McKie&Co

RUDGE REVENUE REVIEW

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INDEX

SECTION I

"LIFE OF AN EXPERT WITNESS"

THE NEED FOR AN EXPERT

Tax is complex and the financial consequences of a mistake can be catastrophic. Deciding where the legal liability for the consequences of such a mistake lies itself calls for high levels of professional knowledge and judgement. Those who specialise in litigation cannot be experts in Revenue Law and practice. The Court, in reaching its decisions in such cases, must form a judgment on many matters requiring professional experience in the practice of taxation. In cases concerning negligent tax advice the litigator and the Court require the aid of an expert.

The Courts have heard expert evidence at least since the sixteenth century.[1] An expert witness falls into a special category governed by Part 35 of the Civil Procedure Rules and the Practice Direction "Experts and Assessors." Guidance on their application is given by the "Civil Justice Protocol for the Instruction of Experts to give Evidence in Civil Claims." An expert witness will owe a contractual duty to the party engaging his services under normal contractual principles but his over-riding duty is to help the Court in matters within his expertise. Under CPR 35.1 "expert evidence should be restricted to that which is reasonably required to resolve the proceedings." Without the Court's permission an expert cannot be called to give evidence and an expert report cannot be put in evidence.[2] Even if the evidence is admitted, the weight attached to it is a matter for the Court.[3]

It has been held, however, that a Court should be "slow to find a professionally qualified man guilty of a breach of his duty of skill and care towards a client … without evidence from those who are in the same profession as to the standards expected on the facts of the case and the failure of the professionally qualified man to measure up to that standard."[4]

It is the Court's task to determine the effect of the Law of England and Wales in respect of the facts relevant to the case. Paradoxically, therefore, where a tax adviser acts as an expert witness, one matter on which he cannot give evidence is on his primary area of expertise; the content of the Revenue Law and of its application to the facts. In giving evidence, however, on such matters as what advice a reasonably competent tax adviser would have given had he been in the same circumstances as the adviser alleged to have been negligent, it is inevitable that his evidence will refer to the expert's understanding of the legal effect of the provisions relevant to the allegedly negligent advice.

Long before the matter comes to Court, the litigating solicitor will require the support of a taxation expert to fully understand all the elements of his client's case. A taxation expert will

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1 *Buckley v Rice Thomas* (1554) 1 Plowd 118
2 CPR 35.4(1)
3 *R v Rivett* (1950) 34 Cr App Rep 87
4 *Sansom v Metcalfe Hambleton & Co* [1998] 26 EG 154, CA

not only provide to the litigator his opinion on matters on which he might give evidence were the case to proceed to a hearing, but also on the application of the Revenue Law relevant to the allegedly negligent advice. His advice will be of importance in relation to all of the elements of the case; that is, as to duty, breach, causation and quantum.

In the box below we give an example of a client alleging professional negligence in respect of tax advice on EIS Deferral Relief.

Example

Mr Glucose is a director, and owns the entire share capital, of two companies, Industrial Cider Limited ("ICL"), which manufactures industrial cider, and Glucose Properties Limited ("GPL") which owns various let residential properties.

Mr Glucose has engaged Brown, Jones & Smith LLP ("BJS"), Chartered Accountants, to prepare the companies' accounts and to audit them, to act as his own and the companies' tax agents and to "provide taxation advice on request from time to time" in respect of his own and the companies' affairs. Accounts are made up to 30th April in each year.

On 1st January 2009 Mr Glucose invests £900,000 in ICL and claims EIS Capital Gains Tax Deferral relief on his investment under TCGA 1992 s.150C. From 1st August 2009, ICL employed Mr Glucose's son, Carbon, for one month during his first vacation from University as a marketing consultant paying him £5,700, an amount which was chosen as being just below the earnings threshold. On 1st December 2009, Mr Glucose telephoned Mr Brown of BJS for advice in respect of a proposal that GPL should sell (the "Property Transaction") a building (the "Property") to Mr Glucose for £1m. He asked to be advised whether the Property Transaction would have to be disclosed in GPL's accounts and if there would be any adverse tax consequences in respect of it. He was advised that the transaction should be disclosed and that, if the selling price was less than the market value of the property, there would be a benefit in kind charge under ITEPA 2003 s.206.

On the 30th January 2012 HMRC opened an enquiry into Mr Glucose's return for 2009/2010 and in the course of that enquiry the Valuation Office arrived at a final value for the Property at the date of the Property Transaction of £1,200,000. The Inspector issued a Closure Notice assessing a benefit in kind of £200,000 and a capital gain of £900,000 accruing under TCGA 1992 Schedule 5B para 4 on the basis that the sale of the property by GPL to Mr Glucose at an undervalue was a return of value within para 13(2)(g) ibid, treated as having been made by ICL by reason of para 13(10) ibid. He therefore increased Mr Glucose's Income Tax Assessment by £80,000 ((£1,200,000 - £1,000,000) @ 40%), and raised a Capital Gains Tax assessment of £162,000 (£900,000 @ 18%). The Inspector also raised a penalty for the careless error in the Tax Return of £72,600 ((£162,000 + £80,000) @ 30%).

Mr Brown of BJS, having considered the Inspector's letter, rang Mr Glucose, explained the assessment to him and admitted that he had overlooked that, if the Property Transaction took place at an under value, in addition to being a benefit in kind the transaction would also be treated as a return of value by ICL leading to a claw back of all of the EIS deferral relief claimed within the previous three years. He advised Mr Glucose that he might be able to avoid the Capital Gains Tax charge by replacing an amount equal to the undervalue of £200,000 in the company.

Mr Glucose's solicitors subsequently issued proceedings for breach of contract and negligence claiming damages on the basis that BJS were engaged to provide taxation advice on the consequences of the Property Transaction, their advice was negligent, that Mr Glucose had relied on that advice in taking the decision to proceed with the Property Transaction, that he would not have proceeded had correct advice been given and that he had suffered damage of £314,600 (£162,000 + £80,000 + £72,600) plus interest as a consequence.

DUTY

Did BJS have a duty to give correct advice in respect of the consequences of the proposed transaction for the EIS Relief which he had claimed? The exact terms of Mr Glucose's request for advice on the Property Transaction is a matter of evidence which BJS and their solicitors need to determine but once the factual background is determined, unless it is entirely straightforward, the Expert will give his opinion of whether a reasonably competent tax adviser would have understood that request to be a request for advice not only in relation to the company's tax affairs but also in relation to Mr Glucose's personal affairs.

BREACH OF DUTY

If BJS did have a duty to advise on the EIS consequences of the Property Transaction should BJS have warned Mr Glucose that if the transaction were at an undervalue it would lead to a clawback of the EIS Reliefs? An adviser receiving the closure notice might well argue that a purposive interpretation of the relevant legislation would restrict the extent of the deeming provision of TCGA 1992 Sch 5B para 13(10). A reasonably competent tax adviser, however, called upon to give advice in relation to EIS Deferral Relief would surely have advised that on a literal reading such a transaction at an under value would be a return of value, that there was a good chance both that HMRC would raise an assessment on the basis that there was a chargeable event under TCGA 1992 Sch 5B para 3(1)(c) and that a Court would confirm the assessment.

CAUSATION

BJS's litigating solicitor will want to examine closely the question of reliance on the advice. If Mr Glucose would have proceeded with the transaction even if he had been properly advised then he would not have suffered loss as a result of BJS's breach. Mr Glucose had been advised that if GPL sold the property for less than its market value a tax charge would arise but he proceeded with the transaction in any event. Perhaps he did so thinking that the transaction price was at market value? What evidence is there that, if Mr Brown had advised him of the possibility of the withdrawal of EIS Relief, he would have altered the proposed transaction? Important though that question is, it is not one to which the expert's evidence is likely to be very significant. No doubt he could give evidence of his experience of how other clients have typically approached similar decisions but the probative value of such evidence in relation to Mr Glucose's reliance or otherwise on Mr Brown's advice would be very small.

QUANTUM

The Income Tax Liability

Quantifying the damage suffered if the advice was negligent and Mr Glucose relied on it is rather more complicated than it looks. One might think that one could not take account of the Income Tax liability because Mr Brown specifically warned Mr Glucose that it would arise if the transaction took place at an under value. The measure of the damage resulting from BJS's failure to point out the EIS consequences of the proposed transaction, however, is the difference between Mr Glucose's actual position and the position he would have been in, had the advice been given. If it is the case that he would not have proceeded with the Property Transaction had he been warned about its EIS consequences, he would not have incurred either the Capital Gains Tax or the Income Tax liability and therefore the liability for Income Tax is part of the measure of his damage.

