RUDGE REVENUE REVIEW

ISSUE 4

"Annual income twenty pounds, annual expenditure nineteen nineteen six, result – happiness. Annual income £576bn, annual expenditure £628bn, result – macroeconomic stability."

Wilkins Micawber
Chancellor of the Exchequer
Pre-Budget Report 24th November 2008

The Pre-Budget Report was a seismic event in the economic history of the nation – a dramatic exposure of the financial profligacy of the last eleven years and an exercise in fantasy about the nation's ability, regardless of the economic situation, to pay for the ever expanding state. From the point of view of tax planning, however, it was something of a damp squib; limited anti-avoidance measures and tax rises carefully timed to come into effect after the next election.

So, in this issue of the Rudge Revenue Review, we concentrate on other matters. Garry Hillier of HB Cranfield Wealth Management Limited reminds us of the approaching deadline for protecting pre-A day pension funds. We examine an interesting new insurance product designed to meet the needs created by the "reform" of the Inheritance Taxation of trusts. We examine the decision in the case of *Underwood v HMRC* which has important implications for understanding the nature of a Capital Gains Tax disposal and, in particular, of sub-sale transactions.

It is a pleasure, in this advent season of preparation, to wish all of our clients and contacts a very happy Christmas and to look forward to helping you with your taxation problems in the New Year.

Simon McKie **Sharon McKie**

McKie&Co

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SECTION I

PROTECTING PRE A-DAY PENSION FUNDS

DEADLINE 5TH APRIL 2009

1.1.1 The pensions tax regime which came into effect on 6th April 2006 introduced a new set of rules applying to all approved pension schemes, both occupational and personal. The new rules provide a limit, known as the “lifetime allowance” (LTA) on the value of pension benefits an individual can accumulate within one or more “registered” pension schemes during their lifetime before a tax charge is incurred.

1.1.2 The LTA was introduced at a level of £1.5 million for the tax year 2006/2007, the first year of the new regime. It increases annually and is £1.65 million for the 2008/2009 tax year rising to £1.8 million for the 2010/2011 tax year. In the Pre-Budget Report it was announced that the LTA is then to be capped at this amount until 6th April 2016.

1.1.3 The capital value of any pension benefits an individual draws (“crystallises”) from a registered pension scheme in the current tax year (2008/2009) when added to the capital value of any benefits previously drawn in the same or another registered pension scheme in excess of the £1.65 million allowance will be subject to an LTA charge at an effective rate of 55%.

1.1.4 There may also be cases where individuals have accumulated pension savings and/or rights in a registered pension scheme(s) which have a value in excess of the

LTA at 5th April 2006 ("A-day") or whose pension benefits are expected to be in excess of the prevailing LTA at the date when benefits are to be drawn. When assessing the value of pension rights/benefits at 5th April 2006 it is necessary to also take into account pension entitlements already in payment.

1.1.5 Transitional rules were introduced allowing individuals to **protect** their pension rights/benefits from the potential LTA charge applying under the new regime.

Deadline

1.1.6 The deadline for registering protection from the LTA charge is **5th April 2009**. A failure to register pension benefits/rights by this date will mean the protection will be lost and the charge will apply on pension rights/benefits in excess of the LTA.

1.1.7 It is therefore vitally important for individuals to apply for protection whose pension savings/benefits are in excess of £1.5million at 5th April 2006 or who anticipates the total value or all pension benefits will be in excess of the LTA.

1.1.8 Advisers will need to ensure they obtain a valuation of an individual's pension funds **prior to** an application to register for protection.

ENHANCED AND PRIMARY PROTECTION

1.2.1 There are two types of protection that may be registered with HMRC – enhanced and/or primary. Even if he is a member of an employer's/occupational pension scheme, it is the individual's responsibility to register pre A-day rights.

1.2.2 Both types of protection (enhanced and primary) may be registered. A decision may be taken at the date pension benefits are to be taken after A-day as to which protection is to be utilised.

Primary Protection

1.2.3 Primary protection is only available to individuals whose total pension rights/funds is valued in excess of £1.5 million as at 5th April 2006. Registration for primary protection enables an individual to obtain a personal lifetime allowance which increases at the same rate as the published standard lifetime allowance, broadly in line with the Retail Prices Index.

1.2.4 For example, where an individual has total pension benefits/rights at A-day of £3million, he/she will have a personal lifetime allowance of 2 times the standard lifetime allowance for the tax year in which he/she crystallises pension benefits and primary protection has been notified.

1.2.5 Primary protection will not therefore offer complete protection from the LTA charge. The charge will be dependent on whether the growth in the individual's pension fund assets exceeds the growth in the LTA.

Enhanced Protection

1.2.6 Enhanced protection is open to everyone irrespective of the value of their approved pension rights/benefits at A-day. Enhanced protection is usually considered where the cumulative value of an individual's pension rights/benefits (including the capitalised value of pensions already in payment) was above £1.5 million at A-day or it is anticipated it will be above the appropriate lifetime allowance at the time when benefits are to be taken (crystallised).

