluded HMRC take the view that they can still benefit under a future exercise of the power since they remain within “B”.
- 1.5 Nor is there a problem if a beneficiary dies under 18 leaving children in whose favour there will be incorporated substitutionary provisions. Hence if B1 dies before 18 leaving children and his presumptive or fixed share passes to those children under

the terms of the Will, it is only from that point that the presumptive share of B1 will cease to qualify under s.71A and fall within the relevant property regime. The mere possibility that B1 could die before 18 with children taking his share does not breach the s.71A conditions. Any power of selection though must not be capable of varying the presumptive share of the deceased B1 once he has died - because B1's children are not within the definition of B and their share must not be increased or decreased after B1 has died.

- 1.6 No overriding powers of appointment can be included so that "B's" absolute entitlement could be defeated at 18 although the legislation provides that the existence of an extended power of advancement (i.e. an express or statutory power of advancement that could be used to defer the beneficiary's capital entitlement by, for instance, providing that his share was to be held on life interest trusts beyond the age of 18) will not in itself cause the trust to fail to satisfy the s.71A conditions from the outset. However, if the settled power of advancement is exercised so as to defer vesting of capital at 18 (e.g. by the making of a settled advance) then although there is no charge under s.71A on the ending of the bereaved minor trust the relevant share from that point falls within the relevant property regime.
- 1.7 All the points above apply to s.71D trusts set up by Will and to accumulation and maintenance (A&M) trusts which are converted to fall within s.71D before 6th April 2008 (or before a beneficiary has attained an interest in possession if earlier). Hence it will be necessary to ensure that any powers of appointment that are retained do not permit a beneficiary's absolute share to be altered after he has reached 25 or defeated on reaching that age and if a power of appointment is exercised revocably it must not be capable of benefiting anyone who has been wholly excluded from benefit (even if under 25 and even if the exclusion was revocable).

2. The class closing rules

- 2.1 Difficult questions arise where an existing A&M trust is converted into an s.71D trust. Existing A&M trusts can become s.71D trusts provided this happens on the earlier of the beneficiary taking an entitlement to income or by 6th April 2008. It will not be possible to convert an A&M trust into a s.71D trust after the beneficiary has become entitled to income on or after 22nd March 2006 because once a beneficiary takes entitlement to income it no longer qualifies as an A&M trust under s.71. Section 71D(3)(b) requires conversion of the trusts immediately before the property ceases to be property to which s.71 applies. Hence it will need to be s.71D-compliant by the time the beneficiary attains an interest in possession. Of course if one beneficiary becomes entitled to income from part of the trust fund the remaining part will remain within the A&M regime and so may be converted subsequently (but before 6th April 2008).
- 2.2 In the case of existing A&M trusts it is possible that the class of potential beneficiaries will not yet have closed. (This is different from s.71A and s.71D trusts set up by Will where by definition the deceased parent cannot have any further children, apart from the case of a child en ventre sa mere whose father has died). In the same way that HMRC do not consider "B" can include a beneficiary who has been excluded from benefit (albeit revocably) HMRC do not consider that B can include any unborn beneficiary, again, apart from a child en ventre sa mere.

- 2.3 So if, for example, an existing A&M trust in favour of the settlor's grandchildren provides that the class closes only when the eldest becomes 25 and the trust currently benefits only B1 and B2 (say grandchildren of a settlor) being the sole living beneficiaries aged 8 and 9, in order to be s.71D compliant, the terms of the trust must be amended to exclude any future born beneficiaries. If B1 and B2's parent has a further child in 2009 that child must not be capable of benefiting from the trust fund (except in the event of the death of either B1 or B2 in which case the relevant portion of the trust will from that point fall within the relevant property regime).
- 2.4 Hence the power to appoint shares must only be exercisable between all or some of the beneficiaries under 25 who are alive at the date of conversion to s.71D status. HMRC consider this follows from the drafting in s.71D(1)(a),(3)(b)(i) and (6)(a) when taken together.
- 2.5 This is not the case if an existing A&M trust continues to satisfy the conditions in s.71 beyond April 2008 because it falls within para 3 schedule 20 FA 2006. A trust which provides for all grandchildren to take outright at 18 will continue to have A&M status under s.71, as amended by para 3, Sch 20, beyond April 2008. It will be possible to pay income and capital between them in such shares as the trustees think fit and for future born children to benefit if the trust deed permits this flexibility provided that no child's share can be varied after reaching 18. The class should therefore generally be closed once the eldest child reaches 18.