A Deferral not an Absolute Liability

BJS might argue that relief under s.150C only defers liability until a later disposal of the shares.[5] Mr Glucose's response to that would be that he might have retained the shares until his death so that no gain would arise. On this issue the Expert could give evidence from his experience of what proportion of clients claiming EIS Relief do actually crystallise at a later stage the gain which they have held over.

Carbon's Remuneration

The really interesting issues as to quantum, however, arise in respect of the prior transaction with Carbon.

Any transaction with Carbon which would be a return of value if made with Mr Glucose will be a return of value.[6] The payment by a company of remuneration for services as an employee which is not such remuneration as may be reasonable in relation to the duties of that employment is a return of value.[7] It is a question of fact whether the payment made to Carbon was reasonable in relation to his duties and that is not a question on which a person expert as a tax adviser could give expert evidence. Nonetheless, it is an issue which BJS's litigating solicitors should investigate. Assuming that the remuneration was not reasonable in relation to Carbon's duties there would have been a return of value, as a result the shares

5 TCGA 1992 Sch 5B para 3(1)
6 TCGA 1992 Sch 5B para (10)(b) and para 19
7 TCGA 1992 Sch 5B Para 13(2)(i) and (7)(a)

would have ceased to be eligible shares and there would have been a chargeable event under which all of the gains held over by Mr Glucose would have been brought into charge.

The result of that is that although the Property Transaction was a chargeable event, no gains would have accrued to Mr Glucose by reason of it. So arguably the Capital Gains Tax charge should not form part of the quantum of his claim.

Also, rather strangely, in this case BJS would be in a better position if Mr Brown had been aware of the transaction with Carbon at the time he advised Mr Glucose than if he had not. In that case his proper advice to Mr Glucose (subject to para 13B which we discuss below) would have been that although the property transaction was a chargeable event it would not lead to a Capital Gains Tax charge because that charge had already accrued. As we have seen, Mr Glucose was willing to proceed with the transaction even though he had been warned about the Income Tax charge so the position would then have been that Mr Glucose would not have been in any better position had he been properly advised because he would, presumably, have proceeded with the property transaction in any event. If, however, Mr Brown was not aware of the transaction with Carbon at the time he advised on the Property Transaction, a reasonably competent adviser would have advised Mr Glucose of the risk that the property transaction would trigger a clawback of the EIS Relief with the result that, if Mr Glucose, on the basis of that advice, would not have proceeded with the transaction, the Income Tax charge would be damage which he would have suffered from relying on the incorrect advice of Mr Brown.

<u>Replacement of Value</u>

Paragraph 13B provides that where there has been a return of value, the return of value is reduced to the extent that the value is replaced in the company concerned. Under para 13C(2)(b) it must, however, be replaced as soon after the original return of value "as is reasonably practical in all the circumstances." The existence of this provision has two effects on Mr Glucose's claim.

It appears that Mr Brown advised Mr Glucose about this provision. A claimant for damages for breach of contract has a duty to mitigate his loss. It is arguable that Mr Glucose should have mitigated his loss by replacing value in the company. Did he fail to do so? Was he advised that the time was already past at which it was first reasonably practical for him to have replaced the value so that relief under paras 13B would not apply? Did he do so but fail to persuade HMRC that the relief applied? In that case, should he have appealed against the closure notice? These are issues for further enquiry which an Expert would highlight for the litigating solicitors and, once further evidence was gathered, on which an Expert might give evidence as to the approach which would have been adopted by a reasonably competent tax adviser.

Sections 13B and 13C also affect BJS's argument in relation to the transaction with Carbon. For if Mr Brown became aware of that transaction within the time that it was still possible to replace value in the company satisfying the condition that that was as soon as possible as was reasonably practical in the circumstances, then a reasonably competent adviser would have advised Mr Glucose to do so at the time Mr Brown gave his advice in respect of the

Property Transaction. In that case, the prior transaction with Carbon would not have prevented the clawback of Mr Glucose's rolled-over gains being triggered by the Property Transaction.

The Need for Negotiation

The example shows that even in situations which appear quite straightforward, the issues raised in professional negligence litigation can be complex. The outcome of such cases is never entirely predictable. On the professional side, they will usually be managed by the professional indemnity insurers of the firm concerned who will usually be experienced and hard-nosed negotiators. It is rare for a client suing for professional negligence to achieve a result which he regards as fair compensation for his loss.

For the professional who is the subject of a claim preparation for a Court hearing is tremendously time consuming. His insurers will insist on his taking every effort to provide them with the information which they require and to prepare thoroughly for the hearing. Both sides, therefore, have a strong interest in negotiating a settlement so as to bring the issue to a close and to reduce their risk of the costs in the case.

MEDIATION

The Civil Procedure Rules provide that the over-riding objective of the civil procedure code is to enable the Court to deal with cases justly[8] and, in furthering this objective, the Courts must actively manage cases.[9] Part of that active management is encouraging the parties to use an alternative dispute resolution procedure if the Court considers that appropriate.[10] If one party refuses to do so he will be at risk of an adverse consequence in respect of costs.[11] Rather, to my surprise, I have found mediation is a very effective way of concentrating the parties' minds on the relative strength of their positions and encouraging realistic negotiations.

WHAT AN EXPERT CAN CONTRIBUTE

Whether you are the Claimant or the Defendant, being a party to an action for negligence is extremely stressful and almost always deeply unsatisfying. A good expert can help reduce the stress and aid the achievement of a realistic outcome. For the expert there are few things more satisfying than bringing clarity regarding the application of Revenue Law to the often complex and messy facts of such a case.

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8 CPR 1.1(1)
9 CPR 1.4(1)
10 CPR 1.4(2)(e)
11 *Dunnett v Railtrack Plc (in railway administration)* [2002] EWCA Civ 303, *Burchell v Bullard* [2005] EWCA Civ 358

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SECTION II

"UNSETTLED TRUST"

A curious anomaly exists in respect of settlements creating interests in possession for the settlor and/or his spouse which have existed since the 22nd March 2006 or in which an immediate post-death interest subsists. Unless the relevant legislation is amended or the matter is clarified by the Courts, that anomaly will continue to create for many years a worrying uncertainty as to the tax consequences which will result when such settled property vests absolutely.

Section 80

Section 80[12] applies where a settlor or his spouse (or civil partner) is beneficially entitled to an interest in possession in property immediately after it becomes comprised in a settlement. Where the section applies, the property is treated, for the purposes of Chapter III of Part III (concerning relevant property settlements), as not becoming comprised in a settlement at the time the trust is made but rather, at the time when the property becomes held on trusts under which neither the settlor nor his spouse have an interest in possession. In that case it is treated as becoming comprised in a settlement (the "Hypothetical Settlement") made by one of them that was last entitled to an interest in possession in the property.

An "interest in possession" for this purpose is restricted to a "postponing interest" (an immediate post death interest or a disabled person's interest") but only if the first occasion on which the property became comprised in the settlement is on or after 22nd March 2006.[13] Reference in s.80(1) to the spouse (or civil partner) of the settlor includes references to the widow or widower or surviving civil partner of the settlor.[14]

Section 82

Where s.80 applies, under s.82 the property will not be treated as excluded property unless the settlor of the actual settlement was not domiciled in the United Kingdom at the time that the settlement was actually made <u>and</u> the deemed settlor of the Hypothetical Settlement was not domiciled in the United Kingdom at the time he is deemed to have made that settlement. Section 82 also applies only for the purposes of Chapter III of Part III.

Sections 80 and 82 together create a curious anomaly where, as is not uncommon, a life interest for the settlor, or a life interest for the settlor's spouse, is succeeded by an absolute interest. Typically that absolute interest will be for the settlor's children. I shall illustrate the anomaly by reference to the facts set out in Example I.