1.2.7 Enhanced protection offers complete exemption from the 55% LTA charge if the accumulated pension fund/benefits on crystallisation or death exceeds the prevailing LTA.

1.2.8 An important condition for registering for enhanced protection is that an individual must not make any further contributions to any defined contribution registered pension scheme after A-day and may only accumulate further benefits within a final salary occupational pension scheme within specific limits.

TAX FREE CASH SUMS

1.3.1 The new pension regime also limits an individual's tax free cash lump sum entitlement to 25% of the prevailing LTA (up to £375,000 at the date when the new rules were introduced - A –day). Where an individual's cash lump sum entitlement is more than £375,000 prior to 5th April 2006, these benefits can also be protected by the new regime.

LOSS OF PROTECTION

1.4.1 An individual can give up enhanced protection voluntarily, if appropriate, and this would normally be considered at the time when the individual wishes to draw benefits if it is felt that primary protection would provide a better result than enhanced protection. Accordingly, enhanced protection can be given up and an individual can then rely on primary protection provided that this has also been registered by 5th April 2009. It is important to note that primary protection cannot be given up voluntarily.

ACTION

1.5.1 Advisers will need to consider prior to 5th April 2009 registering for enhanced /primary protection or both to ensure that maximum flexibility is retained.

1.5.2 The appropriate protection must be registered by 5th April 2009 to avoid potentially significant tax consequences. Time delays can arise in obtaining the valuation of

existing pension rights from pension providers and therefore for those who have not yet registered for protection it is important this issue is addressed now.

SECTION II

NO SURRENDER!

THE PROBLEM

Finance Act 2006 Section 156 and Schedule 20

2.1.1 The changes to the Inheritance Taxation of Trusts made by Finance Act 2006 s.156 and Schedule 20[1] have the result that it is not possible to make a trust designed to benefit an individual by way of a lifetime transfer which does not fall within the relevant property regime of Inheritance Tax Act 1984 Part 3 Chapter 3 unless the trust falls within a very limited class of privileged settlements. Parents and grandparents who wish to pass their wealth on trust to the succeeding generations during their lifetimes so as to minimise their Inheritance Tax liability on death must now either make an immediately chargeable transfer or an absolute gift on bare trusts. Under such an absolute gift the donee will receive unfettered control of the donated assets at the age of 18.

Protecting prodigal sons from themselves

2.1.2 At the time the changes were introduced, virtually the only people in the country who thought that they were a good idea were Government Ministers who, one presumes, have never had read to them the parable of the Prodigal Son. It is very rarely in the long-term interests of an eighteen year old to be given unfettered control of substantial amounts of money. So advisers have turned their attention to finding

[1] All references in this article are to the Inheritance Tax Act 1984 unless otherwise stated

ways in which gifts on bare trusts could be made of assets which it would be impossible, or at least, difficult, for a beneficiary to turn to account in the period during which he is insufficiently mature to be trusted to do so prudently.

The Company's Solution

2.1.3 It was a problem tailor-made for the insurance industry and commentators quickly suggested that a whole of life maximum investment policy on the life of the donor with restricted surrender rights would go a long way towards providing a solution. A well known non-resident insurance company (the "Company") has created an arrangement (the "Plan") to meet the demand for such policies which is being marketed as the successor to accumulation and maintenance trusts. This article describes the Plan and considers its taxation effects and whether it meets the need which it is designed to serve.

THE PLAN

2.2.1 In many ways, the policies issued under the Plan are absolutely conventional single premium insurance bond policies. The policy documentation includes an application form (the "Application Form"), a supplement to the application form (the "Supplementary Form"), a draft bare trust (the "Draft Trust Deed") and a draft deed of assignment (the "Draft Assignment"). The Company has kindly supplied all of these documents to McKie & Co except the Application Form and has also supplied a marketing document describing the Plan (the "Plan Description"), its instructions to

Counsel concerning the plan (the "Instructions") and Counsel's Opinion (the "Opinion") thereon.

The General Conditions

2.2.2 Policies issued under the Plan are governed by the Company's general conditions which are applicable to its whole of life "investment" policies generally. The policies are modified by two special conditions which apply only to policies issued under the Plan and which are set out in the Supplementary Form.

The Term and the Premia

2.2.3 The policies are single life, or joint life last survivor, whole of life policies. That is, if only a single person is insured, they mature on the death of that person. If two or more lives are insured, they mature on the death of the last of those persons to die.

2.2.4 The policy comes into existence on the payment of a premium and further premia may be added by the policyholder although the Company reserves the right to refuse such additional premia. The minimum permitted initial premium is £100,000 and the minimum additional premium is £10,000.

The Notional 'Portfolio'

2.2.5 The benefits under the policy are calculated by reference to the value of a group of assets described as a 'portfolio' which are identified by a portfolio reference number in the accounts of the Company.