3. The scope of settled powers of advancement

- 3.1 HMRC accept that the mere possibility of a power of advancement being used to defer entitlement to capital at 18 or 25 does not cause the trust to fail to satisfy the requirements of s.71A or s.71D given the terms of s.71A (4) or s.71D(7) respectively. If the power of advancement is exercised in favour of that person so as to create continuing trusts under which the beneficiary's capital entitlement will be deferred beyond the age of 18 or 25 as appropriate, those trusts will fall within the relevant property regime (with either no exit charge in the case of BMTs or with the usual exit charge under s.71E, computed according to the provisions in s.71F, assuming the proper exercise of the power causes property to be "paid or applied for the advancement or benefit of B"; otherwise, the computation would be under s.71G).
- 3.2 HMRC accept that in the case of A&M trusts (including trusts which are modified so that they satisfy the amended s.71 definition after 6th April 2008) the mere inclusion of a wide power of advancement is unobjectionable. The exercise of such a power will not trigger an inheritance tax charge if the beneficiary takes absolutely or an interest in possession (albeit not qualifying) on or before 18 (see s.71(4) IHTA 1984) and his capital entitlement is deferred beyond 18, although in the latter event, the trust for the beneficiary will thenceforth be a relevant property trust unless it can come within s.71D."

Comment

These three further points should be read with care, with a view to correct drafting. Generally, HMRC's views are welcome. However, under 1 (the meaning of 'B' or 'bereaved minor' in the legislation), we would take issue with the view expressed at 1.3 which we do not see follows from the legislation. Why should the revocable exclusion of a particular individual from future benefit under an s.71A or s.71D trust prevent the trustees from bringing him back into benefit,

so long of course as he is under the specified age of 18 or 25? However, pending further clarification on that issue, it might be safest to adopt the suggestion made at 1.4 when exercising such a revocable power.

As to 2.5 and the final sentence, while obviously the share of a child who has attained 18 cannot be varied, presumably the trustees could still vary the shares of children under that age and so (if thought desirable) bring in future born children?

Perhaps the greatest significance, however, is (3) (the scope of settled powers of advancement). HMRC effectively acknowledge that one can defer beyond age 18 or 25 as appropriate the age of capital vesting through judicious exercise by the trustees of their powers of appointment, so taking advantage of more favourable regimes before the relevant property regime takes effect at age 18 or 25 as appropriate.

What matters is that in exercising a power of advancement the trustees are clear that it is for the benefit of the beneficiary. And here it would be helpful (though not essential) for them to have a letter from the beneficiary with independent advice (after the action has been taken, to avoid the beneficiary being construed as a settlor) agreeing that the trustees' action is indeed for his benefit. The House of Lords decision *IRC v Pilkington* [1964] AC 12 is fundamental for the scope of the exercise of the power, as amplified by subsequent decisions. Note incidentally that, although we customarily talk in this context of an extended s.32 power, there is in both s.71A and s.71D the possibility of the trust including '*powers to the like effect*' as the *powers mentioned in any of paragraphs (a) – (d) above*', i.e. appropriate express powers, which seems to be recognised by HMRC's reference at 3.2 to '*a wide power of advancement*'.

C. STAMP DUTY LAND TAX

7. SDLT and Partnerships : Definition of 'Partnership Property'

Context

HMRC have, since the introduction of the substantive partnership regime on 19th July 2004, resolutely stuck to their view (expressed in the draft SDLT Manual chapter 35100) that

“partnership property is any interest or right held by or on behalf of a partnership, or the members of a partnership, for the purposes of the partnership business. This means that property held by one of the partners and used for the purposes of the partnership business is partnership property.

Relevant partnership property is every chargeable interest held as partnership property immediately after the transfer except:

- chargeable interests transferred to the partnership as part of the transaction; and
- market rent leases.”

This HMRC view (vigorously contested by the professions) has had, largely adverse, implications for all of the three charges on transfers of land to a partnership, transfers of an interest in a partnership owning land and transfers of land from a partnership (all subject to the changes introduced by FA 2006).

HMRC climbdown

Stamp Taxes Policy now accept that property which was owned by some only of the partners would not be deemed to be 'partnership property' when it was used by the partnership otherwise than pursuant to a lease granted to the partnership. They have confirmed that draft SDLT 35100 no longer represents their view.

Comment

However, note that HMRC Stamp Taxes are not necessarily agreeing that 'partnership property' for SDLT purposes carries the same meaning as for the general law. What would be the case, for example, where the land were owned by all the members of the partnership (outside the partnership) who then licensed it to the partnership? It is not yet entirely clear what the compliance and liability obligations would be in such case, at least according to HMRC. Discussion on this point continues with HMRC.

8. SDLT : Transfer of Land by Partnership to Connected Company

Context

FA 2003 s.53 applies a market value charge where the purchaser of land is a company and:-

- (a) the vendor is connected with the purchaser; or

- (b) some or all of the consideration for the transaction consists of the issue or transfer of shares in a company with which the vendor is connected.

That is, the exemption for no chargeable consideration under FA 2003 Sch 3 para 1 is disapplied.