12 All reference in this article are to the Inheritance Tax Act 1984 unless otherwise stated
13 Section 80(4)
14 Section 80(2)

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> ***Example I***
>
> On 1st January 2009 Mr Fillbarrel died. Under his Will he settled substantial non-UK situs assets on trusts under which his wife had an initial life interest with an absolute interest in remainder to his son, Duffin. Immediately before Mr Fillbarrell's death, Mr and Mrs Fillbarrel were resident and ordinarily resident in the United Kingdom but were not domiciled in a country of the United Kingdom nor were they deemed to be so domiciled under s.267.
>
> Mrs Fillbarrell died on 31st December 2011 when she was domiciled in England.

On Mr Fillbarrell's death

Section 49 applied to Mrs Fillbarrell's life interest because her interest was an immediate post-death interest within s.49(1A)(a)[15] and so she was treated as beneficially entitled to the property in which her interest subsisted.

Mrs Fillbarrell's Death

On Mrs Fillbarrell's death, her interest in possession came to an end. The trust property was deemed to form part of her estate immediately before her death under s.49 with the result that the transfer of value deemed, by virtue of s.4, to take place immediately before her death included the value of the settled property. Sections 80 and 82 did not apply for this purpose because they apply only for the purposes of Chapter III of Part III which applies only to property which is relevant property. Property to which s.49 applies is not relevant property.[16] Therefore, s.48(3) applied because the settlor, Mr Fillbarrell was not domiciled in the United Kingdom at the time the settlement was made and so the non-UK situs property in the settlement was excluded property.[17] In respect of the deemed transfer of value arising under s.4 immediately before Mrs Fillbarrell's death, therefore, the property in which her life interest subsisted did not suffer Inheritance Tax.

Immediately upon Mrs Fillbarrell's death, the trust property was held by the trustees for Duffin absolutely. Under general principles it was therefore held on trust. As soon as Duffin's absolute interest arose, however, the property ceased to be settled property within s.43 because the property was no longer "held in trust for persons in succession or for any person subject to a contingency."[18]

As, on Mrs Fillbarrell's death, the property held on trust by the trustees ceased to be settled property within s.43 one might have thought that s.80 could not apply. Section 80, however, applies where an interest in possession for a settlor or his spouse has existed in property immediately after it has become comprised in a settlement. Where this condition is satisfied:-

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15 Section 49(1A)(a) and s.49A
16 Section 49(1A) and s.58(1B)
17 Section 48(3)(a)
18 Section 43(2)(a)

"… the property shall for the purposes of this Chapter be treated as not having become comprised in the settlement on that occasion; but when the property or any part of it becomes held on trusts under which neither of those persons is beneficially entitled to an interest in possession, the property or part shall for those purposes be treated as becoming comprised in a separate settlement made by that one of them who ceased (or last ceased) to be beneficially entitled to an interest in possession in it."

It will be noticed that where s.80 applies the property is treated as becoming comprised in the settlement "When the property or any part of it becomes held on trusts under which neither of those persons [the settlor and his spouse] is beneficially entitled to an interest in possession …". So the event which triggers the application of the section is the property becoming held on trusts under which neither the settlor nor his spouse has an interest in possession whether or not those new trusts amount to a settlement within s.43. The only requirement for there to be a settlement within the s.43 definition is for there to be a settlement immediately on the property first being settled.

It has been argued that in the context of s.80 the 'trusts' referred to in s.80 must be trusts under a settlement within s.43. There is nothing in the wording of the section, however, to suggest that that is the case. It appears that the draftsman has deliberately adopted the words 'settlement' and 'trust' because their meanings are not co-extensive. Indeed, the whole scheme of the application of Inheritance Tax to trusts depends upon 'settlement' being a more limited term than 'trust'. It is very deliberately limited by the statutory definition in s.43.

Normally, where the application of the Inheritance Tax legislation to an interest under a trust is to be limited to an interest arising under a settlement, the draftsman expressly limits the relevant provision in that way. For example, s.47 defines a reversionary interest as "a future interest *under a settlement*" (emphasis added). Section 51 applies "Where a person beneficially entitled to an interest in possession in *settled property* [emphasis added] disposes of his interest …" Section 49A applies "Where a person … is beneficially entitled to an interest in possession in *settled property* [emphasis added]." If the "trusts under which neither of … [the settlor or his spouse] … is beneficially entitled to an interest in possession" referred to in s.80 were intended by the draftsman to be restricted to trusts under a settlement within s.43 one would have expected the draftsman to use some such phrase as "held on the trusts of a settlement."

Immediately, on Mrs Fillbarrell's death, therefore, it is arguable that s.80 would have the result that the property is to be treated, but only for the purposes of Part III Chapter III, as becoming comprised in a settlement settled by Mrs Fillbarrell. The question is what is the effect of that? The deeming provision in s.80 does not provide that the property is to be treated as continuing to be settled property. So it might be argued that the effect of s.80 is that the property would be settled property (and therefore relevant property) only for an instant. If that were correct, the property would immediately thereafter cease to be relevant property because it would not be property "held in trust for a person in succession or for any person subject to a contingency …" so there would be an exit charge under s.65 but, because the property would have been relevant property for an instant only, that charge would be at nought per-cent.[19]

On the other hand, it might be argued that if the property is deemed to be comprised in a settlement it must remain comprised in that settlement until an event occurs to remove it. That event might be thought to occur when the trustees transfer the assets to the absolute owners. In that case, if the transfer took place more than three months after the relevant death, there would be an exit charge under s.65. Because of ss.80 and 82 the foreign situs assets would not be exempt property in respect of that charge. What is more, in calculating the rate of tax at which the charge was made one would apply ss.80 and 82 to the hypothetical chargeable transfer under s.68(4) so that the foreign situated property in the settlement immediately before Mrs Fillbarrell's death would not be treated as exempt property for that purpose.

At a time when HMRC is increasingly anxious to collect the maximum amount of tax, interest and penalties in respect of Inheritance Tax, it is important for taxpayers to know whether a charge can arise in these circumstances. It would be interesting to know HMRC's view of the matter.

[19] Section 65

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SECTION III

"BLIND GUIDES"

"If the blind lead the blind, both shall fall into the ditch"[20]

HMRC's Guidance on Trustee Residence must be read with a large pinch of salt.

PROFESSIONAL TRUSTEE DEEMED RESIDENCE RULE

Taxation of Chargeable Gains Act 1992 s.69 contains rules for determining where the trustees of a settlement are resident and ordinarily resident for the purposes of that Act and ITA 2007 ss.475 and 476 contain similar rules for Income Tax purposes. These definitions of residence were first enacted in Finance Act 2006 with effect from 6th April 2007 and were first published in draft in January 2006. The draft definitions were in a form which has been carried unchanged into TCGA 1992 s.69 whilst the Income Tax legislation was rewritten under the Rewrite Project, so that the two residence tests are now in different terms.[21]

The draft legislation included a deeming provision (the "Professional Trustee Deemed Residence Rule") which is now found in both TCGA 1992 s.69(2D) and in ITA 2007 s.475(6) which treats a trustee who is not resident in the United Kingdom as if he were so resident:-

> "…any time when he acts as trustee in the course of a business which he carries on in the United Kingdom through a branch, agency or permanent establishment there."[22]

THE PUBLICATION OF THE GUIDANCE

The Society of Trust and Estate Practitioners warned that the Professional Trustee Deemed Residence Rule was a major threat to the practice of professional trustees in the United Kingdom. The Government's response to this criticism was to promise that HMRC would publish "guidance". That Guidance was published on 1st July 2009. This article examines the Guidance and considers whether it is accurate or useful.

THE GUIDANCE'S CONCEPTUAL FRAMEWORK

Different Tests for Companies and Other Taxpayers?

After some introductory material the Guidance begins by stating:-

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20 Matthew Chapter XV Verse XIV

21 The intention of the Rewrite Project was that the rewritten legislation should have the same effect as the legislation from which it derived

22 TCGA 1992 s.69(2D). It will be noted that this provision uses the masculine gender. The Interpretation Act 1978 s.6 provides that words importing the masculine gender include the feminine and vice versa, but it does not provide that words importing the masculine gender include the neuter. Is it perhaps arguable that TCGA 1992 s.69(2D) applies only to natural persons? The equivalent provision in ITA 2007 s.475(6) is differently worded being in the Rewrite style and does not use the masculine pronoun to refer to the trustees

> "…that for trustees the "*branch*" and "*agency*" tests apply to non-corporate trustees and the "*permanent establishment*" test to corporate trustees. Non-UK resident trust companies that are trustees therefore need only be concerned about being treated as UK resident if they carry on a business through a permanent establishment in the UK."