2.2.6 This group of assets is segregated in the accounts of the Company purely for the purposes of calculating the benefits paid under the policy. The assets comprised in the portfolio belong beneficially to the Company and not to the policyholder. The management of the assets is undertaken by the Company but the policyholder may set a broad investment strategy to be followed by the manager and he may change this broad strategy from time to time. It is a specific term of the policy that the policyholder has no right either to manage the underlying assets or to exercise any control over them whatsoever although this must be subject to the policyholder's right to set the broad investment strategy.

2.2.7 Rather unusually, the Company maintains a separate portfolio for each policy although the investments comprised in the portfolio may include holdings in the Company's funds. It is more normal for an insurance company to create a single fund for the purposes of all or a group of the investment policies which it issues notionally divided into units, the units being allocated to individual policies for the purpose of calculating policy benefits.

Policy Benefits

2.2.8 When the policy is surrendered in whole an amount (the "Surrender Benefit") becomes payable to the policyholder which is equal to the value of the portfolio. On part surrender, a proportionate amount of the Surrender Benefit is payable. When the policy matures (on the death of the life assured or the last death of the lives assured) a benefit (the "Maturity Benefit") becomes payable which is equal to the portfolio value at the time of death plus an additional amount which is the lower of 1% of that

value and £5,000. It is possible to opt for the Maturity Benefit to be increased by an additional amount to provide a larger differential between the surrender value and the maturity benefit increasing what one might call, loosely, the real insurance element of the Plan. An additional charge is then made against the portfolio value.

Charges

2.2.9 Charges are made under various heads by the Company against the value of the portfolio and third party transaction costs are also charged against it.

2.2.10 The general policy conditions do not define the method of computing these charges with exactitude and so it will be necessary for the policyholder, or his adviser, to agree a basis of charge at the time of taking out the policy if the Company are not to be left with a large degree of discretion in calculating its charges. Even so it is a specific term of the policy that the Company has the 'right to increase the charges at any time' subject to giving the policyholder one month's notice and an explanation of the circumstances of the increase.

2.2.11 If the contract is surrendered before the expiry of an initial period, an early surrender charge may be deducted from the portfolio value in calculating the Surrender Benefit. The general policy conditions do not define the term of the initial period or the amount of the early surrender charge and so, again, this is a matter to be specifically agreed before the policy is issued.

Unrestricted Right of Assignment

2.2.12 The policyholder from time to time has a right to assign or otherwise charge the rights conferred under the contract.

The Supplementary Form

Surrender and Withdrawal Rights

2.2.13 Under the General Conditions, the policy may be surrendered in whole or in part by the policyholder by written notice at any time. Regular withdrawals may be made at quarterly, six-monthly or annual intervals of an amount that is specified by the policyholder.

2.2.14 The Supplementary Form, however, contains provisions which modify the general conditions. On applying for a policy the applicant may specify on the Supplementary Form an initial period in whole years during which there will be no option to surrender the policy in whole or in part. He may also specify an initial period of whole years during which the regular withdrawal right is restricted to a cumulative annual percentage which may not be more than 5%.

The Draft Trust Deed

2.2.15 The draft Trust Deed is in the form of a declaration by the original policyholder that the policy is to be held on trust for a single beneficiary absolutely. The form names the settlor as one of two trustees.

2.2.16 Of course there is no reason why an individual should not use a bespoke trust deed. As this product is aimed at those settling sufficient sums on children and young adults as to cause the donor's transfers to exceed his nil-rate band it is likely that the sums concerned will be sufficiently large that it would be imprudent to undertake the transaction without taking proper professional advice including advice on the terms of an appropriate bare trust.

The Draft Assignment

2.2.17 Under the Draft Assignment the policy may be assigned. It provides space for only one assignee and provides that:-

> "… the Assignor as beneficial owner hereby assigns unto the Assignee all that the Policy/ies and all monies which are assured thereby and all benefits and other monies which may become payable in respect thereof to be held by the Assignee as beneficial owner free from any trust or encumbrance."

2.2.18 The Plan Description, however, states that under the Plan, the original policyholder, having been issued with the policy:-

> " … then assigns the policy by way of outright gift to, or to bare trustees for, a child, grandchild, relative or third party."

AN EXAMPLE

Harry Masters is a very wealthy man. He has made no previous chargeable transfers. He wishes to make a transfer of his wealth in favour of his son Dabinett, so as to make a potentially exempt transfer whilst he is young enough to have a good chance of surviving the gift by a period sufficient to allow it to fall out of charge for Inheritance Tax purposes. He takes out a policy under the Plan paying a single premium of £1,500,000 and completes the standard Draft Trust Deed in respect of the policy appointing himself and his wife as trustees and naming Dabinett as the sole beneficiary. He then immediately assigns the policy to himself and his wife jointly using the Draft Assignment and sends the assignment to The Company for registration. Dabinett will be ten years old on 30th June 2009, and, in general, Harry thinks that one is not usually mature enough to have unfettered control of substantial wealth until one is 30 so on taking out the policy he opted for the surrender right to be suspended until 30th June 2029 and he excluded all regular withdrawals until that date. The market value of the policy subject to these restrictions at the time that the policy is assigned is £1,030,000.