Exception for partnerships: Sch 15 a complete code in itself

HMRC accept that s.53 does not apply where land is transferred out of a partnership to a company with which the partners are connected. Here the question is how Sch 15 para 18 applies. There will be a positive SDLT charge if the sum of the lower proportions (“SLP”) is less than 100, based on market value. SLP is determined under para 20, with the relevant owners being those entitled to the land immediately after the transaction. In this case of course the relevant owner is the company who immediately before the transaction was connected with the partners who owned the land. The corresponding partners were those partners, who between them were entitled to the whole of the partnership share. So the SLP is 100 and the market value charge is nil!

The point:-

- will also apply to intra-group deals if either SDLT group relief is not available or is clawed back; and
- usually applies to informal leases by shareholders/directors to their companies.

Comment

There does seem to be an extraordinary distinction, accepted by HMRC Stamp Taxes, between the case where an individual transfers land to a company with which he is connected on the one hand and where the transferors are members of a partnership on the other. Worth thinking about - and taking advantage of in appropriate cases! The mandatory SDLT disclosure regime for transactions in non-residential property for a consideration of at least £5 million should not apply when there is no actual consideration.

D. MISCELLANEOUS

9. Remittance Basis Claims by Those Outside SA

Context

The ATT Website contained a statement that HMRC had confirmed that a non-UK domiciliary does not have to make a claim to be non-UK domiciled and to make an application of the remittance basis, in order to confirm the freedom from UK tax for offshore income and gains. This is supported by an item in last month's TAXline.

When is a claim not needed under ITTOIA 2005 s.831?

The Tax Law Rewrite of what was TA 1988 s.65 — now ITTOIA 2005 s.831 - made it clear that for 2005/06 onwards the remittance basis has to be claimed. A recent news item on the ATT website focused on the situation where a non-UK domiciled individual has income arising outside of the UK, but has no income arising within the UK and consequently has not received a self assessment return. If they do not file a specific claim under ITTOIA 2005 s.831, will they be regarded as assessable on the whole of the income arising?

It is reported that HMRC have confirmed that in these circumstances, the individual will need to consider notifying chargeability under TMA 1970 s.7. However, if the individual is able to make a claim under s.831 and there have been no remittances of relevant foreign income, then there will be no need to notify - in other words, a return is not needed just to make the s.831 claim. If HMRC subsequently enquire into the individual's affairs, there will be an issue only if the individual's personal circumstances do not entitle them to claim the remittance basis or it transpires that there were remittances that have not been notified.

Although this view has not been published, HMRC have confirmed to TAXline that the ATT news item does indeed reflect their approach, and it may be included in HMRC's guidance on relevant foreign income which is currently being revised.

(TAXline June 2007)

Comment

This is a very interesting exception to the general principle that a claim to the remittance basis for income tax by someone domiciled outside the UK under the general law does require a specific claim. Of course there should be no income otherwise subject to UK tax, e.g. as having a UK source. And, against the possibility of a subsequent enquiry, one must be absolutely clear that the individual is indeed non-UK domiciled under the general law.

10. *Bona Vacantia* – The Choices

Context

The Treasury Solicitor's department has now published confirmation that they will not take a point on the technically unlawful return of capital where a limited company takes advantage of ESC Cl6, provided that the unlawful distribution (broadly, share capital, premium and non-distributable reserves) does not exceed £4,000 (see Guidance Note BVC17 at www.bonavacantia.gov.uk).

Four unattractive choices

Where the potentially unlawful distribution exceeds £4,000 there are a number of unattractive choices. One is to make an unlawful distribution and wait for the Treasury Solicitor to notice. Few advisers would want to condone that. Another is to leave an appropriate amount of value in the company when it is struck off. Few clients will welcome that. A third is to appoint a liquidator, with its attendant costs. A fourth, if the client would rather pay a lawyer than a liquidator ('rocks' and 'hard places' spring to mind), is to seek a reduction in share capital by application to the court.

Two more attractive choices

More attractive choices would normally be:-

1. To repurchase most of the shares with a '*permissible payment out of capital*' (available only for private companies), which would normally be much cheaper than a liquidation (albeit that stamp duty will be payable).
2. To re-register the company as an unlimited company and thereby permit lawful distribution of share capital, which may be the quickest and cheapest course provided there are no concerns about members becoming liable for any liabilities that later surface.

Comment

Guidance Note BVC17 explains that the reason for the limit of £4,000 is that the Treasury Solicitor believes this is the average cost of putting a company into liquidation. No higher sum would be acceptable, because of the risk to the public purse if a creditor should subsequently come forward and try to recover from the Crown the amount of the distribution which the Treasury Solicitor had authorised.

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NOTE: You should not act (or omit to act) on the basis of this Bulletin without specific prior advice.

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