It can be seen from s.69(2D) which is quoted above that there is nothing in that sub-section which suggests that different tests apply according to whether the trustee is a natural or legal person.[23]

The Guidance goes on to say in paragraph seven:-

> "As the legislation refers to a business carried on in the UK through a "branch, agency or permanent establishment" the same principles … and…examples…apply in the case of non-corporate trustees (a branch or agent) as they apply in the case of corporate trustees (permanent establishment). Because most cases will in practice involve non UK resident trust companies the examples refer only to them. However where particular concepts that are peculiar to permanent establishment are concerned e.g. the independent agent exemption, then they affect only corporate trustees, and the language used reflects that".[24]

When the Guidance was released in draft the CIOT commented that the Guidance:-

> " … needs, for completeness, to deal with non-corporate trustees, who may be acting in the course of business or acting as trustees where they do so through a branch or agency in the UK."

It was, presumably, in response to this comment that the authors inserted paragraph seven, which was not in the original draft, hoping to justify making the minimum of changes to the Guidance.

Neither "branch", nor "permanent establishment", however, are terms with clearly defined meanings in law and agency is also, to a lesser extent, a legal concept of uncertain limits. What is clear is that they don't mean the same thing. Each term requires explication and illustration by means of examples but the Guidance has chosen, effectively, to deal only with permanent establishments.

No Reference to the Statutory Definitions

It is a peculiarity of the Guidance that it develops its examination of the meaning of "permanent establishment" without referring to the statutory definition which applies for the purpose of determining whether a company has a permanent establishment in a country. That

[23] FA 2003 s 148 which contains a statutory definition of a permanent establishment applies only for the purpose of determining whether a company has a permanent establishment in a territory (see below). It may be because of this that HMRC have adopted their view of the dual structure of s. 69(2D). If so, that is surely too shifting a ground on which to found such a radical restructuring of the provision

[24] Para 7. All references in this article are to the Guidance unless otherwise stated

definition is found in FA 2003 s.148, for the purposes of the Tax Acts[25] and is incorporated into Capital Gains Tax by TCGA 1992 s.288(1). Rather the Guidance refers to the OECD's Model Treaty which contains a definition of a permanent establishment for the purposes of the Treaty in Article 5 and the OECD's Commentary thereon. Clearly neither the Model Treaty nor the Commentary is directly part of UK law. The Treaty's definition of permanent establishment in Article 5 shows a number of differences from that of s.148. It is true that a Court, in the absence of more direct authority, is likely to have regard to the views expressed in the OECD Commentary in construing phrases in s.148 which are identical to those used for the same purpose in Article 5 of the Model Treaty. Nonetheless, the reader needs to be aware that there are important differences between the two definitions and that the opinion of the OECD is by no means determinative of the construction of s.148 under English law.

Strangely Annexe A to the Guidance highlights one of the key differences between the definition in Article 5 of the OECD Model Treaty and the statutory definition given by s.148 without explaining that there is a statutory definition.

<u>The Three Questions</u>

The Guidance goes on to set out three questions which it says are relevant to deciding whether or not a trustee is deemed to be resident in the United Kingdom.[26] Those tests are:-

(a) Is the trustee carrying on a business in the UK?
(b) If the trustee is carrying on a business in the UK, is it carrying on a business through a branch, agent or permanent establishment in the UK?
(c) If so is the trustee carrying on the activity of being a trustee of that particular trust in the course of its business through the branch agent or permanent establishment?

Question (a)

In relation to question (a) the Guidance says:-

> "This question is not related to the business of particular trusts that might be conducted by the trustees. It enquires whether the person who is a trustee carried out business activities (as a professional businessman and not as a trustee of a particular trust) in the UK."

That certainly seems to the author to be an arguable view of the provision but it is also arguable that the provision is not restricted in this way. Rather, that it is only necessary for the trustee to act "as trustee in the course of a business which he carries on in the United Kingdom though a branch agency or permanent establishment there" and that that condition is satisfied both if he carries on a business of acting as a professional trustee and if he carries on a business for the account of the trust fund of the settlement concerned. HMRC's Guidance should distinguish between situations where it is stating a view of the law about

[25] The Income Tax Acts and the Corporation Tax Acts
[26] TCGA 1992 s.69(2)(d) and ITA 2007 s.475(6)

which there can be no reasonable dispute and those where one of two or more tenable constructions of the law has been adopted.

Question (b)

Under Question (b) the Guidance says:-

> "Again this means that the trustee is carrying on through the branch, agency or permanent establishment the sort of activities from which it substantially derives its world-wide profits – providing professional services for a fee – and not what it is doing in relation to an individual trust."

It is difficult to see what distinction the Guidance is trying to make. It may be that this point is simply repeating the view set out above in respect of Question (a) in which case, as we have seen, the Guidance has failed to give due weight to a tenable, alternative construction.

Question (c)

Question (c) is ambiguous. Section 69(2D) requires the person concerned to be acting as a trustee in the course of a business. That business must be carried on in the United Kingdom through a branch, agency or permanent establishment in the UK. Question (c) could be read as being consistent with this construction. It could, however, also be read as stating that the test will be satisfied only if acts of the trustee in respect of the particular trust concerned are carried on through a branch, agency or permanent establishment in the UK. If so, that seems to be a narrower view of the test than is justified by a close reading of the legislation.

CORE ACTIVITIES

The Guidance then goes on to say that:-

> " … in line with the Commentary of the OECD Tax Model Convention, "carrying on the function of being a trustee" means in this context activities which are the core activities of a trustee and not those activities which are auxiliary or preparatory."

In fact the Commentary only refers to core activities at two points and neither of those in relation to carrying on the function of being a trustee. Section 69(2D) makes no distinction between the core activities of trustees and other activities. It provides that if the person concerned acts as trustee in the course of business which he carries on in the United Kingdom through a branch, agency or permanent establishment, that person will be resident in the United Kingdom. There is no provision that this will not apply if the acts are preparatory or auxiliary.

The definition of a permanent establishment in s.148[27] does refer to activities that are preparatory or auxiliary in character providing that:-

[27] Article 5 of the OECD Model Treaty contains similar provisions

"A company is not regarded as having a permanent establishment in a territory by reason of the fact that –

(a) A fixed place of business is maintained there for the purpose of carrying on activities for the company; or
(b) an agent carries on activities there for and on behalf of the company.

if, in relation to the business of the company as a whole, the activities carried on are only of a preparatory or auxiliary character."

That, however, is only relevant to deciding whether or not a company has a permanent establishment not to whether a person is acting as a trustee.

The Guidance goes on to say that:-

"There are other activities which trustees carry on which are not core activities central to [the trustees'] conduct and management of the trust, but are instead preparatory or auxiliary activities. These generally can include information gathering meetings, including meetings with independent agents or with beneficiaries but, as mentioned below, each case will have to be considered individually".

This shows an important misunderstanding. Gathering relevant information about beneficiaries' circumstances or about the performance of the duties of an independent agent are important parts of the duties of trustees. Meetings with beneficiaries, lawyers, investment managers, land agents and others for the purpose of gathering information relevant to the trustees' stewardship of the settled property or the exercise of their dispositive powers will inevitably be acts by a professional trustee in the course of his business of providing professional trustee services.

The Guidance goes on to say that:-

"In deciding whether the conduct and management of a particular trust is being carried on in the course of the corporate trustees' business through a permanent establishment, HMRC … would also consider the issue of frequency."

The Guidance is unreliable here. It may be true that in deciding whether or not the trustee is carrying on a professional trustee business in the United Kingdom through a branch, agency or permanent establishment the frequency of his actions in the UK will be relevant. Once one has established that the trustee provides professional trustee services in the UK through a permanent establishment, however, a single act in the course of that business in respect of a settlement will be sufficient to make the trustee resident in the United Kingdom in relation to that trust.

THE EXAMPLES

The Guidance then provides a series of examples of the application of the Professional Trustee Deemed Residence Rule in accordance with HMRC's understanding of the rule set out in the preceding part of the Guidance.

Having ignored the statutory definition of a permanent establishment, invented a wholly illusory distinction between corporate and individual trustees for the purposes of the rule and confused the provisions relevant to deciding whether there is a permanent establishment with those relevant to whether a trustee carries on business in the UK through a permanent establishment, branch or agency, it is unsurprising that these examples are, in the main, incorrect or misleading.