Harry Masters dies on 21st February 2024 when Dabinett is a little over 25 years old. The portfolio value at that time is £2,940,000. The policy matures on Harry Masters death and pays out a maturity benefit of £2,945,000 (£2,940,000 + £5,000) to Mrs Masters, as the surviving policyholder. She receives it as bare trustee for Dabinett and, at his request, she pays it to him.

It is assumed that current tax rules are not altered in subsequent years.

TAXATION ANALYSIS

2.3.1 We shall now consider the taxation effects of the policy by reference to the facts in the boxed Example.

The Contract is Made

A transfer of value?

2.3.2 When he takes out the policy, the policyholder makes a disposition. That disposition will be a transfer of value if it results in a decrease in the value of the estate of the person making it.[2] In our Example, Harry makes a transfer of value because, before entering into the policy his estate contains cash of £1,500,000 and after entering into it his estate no longer contains that cash but rather has a bundle of rights under the

[2] Section 3(1)

policy which has a market value of £1,030,000. He therefore makes a transfer of value of £470,000. In fact, one would expect that in virtually every case there will be a transfer of value. The policy involves giving up a right to access the funds invested in it wholly or partly for a period. No enhanced return is offered for tying up one's money in this way as it would, for example, if one made a fixed term deposit with a bank. That being the case, the value of the policy when it is made is almost certain to be less than the initial premium paid in respect of it. Whether that reduction in value will be significant will depend on the amount of the premia, whether withdrawal rights as well as surrender rights are suspended and the lengths of the suspension periods.

Is it an exempt transfer?

2.3.3 The transfer of value will not be a potentially exempt transfer because, although it is made by an individual, it is not a gift to an individual or to a privileged trust.[3] Indeed, it is arguable that it is not a gift at all. It will be a chargeable transfer unless it is exempt under any provision.[4] The Opinion suggests that it will not be a chargeable transfer because it will be exempt under IHTA 1984 s.10. Sub-section 1 of that section provides that:-

> "(1) A disposition is not a transfer of value if it is shown that it was not intended, and was not made in a transaction intended, to confer any gratuitous benefit on any person and either -

[3] Section 3A(1A)
[4] Section 2

(a) that it was made in a transaction at arm's length between persons not connected with each other, or

(b) that it was such as might be expected to be made in a transaction at arm's length between persons not connected with each other."

2.3.4 For this purpose a 'transaction' includes a series of transactions and any associated operations.[5] It seems clear that the making of the contract, the declaration of trust over the contract and the assignment of the contract to the trustees are a series of transactions (and they are also, of course, associated operations) and, therefore, that the transaction to be considered for the purpose of applying s.10(1) is a composite transaction which includes the settlement of the policy and its assignment to the trustees.

2.3.5 That being the case, it is difficult to see how the disposition consisting of the making of the policy can satisfy the condition that it "… was not made in a transaction intended to confer any gratuitous benefit on any person."

2.3.6 As we shall see, the Opinion, in concluding that the making of the policy will probably be an exempt transfer under s.10, also finds support in a purposive argument. As that argument depends upon considering the valuation of the transfer of value which takes place on the assignment it is considered below. It is there concluded that it does not have sufficient weight to demonstrate that the exemption is applicable.

5 Sub-section (3) ibid

2.3.7 On that basis, the possibility that the making of the contract will be an immediately chargeable transfer is a weakness of the Plan and it will be necessary, for any person implementing it, to pay careful attention to the valuation of the policy at the time it is taken out. The reduction in the value of the original policyholder's estate in many instances may be within the nil rate band and may, in some cases, be quite small. If the premia paid in our example had been £750,000 not £1,500,000 the reduction in Harry Masters' estate would have been in the region of £235,000 (£470,000 x £750,000/£1,500,000), well within the nil rate band. The problem will also be mitigated if the withdrawal option is chosen so that regular withdrawals may be made from the policy. In that case, because it would be possible for the policy holder to benefit from the policy to some degree whilst the surrender right is suspended, the depreciation in value on entering into the policy will be reduced. On the other hand, the beneficiary's ability to turn the policy to account by selling it or using it as security for borrowing will then be increased which rather defeats the purpose of the Plan.

<u>The Assignment on Bare Trust</u>

Inheritance Tax

2.3.8 The assignment on bare trust will be a transfer of value which will not be exempt but rather will be a potentially exempt transfer. That is because it will satisfy the conditions that it is:-

(a) made by an individual on or after the 22nd March 2006;

(b) would otherwise be a chargeable transfer; and

(c) constitutes a gift to an individual.[6]

2.3.9 In determining the value transferred the special rule in s.167 will apply. Section 167(1) and (2) provide that:-

"(1) In determining in connection with a transfer of value the value of a policy of insurance on a person's life or of a contract for an annuity payable on a person's death, that value shall be taken to be not less than -

(a) the total of the premiums or other consideration which, at any time before the transfer of value, has been paid under the policy or contract or any policy or contract for which it was directly or indirectly substituted, less

(b) any sum which, at any time before the transfer of value, has been paid under, or in consideration for the surrender of any right conferred by, the policy or contract or a policy or contract for which it was directly or indirectly substituted.

(2) Subsection (1) above shall not apply in the case of -

(a) the transfer of value which a person makes on his death, or

(b) any other transfer of value which does not result in the policy or contract ceasing to be part of the transferor's estate"[7]

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6 Section 3A(1A)

7 It is because of sub-section (2)(a) ibid that the valuation rule does not apply on the making of the contract

2.3.10 The result of this is that the measure of the potentially exempt transfer arising on the assignment will be the premium paid under the policy. In our example that would be £1,500,000.

2.3.11 There is obviously an element of double accounting here. If Harry Masters were to die immediately after subjecting the policy to bare trusts in favour of his son, Dabinett, he would have made a chargeable transfer of £470,000 and, shortly afterwards, a potentially exempt transfer of £1,500,000 which, by reason of being within seven years of his death, would have proved to be a chargeable transfer. Inheritance Tax would have been charged on £1,970,000 (£1,500,000 + £470,000) whereas his estate in reality would only have been reduced by £1,500,000. That is obviously an anomalous result and, on the basis of it, Counsel argues in the Opinion that HMRC are unlikely to take the point that there is a chargeable transfer of value at the time that the contract is made because, on a purposive construction, s.10 is to be taken to apply to it.

2.3.12 The basis of this view is that the purpose of s.167 is to prevent avoidance of tax through the payment of premia for policies subsequently given away which are worth less than the premia paid for them. Counsel points out that in the case of the Plan, a potentially exempt transfer arises on the assignment which is plainly not less than the premium paid with the result that there is no tax avoided. Counsel does go on to say, however, that it will be safer for the policy holder to have limited five percent withdrawal rights during the initial period, presumably on the basis that the withdrawal rights would increase the value of the policy so that, if he were wrong in considering

that the making of the policy will be exempt under s.10, the measure of the chargeable transfer arising at that time would be reduced.

2.3.13 The problem with this view is that s.167 is only in point if the transferor dies within seven years of the gift so that what would otherwise be a potentially exempt transfer becomes chargeable. It is difficult to see how a consideration of the purpose of a provision governing a later transfer of value, which may never become chargeable, can condition the construction of the provisions relevant to the making of the policy. It may be that a purposive argument could be mounted to disapply s.167 in determining the amount of the transfer of value on the assignment but we would not be sanguine even to that extent. Such a construction would do considerable violence to the statutory words which the Courts are rarely willing to do in the taxpayer's favour.

2.3.14 So not only would it appear that the making of the policy creates an immediately chargeable transfer but there also appears a real risk that s.167 could have the effect that a double charge to Inheritance Tax would be created by the Plan.

2.3.15 In practice, where the five percent withdrawal option is exercised, it may be that the premium paid would have to be extremely high before a significant charge would arise on the making of the policy and for there to be a significant element of double counting. Nonetheless, this is a major concern about the product and a person considering using it would need to consider the question of valuation extremely carefully before doing so.

Income Tax

2.3.16 A policy taken out under the Plan will be a non-qualifying policy of life assurance for the purposes of ITTOIA 2005 Part 4 Chapter 9 and it will be a foreign policy for those purposes.[8] If there is a chargeable event in respect of the policy on which a chargeable event gain arises and the beneficiary is UK resident, that gain will form part of the beneficiary's assessable income subject to both basic and higher rate Income Tax as appropriate.[9] The assignment of rights under a life assurance policy, however, is not a chargeable event for these purposes so the assignment by the original policy holder to the trustees will not give rise to a chargeable event gain.

The Maturity of the Policy

Inheritance Tax

2.3.17 When the policy matures on the death of the life assured (or on the death of the last life assured to die) it will not form part of the life assured's estate and so it will not be subject to Inheritance Tax at that time. So, in our example, the policy proceeds of £2,945,000 do not bear Inheritance Tax. As we have seen, if the life assured were to die within seven years of making a gift of the policy, that would result in his potentially exempt transfer proving to be a chargeable transfer.