Example 1

Example 1 is, however, helpful. It gives an example of a non-UK resident trust company which holds several meetings in the UK with a potential settlor to discuss proposed terms for the trust and suitable investments. As the settlement does not yet exist, the trust company cannot be acting as a trustee in respect of that settlement in these discussions.

Example 2

Example 2, however, illustrates the danger of the Guidance's error of applying a core activities test in deciding whether or not the trust company is acting as a trustee. It gives an example of a trust company which:-

> "…holds quarterly meetings in the UK at its London offices [presumably in respect of the settlement concerned] with investment advisors. The purpose of these meetings is for …[the trust company]… to collect purely factual information about potential assets to inform future investment strategy for the…[trust]. The actual decisions about the investment strategy are taken by …[the trust company]… outside the UK."

The Guidance correctly says that the trust company has a permanent establishment in the UK. It goes on to say, however, that:-

> "…the significance of the meetings with the investment advisors is not sufficient for [the trustee] to be regarded as acting as trustee in respect of [the trust] through that permanent establishment. They will not, therefore, be regarded as UK resident for the purposes of [the trust]."

Obtaining information to enable the trustees to make prudent investment decisions, however, is an important duty of trustees and when it does so it is clearly acting as a trustee and in the course of its business of providing trustee services. If the offices at which the meetings take place are a permanent establishment and part of the company's business of acting as professional trustees is carried on in the United Kingdom through those offices all the ingredients for deemed residence under the Professional Trustee Deemed Residence Rule are present.

Example 2b

Example 2b shows how the view expressed in the Guidance that the frequency of the trustee's acts is relevant to deciding whether the Professional Trustee Deemed Residence Rule is satisfied leads to an incorrect conclusion. The example is as follows:-

> "July Ltd, a non-UK resident trust company is trustee of the August Trust. It always carries out the core activities of the August Trust at its office overseas. The beneficiary of the trust has a single one-off meeting with July Ltd at July's Manchester office to discuss the potential release of capital from the August Trust. The discussion involves the imposition of certain conditions on the beneficiary before such a release.
>
> HMRC view: On the face of it July Ltd by discussing the release of capital and the imposition of conditions with the beneficiary has engaged in a core activity and this has taken place at what is July's permanent establishment in the United Kingdom. So *prima facie* July Ltd is acting as trustee of the August Trust through a permanent establishment However, the whole context has to be looked at – i.e. where the decision making on the trust is being carried on and if the meeting in the United Kingdom was a one-off. If the trustee took the information from the meetings out of the United Kingdom with them and then discussed and made the decisions outside the United Kingdom, they would not be UK resident. If there was any doubt as to where the decision making is taking place we would as part of our considerations consider the frequency of any meetings both within and outside the United Kingdom."

Assuming that July Ltd's offices are used for the purposes of its trade as a professional trustee generally, it is clear that it carries on a business in the United Kingdom through a permanent establishment here. Discussions with a beneficiary in respect of a proposed capital advance are clearly an act undertaken as a trustee of the particular trust concerned and that act is in the course of the trustees business of providing professional trustee services. So the conditions of TCGA 1992 s.69(2D) are clearly satisfied. The frequency of the meetings in respect of the particular trust concerned are irrelevant.

Agents of independent status

FA 2003 s.148(3) provides that:-

> "a company is not regarded as having a permanent establishment in a territory by reason of the fact that it carries on business there through an agent of independent status acting in the ordinary course of his business."

The Guidance refers to creating "a dependent agency permanent establishment". If this phrase has any meaning, the Guidance has converted a negative rule ("is not regarded as having a permanent establishment") into a positive one.

The Guidance goes on to say:-

"Where the services that are provided to the trust are only those that the person is contractually obliged to provide under their agreement with the non-UK resident trustee and are remunerated at arm's length, then this is unlikely to create a dependent agency permanent establishment."

Because the Guidance has transformed a negative test into a positive one it does not deal with the difficulties which emerge where the relationship with a service supplier is not a simple agency. For example, it is common for investment managers to hold the managed assets as nominee for their clients so that the assets are held by the managers as trustee and not as agent. Trustees exercise many of their activities of holding and dealing with the trust assets through the mechanism of such nominee arrangements. If the investment manager operates through a permanent establishment in the UK it is clear that a trustee will be acting through that permanent establishment. The Guidance says, however:-

"Where, say, a UK subsidiary is providing services to a trust, then unless the powers granted to it by a non-resident trust company are such that it becomes a '*dependent agent with authority to do business on behalf of the non-resident trustee*' (see paragraph 5 of Annex A) we will not contend that the UK company's actions cause the non-UK resident trustee company to have a permanent establishment."[28]

Perhaps the phrase 'we will not contend' acknowledges that here the Guidance is actually offering a disguised concession. If so, it is arguable that the disguised concession is *ultra vires*.[29]

Example 3a

In Example 3a a non-resident trustee engages an investment manager on terms that the manager has the authority to buy and sell commodities with a view to realising profits for the trust subject to trading limits set by the trustee. The Guidance says that:-

"the investment manager is appointed by the trustee and so is its agent. If it receives an arm's length fee for the investment management services, it will not ordinarily constitute a dependent agent of the non-UK resident trustee."

As we have seen, that may not be true because it is likely that the investment management will hold the investment assets as nominee, that is, on bare trusts, for the trustee. The example goes on to say:-

"If, however October Ltd was providing investment management services to the trustees other than on arm's length terms i.e. was acting as their dependent agent, rather than simply providing a service to them, in that case the trustees would be likely to have a dependent agent permanent establishment."

[28] It may be that FA 2003 s.448(3) and Sch 26 paras.(3) and (4) will provide some relief here but that is dependant upon falling within the detailed terms of those provisions

[29] *R (on the application Wilkinson) v Inland Revenue Commissioners HL* [2005] STC 270

If all the Guidance is saying here is that a person charging less than the market rate for a service is likely also not to be independent then that is no doubt true but it is hardly useful to say so. If, however, the Guidance is attempting to say that charging less than a market rate for services has the result that the provider is a dependent agent then this is clearly not the case.

ACCURATE AND USEFUL?

In all then the Guidance is imprecise and in places misleading. Is it useful in that it can be relied upon as indicating that HMRC will not apply the full rigour of the statutory provisions? Unfortunately, it is not. The Guidance is liberally sprinkled with words and phrases such as "generally", "unlikely", "could not by itself", "will be likely" and "normally" which indicate HMRC's determination not to be too closely bound by its general statements.

The Guidance will do nothing to retrieve the business which has been lost to the United Kingdom due to the uncertainty which the introduction of the Professional Trustee Deemed Residence Rule created. Publishing "guidance" rather than revising the legislation, is entirely beside the point. Offshore trustees selecting investment managers, stock exchanges or accountancy firms are not going to rely on the UK Government relieving them of a liability due under the law by unacknowledged concessions when they can obtain similar services in other jurisdictions without taking that risk.

SECTION IV

AN ASSURED PLAN

Introduction

The Isle of Man Assurance Limited (the "Company") offers an arrangement (the "Arrangement") using a bond consisting of a group of endowment assurance policies (the "Policies") which are issued to a policyholder (the "Original Policyholder") who then assigns (the "Assignment") the Policies on trusts.

The Policies

The Policies confer rights to benefits on surrender (the "Surrender Benefit"), on the maturity of the Policy on a fixed date (the "Maturity Date") (the "Maturity Benefit") and on the death of the last of the lives assured. The Maturity Date may be postponed at the option of the policyholder from time to time (the "Extension Right"). On entering into the Arrangement, a set of Policies is specified with Maturity Dates designed to generate payments at regular fixed dates.

The Settlement

The trusts are at the heart of the arrangements. The Company provides various forms of settlement including a children's settlement (the "Settlement") which is most commonly used.

The Trusts of the Settlement

The Clause 3 Powers

Under Clause 3, the trustees have a wide power during the Trust Period to declare trusts, over one or more Policies for the benefit of all or any one or more of the "Appointed Class" which includes the children and remoter descendants of the Original Policyholder. In default of an appointment under this power the trustees have broad discretionary powers during the Trust Period "in relation to each policy" to transfer or apply the trust capital to or for the benefit of the Appointed Class. No power under Clause 3 may be exercised so as to benefit the Original Policyholder."