Income Tax

2.3.18 The maturity of a non-qualifying policy of life assurance by reason of a death which gives rise to the payment of benefits under the policy will be a chargeable event. In

[8] ITTOIA 2005 s.476(3)
[9] ITTOIA 2005 s.465(2), ss.491, 461 and 463

calculating the chargeable event gain, however, the value of the policy taken into the calculation is not the amount payable on the maturity of the policy on the death but rather the value for which it could have been surrendered immediately before the death.[10] So if the death occurs during the period in which the surrender right is suspended, and there is no withdrawal right, the value of the policy for the purposes of calculating the chargeable event gain will be nil and therefore there will be no chargeable event gain.

2.3.19 Where withdrawal rights are retained, there will be a value for the policy within ITTOIA 2005 s.493 but it is unlikely that in those circumstances the total benefit value of the policy would be less than the deductions to be made in calculating the chargeable event gain under s.491(2) ibid.

2.3.20 If the policy were to mature after the suspension period expires, however, when the policy had acquired surrender rights, the accumulated yield on the policy would be subject to Income Tax because, in effect, it would create a chargeable event gain. If, in our example, Harry Masters had provided for the surrender rights to be suspended only until Dabinett's twenty fourth birthday on the 30th June 2023, there would have been a chargeable event gain on Harry's death of £1,940,000 (£2,940,000 - £1,000,000) forming part of Dabinett's assessable income for 2023/2024. Harry's survival for a little less than eight months after the suspension of the surrender rights would have proved to be very costly indeed. Assuming that Dabinett pays a marginal rate of Income Tax of forty percent it would have cost £776,000 (£1,940,000 @ 40%).

[10] ITTOIA 2005 s.493(7)

IS THE PLAN THE SOLUTION TO THE PROBLEMS CREATED BY FA 2006?

2.4.1 Subject to the points raised in this article concerning the possibility of a chargeable transfer arising on the making of the policy and of a double charge to Inheritance Tax on the donor failing to survive his gifts by seven years, the Plan does seem to fulfil its purpose of allowing an effective transfer of wealth to be made out of the donor's estate for Inheritance Tax purposes in favour of a donee.

2.4.2 The net result of Harry Masters' transaction in our example is that he has removed £2,945,000 from his estate (including investment growth of £1,945,000) and only £470,000 of that amount has borne Inheritance Tax. Because of the application of the nil rate band and the annual exemptions and because the lifetime rates of Inheritance Tax apply, the total Inheritance Tax suffered is just £30,400 (20% (£470,000 – (£312,000 + £3,000 + £3,000)) and, ignoring withholding tax suffered by the Company, there has been no Income Tax or Capital Gains Tax on the investment yield at all.

2.4.3 One might go on to ask though whether the Plan succeeds in allowing a donor to make a gift which prevents the donee squandering the wealth which he is given? The answer is that it will do so only partially.

2.4.4 First, if an outright assignment is made, the donee will control the broad investment strategy of the investments linked to the policy by virtue of the policy holder's right to set that strategy. If the property is assigned to trustees, the trustees will hold that

right but it will be subject to a duty to transfer the policy to the beneficiary at his request as from the age of eighteen.

2.4.5 Much more significant, however, is the fact that the donor cannot prevent the donee from selling the policy or using it as security for his borrowing. It may well be that only the most improvident of beneficiaries would do so because it is highly unlikely that he would be able to sell or pledge the policy for an amount anywhere near the portfolio value. That is because the policy will be an illiquid asset (because of the suspension of the surrender rights) of an unusual class and because potential purchasers may be afraid that an obstructive trustee would delay dealing with the policy in accordance with the beneficiary's instructions. If the policy includes withdrawal rights, however, the discount for illiquidity would be reduced and the latter difficulty could be overcome by the beneficiary requiring the trustees to advance the policy to him before selling or pledging it.

2.4.6 It is not always easy to predict how one's children (or grandchildren) will develop in the future. Some people are financially prudent when very young, others never become so. One of the difficulties of the Plan is that it requires the original policyholder to determine the period for which the surrender rights and withdrawal rights are to be suspended before the policy is issued.

2.4.7 Another drawback of the strategy is that if the life assured dies earlier than expected then, as in our example, the beneficiary's illiquid asset will be turned into highly liquid

cash prematurely. The chances of the policy maturing earlier than expected could be reduced by writing the policy on multiple lives.

2.4.8 Perhaps there is a more fundamental point to be made. We have seen that the value of the policy immediately after it is made will be less than the premium paid in respect of it. That represents a real drop in the market value of the donor's assets or, one might say, of the total assets of the donor and his family. It is true that the value will be recovered once the policy either matures or accrues surrender rights after the suspension period but the drop in the policy's value in the meantime represents a real, if temporary, drop in the family's wealth.

A MARK II PLAN?

A Right of Veto over Surrender

2.5.1 Is there another approach which might be taken? One possibility is that the original policy holder be given a right of veto over any proposed surrender or partial surrender of the policy, a right which is retained when the policy is assigned. In that way, it would not be necessary for the policy holder to estimate the age at which the beneficiary will be sufficiently mature to be trusted with wealth at the time the policy was made and it would be possible to extend for a very long period, indeed, the period of veto, perhaps until the final maturity of the policy. As the right of veto would be an item of property, but one with a very low value, it would be possible for the settlor to settle it on discretionary trusts without creating a significant inheritance charge on the settlement or creating material decennial charges under s.64.

Reservation of Benefit?

2.5.2 The obvious technical worry is that the right to veto a surrender might be a reservation of benefit within FA 1986 s.102(1) on the basis that possession and enjoyment of the property will not have been bona fide assumed by the donee or, alternatively, or additionally, because the donated property is not enjoyed to the entire exclusion of the donor. In our view there would be little risk of there being a reservation of benefit in the property because the retained rights would have been carved out before the gift.[11]

2.5.3 In any event, if there was felt to be a real risk of the provision applying, the settlement of the right of veto on discretionary trusts from which the donor was excluded would ensure that the reservation of benefit immediately came to an end.

2.5.4 The pre-owned assets charge could not apply to the arrangement because the donor's gift would not be a gift of land and chattels and, if the right of veto were settled, it would be settled on trusts from which the donor was excluded.[12]

An Activation Right

2.5.5 One drawback of this suggestion for a Mark II Plan is that, because there would be a surrender benefit at all times, the yield on the policy would be subject to a chargeable event gain charge whenever the policy matured.

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[11] See *Munro v Commissioners of Stamp Duties of New South Wales PC* [1934] AC 61

[12] FA 2004 Sch 15 paras 3, 6 and 8

2.5.6 An alternative approach might be to provide that there would be no right to surrender the policy at any time until the original life assured had exercised an option to activate that right. Once the ownership of the policy and this activation right had been separated it is difficult to see how there could be a surrender value for the purposes of ITTOIA 2005 s.493 at any time before the right is exercised. The activation right could be settled in the same way as the right of veto.

CONCLUSION

2.6.1 The Plan gives considerable scope for allowing gifts to be made in favour of children and young adults whilst protecting them from the effects of their own improvidence. That protection is not absolute. The possibility of creating a chargeable transfer on making the policy and of creating a double charge to Inheritance Tax in the event that the donor dies within seven years of his gift, has the result that careful attention needs to be given to matters of valuation. It will be interesting to see whether the Company creates a second generation of plans making use of severable rights of veto or activation in the way discussed in the final part of this article.

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SECTION III

MYSTERIUM SUB SILUA

INTRODUCTION

3.1.1 Capital Gains Tax was introduced some forty three years ago. It is, and has been since its introduction, chargeable on capital gains 'accruing to a person on the disposal of assets'[13]. One might have thought, therefore, that the nature of a disposal for Capital Gains Tax would, by now, be absolutely clear. In fact there is no general definition of a disposal to be found in the legislation although particular provisions extend the meaning of the word to various transactions and other situations which would, or might, not be disposals within the general definition.[14] Nor is a coherent treatment to be found in case law. The nature of a disposal is discussed only obliquely in the decided cases.[15]

3.1.2 The recent decisions by the Special Commissioners and by Mr Justice Briggs in the High Court in the case of *Underwood v Revenue & Customs Commissioners* bring the question of what exactly is a disposal for Capital Gains Tax purposes sharply to the fore.[16]

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[13] TCGA 1992 s.1(1). All references in this article are to the Taxation of Chargeable Gains Act 1992 unless otherwise stated

[14] TCGA 1992 ss. 21-27

[15] The standard practitioners' text are also disappointing in their treatments of the subject. The most substantial discussion is to be found in *Whiteman on Capital Gains Tax*

[16] *Underwood v Revenue & Customs Commissioners* [2008] EWHC 108 (Ch) (the Special Commissioner's reference was [2007] STC (SCD) 659). In the article that follows the High Court decision is referred to simply as the 'High Court Decision' and, similarly, the Special Commissioner's decision is referred to as the 'Special Commissioner's Decision'

DRAMATIS PERSONAE

3.2.1 The dramatis personae in the case were Mr Underwood and two companies which he controlled, being Brickfields Estate Limited (Brickfields) and Mac Estates Limited (Mac Estates) and Mr Rackham and two companies which he controlled, being Anti-Waste Limited (Anti-Waste) and Rackham Limited. Although the terms on which Mr Underwood on the one hand and Mr Rackham and his companies on the other dealt with one another were sometimes not such as one would expect between persons with a purely business connection, the Special Commissioner's decision does not record that there was any other form of connection between them.

THE FACTS

Mr Underwood's purchase of the Property

3.3.1 On 24th May 1990 Mr Rackham purchased a commercial property (the Property) for £0.95m and on 16th July 1990 he sold this property to Anti-Waste for £1.4m. On the same day, Mr Underwood purchased it from Anti-Waste. His acquisition was partially financed with a £1m mortgage from a bank (the Bank) secured on the Property. It seems that the same solicitor, a Mr Cunningham, acted for all parties on all transactions considered in the case.