The Clause 4 Trusts

Subject to any exercise of the powers conferred by clause 3, if the "Relevant Event" occurs the trustees are to hold each Policy for such of the "Beneficiaries" (the children of the Original Policyholder) who are living on the "Relevant Date" in equal shares (the "Clause 4 Trusts"). Subject to the exercise of the Clause 3 Powers the Beneficiaries have equal interests in possession in the settled property during the Trust Period.

The Reversionary Interest

Subject to Clauses 3 and 4, the trustees are to hold the Trust Fund and the income thereof for the Settlor absolutely (the “Reversionary Interest”).

The Trust Period, Relevant Event and Relevant Date

The “Relevant Event” in relation to each Policy means the death of the Original Policyholder before the Maturity Date. The Trust Period in relation to each Policy means the period commencing on the day the settlement is made and ending on the earlier of:-

(a) Eighty years after the making of the settlement;

(b) The death of the last survivor of the Beneficiaries and their descendants;

(c) The Relevant Event ceasing to be capable of occurring without actually having occurred.

If the Original Policyholder lives until the Maturity Date of a Policy the Relevant Event in respect of that Policy cannot then occur and the Trust Period in respect of it will end.

Thus, if the Original Policyholder is alive at the Maturity Date of a Policy and the Clause 3 Powers have not been exercised, he will become absolutely entitled to that Policy under the Reversionary Interests at the point at which the Maturity Benefit under that Policy arises. If, however, the Original Policyholder dies before the Maturity Date the Trust Period will determine on the earlier of the death of the last survivor of the beneficiaries and their descendants and the expiration of eighty years.

If the trustees exercise the Extension Right the effect, in respect of the Policy concerned, will be that the Trust Period will be extended and therefore it will be more likely that the settlor will die before the Maturity Benefit becomes payable.

The Issue and Assignment

No significant Inheritance Tax charge will arise on the issue of the Policies.

The assignment of the Policies on the trusts of the Settlement is a disposition which is a transfer of value because it results in a decrease in the value of the estate of the Original Policyholder. Determining the amount of the transfer is complicated but it is likely to be not materially less than the premium paid in respect of the policy.

The assignment will be an immediately chargeable transfer.[30] As the Company’s promotional material makes clear, to the extent that the transfer exceeds the Original Policyholder’s unutilised Nil-Rate Band it will lead to an immediate charge to Inheritance Tax. That means that the Arrangement is primarily suitable only for small transfers.

[30] Section 2. All references in this article are to IHTA 1984 unless otherwise stated

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If the settlor has made a potentially exempt transfer before making the settlement and dies within seven years that prior transfer will be chargeable. That would use up some part of the Original Policyholder's available Nil-Rate Band with the result that the chargeable transfer arising on the making of the settlement might itself bear Inheritance Tax and there would be a further effect on the rate of tax arising on future decennial[31] and exit charges.[32]

Where a chargeable event occurs in relation to a life insurance policy a chargeable event gain may arise.[33] The assignment of all of the rights under a policy or contract is a chargeable event but only if the assignment is for money or moneys worth.[34] The Assignment on the trusts of the Settlement is not for money or moneys worth and therefore is not a chargeable event.

FA 2004 s.84 Schedule 15 and paragraphs 8 & 9 provide that a pre-owned assets charge may arise in respect of a settlement where:-

> **"**the terms of a settlement, as they affect any property comprised in the settlement, are such that any income arising from the property would be treated by …. section 624 of ITTOIA 2005 as income of a person who is … the settlor"

Although the charge operates by reference to ITTOIA 2005 "settlement" and "settled property" have the same meaning as in IHTA 1984.

The definition of "settlement" for Inheritance Tax purposes is given by s.43. It is clear that this section looks at the property which is subjected to trusts and not at the equitable interests in that property arising under the trusts. So in respect of the Arrangement there will be a settlement for the purposes of s.43 if the Policies are held in trust for persons in succession or for any persons subject to a contingency and, if that condition is satisfied, that property will be property comprised in the settlement and therefore "settled property" in respect of that settlement. At the point at which a Policy is assigned on the trusts of the Settlement it is clear that the Policies are both held in trust for persons in succession and are held for a person subject to a contingency. During the Trust Period a Policy is held on the Clause 4 Trusts subject to the Clause 3 Powers. If the Settlor survives to the Maturity Date (a contingency) it will become held on the trusts of the Reversionary Interest (a succession). The whole Policy is, therefore, settled property. It is only when, and if, that contingency is satisfied by the survival of the Original Policyholder to the Maturity Date, that a Policy will cease to be held for persons in succession because it will then be held for the Original Policyholder absolutely and will cease to be settled property.

So until, and unless, the trustees exercise their Clause 3 Powers to create trusts under which the Original Policyholder cannot take any present or future benefit the Original Policyholder

[31] Section 64
[32] Section 65
[33] ITTOIA 2005 s.462(1)
[34] ITTOIA 2005 s.484(1)(a)(ii)

dies or he survives to the Maturity Date, a Pre-Owned Assets Charge will arise unless some other provision provides an exemption. Finance Act 2004 Sch 15 para 13(3) & (5) provides that paragraph 8 is not to apply at any time when the settled property is property subject to a reservation. We shall see that the property is property subject to a reservation so it will be exempted from the Pre-Owned Assets Charge.

As we shall also see, however, in HMRC's view the assignment is not a gift with reservation. If that view were correct, the Pre-Owned Assets Charge would apply.

Correspondence between HMRC and the Association of British Insurers was published in September 2004 concerning the Pre-Owned Assets Charge and insurance policies. In this correspondence HMRC's approach was to regard the 'property' referred to in FA 2004 Sch 15 para 8 not as being the property over which trusts are declared but rather the interests in that property which arise under those trusts.

In 2004, in correspondence between the Company's taxation adviser and the Capital Taxes Office, HMRC, stated that:-

> "Where a settlor settles intangible property into a settlement and subject to … trusts .. [for other persons] the remaining interests in that intangible property is held in trust for the settlor absolutely, then, notwithstanding the reference to s.624 ITTOIA 2005 in paragraph 8 of Schedule 15 –
>
> (1) the intangible property which forms the trust fund of the settlement is not itself "the property" or "the relevant property" referred to in paragraph 8;
> (2) "the property" and "the relevant property" consist of the rights or interests of the beneficiaries in the intangible property, which are separate and distinct from the reversionary rights or interests held on trust for the settlor ….
> (3) the settlor cannot benefit from "the property" held for the beneficiaries and so there is no "relevant property";
> (4) where the settlor's interest is itself comprised in a separate settlement or where it is held upon a bare trust then that interest in the relevant property would form part of his estate within the terms of the exemption in paragraph 11(1) Schedule 15. There would therefore be total freedom from the POAT charge."

It is clearly not correct to say that intangible property which forms the trust fund of the settlement is not itself 'the property' or 'the relevant property' referred to in paragraph 8. An interest arising under the settlement clearly cannot be property comprised in that settlement. There must be a distinction between the property which is subjected to the trusts of the settlement and the interests arising under those trusts. The Clause 3 Powers and the trusts of Clause 4 are expressed to apply in respect of a whole policy. The trusts of the Reversionary Interest apply to the whole Trust Fund. The Assignment does not create a bare trust in the property. It creates interests in succession subject to a contingency. The CTO's construction is, therefore, quite untenable.

The Company has very naturally relied on the apparently unequivocal nature of the CTO's view. There is a generic problem for all insurance companies attempting to create Inheritance

Tax planning products caused by the very low quality of recent legislation. HMRC have attempted to deal with the problem by adopting over-generous constructions of the law. That leaves the taxpayer in a very difficult position. If HMRC were to resile from its position in respect of a particular implementation of the Arrangement the taxpayer concerned would have to rely on the uncertain remedy of judicial review.

The Exercise of the Extension Rights

As the exercise by the trustees of the Extension Right is not a disposition by the Original Policyholder it is not a transfer of value by him.[35] As the body of trustees act in their capacity as trustees and not as individuals, the exercise is not a chargeable transfer by the trustees.[36] Nor is there an exit charge under s.65.

The Vesting of Reversions

Section 65 imposes an 'exit charge' where the property comprised in a Settlement ceases to be relevant property. When the Reversionary Interest vests, the Original Policyholder will become absolutely entitled to that Policy which will therefore cease to be settled property, and thus to be relevant property, because it will no longer be held in trust for persons in succession or for any person subject to a contingency.

A letter from HMRC to the Company in August 2006 says, however, that in respect of arrangements where it can be established that the reversionary interest carved out and held on trust for the settlor is quite separate and distinct from the rights or interests of those who might benefit under the trusts settled by the gift, HMRC would regard that reversionary interest as a bare trust for the Settlor and not as relevant property.

HMRC's view is both surprising and untenable.

Before the vesting, the Policy concerned is held for persons in succession and is therefore relevant property. After the vesting, it is clear that it is not so held and is therefore not relevant property. The conditions for an exit charge under s.65 are clearly satisfied.

The Death of the Original Policyholder

Will there be property subject to a reservation within IHTA 1984 s.102 by reason of the Arrangement? The key to applying s.102 is to identify the property which is the subject of the gift.

The whole Policy is settled and, therefore, is the subject of the gift. It is not just some of the rights arising under the Policies which are assigned to the trustees and subjected to the trusts of the Settlement but rather the Policies in their entirety. Once the Policies have been subjected to the trusts, the Original Policyholder's interest in those policies is contingent on events outside his control (the time of his death and the exercise by the trustees of the

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35 Section 3
36 Section 2

Extension Rights) one of which is within the control of the trustees (the exercise of the Extension Rights).

It is true that Inheritance Tax, following Estate Duty, recognises that it is possible to carve out an interest in property prior to making a gift and that, in that case, the donated property is the property subject to the carved out interest. *Ingram & Palmer-Tomkinson (Lady Ingram's Executors) v CIR* HL [1999] STC 37 is an example of that but it concerned a current and vested interest in property (a lease) which was not subjected to the trusts to which the settled property (the freehold reversion) was subjected.[37] That is very different to the Arrangement, where the Reversionary Interest arises under the trusts of the Settlement, is contingent and can be indefinitely deferred by an exercise of the trustees' powers.

On the 18th May 1987, however, the Inland Revenue (as it then was) published its views on the operation of the gifts with reservation rules saying:-

> "In the case where a gift is made into trust, the retention by the settlor (donor) of a reversionary interest under the trust is not considered to constitute a reservation, whether the retained interest arises under the express terms of the trust or it arises by operation of general law, e.g. a resulting trust."

That is the settled practice of HMRC and is, perhaps, unlikely to be withdrawn at least in respect of policies settled before any announcement of a change. In the light of *Wilkinson,*[38] however, it is doubtful whether HMRC have the power to apply an incorrect view of the law to relieve a taxpayer of liability to tax. In *Garnett v Jones,* [39] *HMRC v Grace*[40] and *Genovese v Revenue & Customs Commissioners*[41] HMRC have shown a willingness to renege on their long standing practices in pursuit of an increased tax yield.

<u>The First Decennial of the Settlement</u>

The first decennial of the Settlement will be an occasion of charge under s.64.

The amount charged is computed by applying a rate calculated under s.66 to the value of the relevant property in the settlement. The rate charged under s.66 is calculated by reference to a specified hypothetical chargeable transfer.

Sub-section (3) ibid provides that the chargeable transfer postulated is one of which the value transferred is equal to an amount determined in accordance with sub-section (4) and which is made immediately before the ten year anniversary concerned by a transferor who has in the preceding seven years made chargeable transfers of an aggregate value determined under sub-section (5). Sub-section (5) provides that the aggregate includes the amounts on which

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[37] A similar point could be made in relation to the New South Wales Stamp Duties case of *Munro v Commissioners of Stamp Duties of New South Wales* TC [1934] AC 61

[38] *R (oao Wilkinson) v CIR* HL [2006] STC 270

[39] *Garnett v Jones (Re Arctic Systems Ltd)* HL [2007] STC 1536

[40] *Revenue & Customs Commissioners v Grace* ChD [2009] STC 213

[41] *Genovese v Revenue & Customs Commissioners* [2009] STC (SCD) 373

any charges to tax have been imposed under s.65 in the ten years before the anniversary concerned.

As we have seen, on a strict reading, charges will arise under s.65 when the Original Policyholder becomes absolutely entitled to policies under the Reversionary Interest although HMRC's position appears to be that a charge will not arise in these circumstances. This in turn affects the calculation of the charge on the succeeding decennial which in turn will affect the calculation of exit charges under s.65 in the succeeding ten years.

The Advance of the Trust Fund

The advance of the entire trust fund to the Beneficiaries will be the occasion of an exit charge under s.65. That exit charge is calculated by reference to the rate of charge on the decennial preceeding the exit event[42] so provided that rate is nil no Inheritance Tax will be charged on the advance. Because the rights arising under the Policies advanced will not have been acquired by any person for actual consideration, any gain arising on the advance of the Policies will not be a chargeable gain.[43] Because the assignment of the Policies to the Beneficiaries by the trustees will not take place for consideration, the advance of the Policies as part of the advance of the entire trust fund will not be a chargeable event.[44]

The Surrender of the Remaining Policies by the Beneficiaries

The surrender of the Policies after they have been advanced to the Beneficiaries will not result in the diminution of their estates and therefore the surrender will not be a transfer of value. It will be a disposal for Capital Gains Tax purposes but any gains arising will not be chargeable gains.[45] The surrender of the Policies by the Beneficiaries will be a chargeable event and if a chargeable event gain arises it will be assessable on the surrendering Beneficiaries unless they are not resident in the United Kingdom in the year of surrender.[46]

Conclusion

Compared to conventional Discounted Gift Trusts, the Arrangement offers the additional benefit of allowing the Original Policyholder's right to cash benefits to be deferred indefinitely without creating a further transfer of value. The cost of this additional flexibility is that there is no 'discount' on the measure of the initial transfer of value. Like much Inheritance Tax planning based on insurance, the Arrangement is heavily dependent on HMRC adopting an over-generous construction of the relevant law. It may be unlikely that HMRC will resile from this construction at least in respect of any arrangements entered into before HMRC announce a change. It is always uncomfortable, however, to rely on HMRC continuing to apply such an over-generous construction.

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[42] Sections 65(3) and 69
[43] TCGA 1992 s.210(2)
[44] ITTOIA 2005 s.484(1)(a)(ii)
[45] TCGA 1992 s.210(2)
[46] ITTOIA 2005 s.465

SECTION V

PENSION FUNDING: RESTRICTION OF HIGHER RATE TAX RELIEF

By Garry Hillier

The 2009 Budget announced a significant restriction of higher rate tax relief for pension contributions and introduced anti-forestalling rules which affect pension contributions made in the tax years 2009/10 and 2010/11 for those with "relevant income" of £150,000.

The measures impose a "special annual allowance" charge on pension contributions above an individual's "special annual allowance" unless the contributions benefit from transitional protection. The tax charge is 20% in the current tax year, on employer and individual contributions.

With effect from 6th April 2011, tax relief for pension contributions will be restricted to 20% of income of £180,000 or more. Tax relief where income is between £150,000 and £180,000 will be between 50% and 20% on a tapered scale.

Anti-forestalling Rules

Relevant Income

To prevent individuals making increased pension contributions in the period up to 6th April 2011, new "anti-forestalling" measures have been introduced which became effective from 22nd April 2009.

The "anti-forestalling" measures only apply for the 2009/10 and 2010/11 tax years to those with "relevant income" of at least £150,000 or more for:-

- Any tax year in which pension provision is made for them; or
- Either of the previous two tax years.

The inclusion of "relevant income" in the previous two tax years is designed to stop individuals attempting to avoid the anti-forestalling rules by reducing their income for a couple of tax years.

"Relevant income" is an individual's total income chargeable to income tax for the tax year, before any personal allowances or other reliefs, subject to certain adjustments.

Total income includes employment or self employment income, rental income, pension income, savings interest, dividends, chargeable gains from life assurance contracts or bonds (without top slicing relief) and income from trusts.

Where an individual enters into a salary or bonus sacrifice agreement after 21st April 2009 in return for an employer's pension contributions or additional pension rights the sacrificed amount is also added back into the calculation of "relevant income".

Certain amounts may be deducted from income to establish an individual's "relevant income" for the tax year and this includes:-

- Relievable pension contributions up to £20,000 made by the individual or a third party on their behalf, in the tax year (but not employer pension contributions on behalf of the individual);

- Any donations made (or treated as made) during the tax year that qualify for gift aid;

- Relief for trading and certain other losses.

Accordingly, an individual who has a **basic** salary of more than £150,000 in a tax year can have "**relevant** income" below this threshold once the allowable deductions noted above have been taken into account.

Full details of taxable income and deductible losses and reliefs are set out in Income Taxes Act 2007 ss.23 and 24.

For individuals who are close to the £150,000 threshold it may be possible to contain their "relevant income" for the current tax year, but income for the previous two tax years is generally fixed. It may, however, be possible for "relevant income" for the tax year 2008/09 to be reduced by a charitable donation made now and carried back. This is possible if the self assessment tax return for the year has yet to be submitted. A charitable donation may be made after the end of the 2008/09 tax year but before 31st January 2010 and then related back to 2008/09 (see Actions to be considered below).

<u>The Pension "Special Annual Allowance"</u>

The pension "special annual allowance" is a tax allowance that **limits** tax relief on pension funding for those "high income individuals" with "relevant income" of £150,000 a year or more as defined above.

The "special annual allowance" runs in tandem with the usual pension annual and lifetime allowances (currently £245,000 and £1,750,000 respectively, for 2009/10) and will apply until 5th April 2011 when the Government intends to put in place final rules.

The "special annual allowance" applying for the period from 22nd April 2009 to 5th April 2011 and 2010/11 tax year is the **highest** of:-

- **£20,000**; or

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- An enhanced allowance of up to **£30,000** (which can apply where money purchase pension contributions have been paid by, or on behalf of, the individual (for example employer contributions) less often than quarterly (such as annual or single contributions). This is based on the **lower** of (a) the average of these infrequent contributions in the three tax years 2006/07, 2007/08 and 2008/09 and (b) £30,000.

  (Therefore if the amount of the infrequent contributions (i.e. less regular than quarterly) over the three years is more than £20,000 the "special annual allowance" is increased to this average, but with a limit of £30,000) ; or

- The individual's "protected pension input amount" (this is based on their normal amount of regular pension provision before 22nd April 2009).

It should be noted that this "special annual allowance" applies to **all** pension provision for affected individuals whether made personally or by an employer or third party.

Example

Susan has relevant income of more than £150,000 and started a personal pension in December 2007. She made a single pension contribution of £35,000 in the 2007/08 tax year and a £40,000 single contribution in the 2008/09 tax year. The average of her "infrequent "contributions over the three tax years 2006/07, 2007/08 and 2008/09 is £25,000 and since this is between £20,000 and £30,000 it becomes Susan's "special annual allowance" for the current tax year.

Special Annual Allowance Tax Charge

If the amount of pension provision made for higher income individuals between 22nd April 2009 and 5th April 2010, or in the 2010/11 tax year, is more than the special annual allowance this will generate a "special annual allowance tax charge" on the individual which means that most of their higher rate relief will effectively be clawed back in excess of the special annual allowance, unless they are "protected savings" (see below).

Protected Pension Contributions from the Special Annual Allowance

Under the "special annual allowance" rules, "high income" individuals can continue their existing regular "normal" pattern of pension contributions in place before 22nd April 2009 without incurring a special annual allowance tax charge – these are known as "protected pension input amounts".

"Protected pension input amounts" which are exempt from the special annual allowance charge, regardless of their size are:-

- The yearly amount of any money purchase pension contributions made on behalf of the individual (personally or by an employer or third party) which is made quarterly or more often **before** 22nd April 2009 (and including any subsequent contractual increases to them); and

- Any continued accrual of defined benefit rights, unless the scheme rules are changed after 22nd April 2009 to increase benefits (for example, from 80ths to 60ths accrual) for less than 50 members.

It should be noted that to be protected the individual's provision must normally:-

- Continue to be made under the **same** pension arrangement as before 22nd April 2009; and

- Continue to be made quarterly or more often after 22nd April 2009 and

- Not increase after 22nd April 2009 other than in line with contractual agreements made before 22nd April 2009.

Example

Andrew a "high income" individual was regularly paying £6,000 a month into a SIPP before 22nd April 2009. He is also a member of a money purchase occupational pension scheme and his employer was paying £1,000 a month into the scheme prior to 22nd April 2009. These levels of contributions totalling £84,000 a year can continue to be made to the respective schemes without Andrew facing a" special annual allowance" tax charge. Andrew would therefore remain eligible for higher rate tax relief this tax year and next.

What is the Pension "Special Annual Allowance Tax Charge"?

Under the rules, "high income" individuals **personally** incur a "special annual allowance tax charge" on any **excess** pension contributions above their "special annual allowance. For the 2009/10 tax year the rate is 20% - the difference between the higher rate and basic rate of income tax. From 2010/11 a 50% top rate of Income Tax will apply for individuals with taxable income in excess of £150,000 and the intention of the legislation is to continue to restrict pension tax relief to basic rate. The charge is collected from the individual under the self assessment income tax system.

As all pension provision (including employer contributions) is taken into account, this means that the individual could incur the" special annual allowance tax charge "even where they have not received the higher rate relief.

Example

Jonathan is a higher Income Tax payer with a SIPP. His employer made a single contribution of £80,000 to a SIPP on 1st August 2009 no other contributions have been paid in the 2009/10 tax year and Jonathan has no protected pension input amounts. Jonathan therefore has a standard special annual allowance of £20,000 and therefore the excess contribution made of £60,000 would incur the special annual allowance tax charge of 20% i.e. £12,000. This is to be paid by Jonathan through his self assessment even though he has not made the contribution himself and was not entitled to any relief in his own right.

Actions to be Considered

Although the anti-forestalling measures have been introduced to counteract arrangements designed to reduce "relevant income" to below £150,000 certain actions may be considered to help reduce the impact of the new rules including:-

- For those individuals whose "relevant income" is around £150,000 a gift aid payment may be considered which may reduce "relevant income" below the threshold. As noted above, where the tax return has yet to be filed relevant income for the 2008/09 tax year may be reduced by a charitable donation providing this is made before 31st January 2010 and then carried back to 2008/09 tax year.

- Where "relevant income" is £150,000 or more then individuals should consider the payment of pension contributions up to their protected input amount (if relevant) or the special annual allowance if higher for both the 2009/10 and 2010/11 tax years to benefit from higher rate tax relief. Alternative tax efficient investments may also be considered together with unregistered pension schemes where appropriate.

- For individuals with a spouse who has "relevant income" of less than £150,000 pension contributions may be considered for the spouse. The maximum contribution being determined by the spouse's relevant earnings.

- For those individuals with "relevant income" between £100,000 and £150,000 consideration may be given to accelerating funding should there be a future prospect of breaching the income limits.

Summary

The new pension rules clearly affect the tax breaks for" high income" individuals and therefore it is important to ensure that appropriate consideration is given to the impact of the new provisions and whether there are opportunities for making pension contributions up to the" protected pension input amount" over the next two tax years or alternatively looking at the use of a spouse's allowances and alternative tax efficient investments.

A review of the implications of the new rules should therefore be undertaking and advice sought to ensure future pension and investment planning is implemented in the most tax efficient way.

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SECTION VI

PENSIONS: CHANGES TO NORMAL RETIREMENT AGE ON 6TH APRIL 2010

By Garry Hillier

Currently individuals are permitted to start drawing their pension and tax free lump sum benefits from their UK registered pension schemes once they attain the age of 50, if their pension scheme rules allow. On 6th April 2010 the minimum retirement age will increase to 55.

Any benefits drawn before attaining the revised "normal minimum retirement age" will be subject to an unauthorised payment charge of 40% and a potential surcharge of an additional 15%. In addition the scheme would suffer a scheme sanction charge of a net 15%. Accordingly, an unauthorised payment charge of up to 70% in total may apply unless the individual is entitled to take benefits earlier than normal.

For any individual who is currently aged between 50 and 54 inclusive (or will be by 5th April 2010) and who is a member of a UK registered pension scheme and benefits have not been "vested " (i.e. put into payment consideration) will need to be given as to whether to start taking pension benefits by 5th April 2010 before the new minimum retirement age of 55 comes into force.

After 5th April 2010 it will be necessary to wait up to five years longer before being able to access pension benefits. Individuals who have already commenced taking pension benefits from their registered pension arrangements are not affected by the new rule changes.

Clearly, individuals should take advice as to whether any action is required to be taken in connection with taking any of their pension benefits who will be aged between 50 and 54 before 6th April 2010.