The '93 Contract

3.3.2 The property market worsened and the Bank began moves to call in its loan. On the 2nd April 1993 Mr Underwood entered into a contract (the '93 Contract) with Rackham

Ltd for the sale of the Property for £400,000 with a completion date of the 31st December 1993. The purpose of this transaction is not recorded but it was accepted by the Special Commissioners that it was not undertaken for tax planning purposes, although its timing might have been affected by tax considerations.

The Option

3.3.3 Also on the 2nd April 1993 Rackham Ltd entered into an option agreement (the Option) with Mr Underwood under which Mr Underwood was to have a call option to re-purchase the Property at any time before the 31st December 1995. Mr Underwood gave one pound for this option. The exercise price was to be £400,000 plus the cost of any capital improvements made by Rackham Ltd and ten per cent of the difference between the value of the property at the date of the option agreement and its value at the date of exercise. Completion was to be twenty eight days after the date of exercise.

3.3.4 On the 28th April 1993 the Property was valued at £400,000 on the open market and at £290,000 in the event of a forced sale.

3.3.5 In the High Court Mr Justice Briggs commented:-

> "The decision affords no explanation why Rackham was prepared, by the combination of the 1993 contract and the option, to incur all the risks of a fall in value of the property, while at least potentially limiting itself to only a 10% share of any increase in value. Nonetheless, and after a full enquiry by HMRC, it was

common ground that the 1993 contract and the option were to be treated as arms length commercial transactions."[17]

The return for 1992/1993

3.3.6 In his tax return for the fiscal year 1992/1993 Mr Underwood claimed a loss on this transaction of £1,174,677 (£1,400,000 - £400,000 less indexation relief and 'other deductions' which were presumably the incidental costs of acquisition and disposal). Against this loss he set a gain of £659,095 and carried forward the balance.

Delayed completion of the '93 Contract

3.3.7 The Bank would not permit the sale to Rackham Ltd to proceed until the loan was repaid and so Rackham Ltd and Mr Underwood agreed to extend the completion date of the '93 Contract to 31st December 1994.

Negotiating a re-financing

3.3.8 It appears that Mr Underwood then negotiated a re-financing of his obligations in the following way.

3.3.9 A Building Society (the First Building Society) agreed to loan £1.25m to Mac Estates secured by a charge on a property owned by that company. Another Building Society (the Second Building Society) agreed to grant a loan of £355,000 to Brickfields secured on the Property. It was a requirement of both loans that the Property should be sold to Brickfields and the loans were only to be released when that happened.

[17] High Court Decision at page 1149

3.3.10 At the end of September the property was professionally valued at £750,000 on a sale in the open market and at £600,000 on a forced sale.

3.3.11 With unpaid interest Mr Underwood's liability to the bank had mounted to £1,160,000. On the 23rd November 1994 the Bank agreed to accept the sum of £640,000 from Mr Underwood in full discharge of this liability. As an aside, therefore, Mr Underwood had achieved a write off of his liability of £520,000; a benefit which was, presumably, tax free.

The Re-Sale Contract

3.3.12 In order to achieve his re-financing, Mr Underwood had to be able to sell the property to Brickfields but he had already contracted under the '93 Contract to sell it to Rackham Ltd for £400,000 with completion to take place on the 31st December 1994.

3.3.13 So Mr Underwood determined to exercise the Option so as to be in a position to sell the Property to Brickfield. The documentation for dealing with the '93 Contract, the Option and the sale to Brickfield was all dealt with by Mr Cunningham and it is to be assumed that he also dealt with the redemption of the Bank's mortgage and the loan on mortgage by the two Building Societies.

3.3.14 Peculiarly, Mr Underwood did not give notice under the Option but rather a new agreement (the Re-Sale Contract) was made between Mr Underwood and Rackham Ltd dated 29th November 1994 under which Rackham Ltd agreed to sell the property

to Mr Underwood for £420,000. This amount was calculated as being ten per cent of the increase in the value of the property between the date of the option (£400,000) and the date of the re-sale contract (£600,000). The oddity that the forced sale value should have been used rather than the open market value was not commented upon either by the Special Commissioners or by Mr Justice Briggs in the High Court. It was accepted by both parties to the appeal that the contract was in effect the exercise of the option and this seems also to have been accepted by the Special Commissioner.[18] No completion date was given in the Re-Sale Contract but the Standard Conditions of Sale applied so that completion was to be twenty working days after the date of the contract; that was 19th December 1994.

The Brickfields Contract

3.3.15 Also on 29th November 1994, the appellant entered into another contract (the Brickfields Contract) under which he agreed to sell the property to Brickfields for the sum of £600,000. Again, because the date of completion was left blank, the Standard Conditions of Sale applied so that completion was to be on 19th December 1994. So at this stage the date of completion of the '93 Contract was 31st December 1994 and of the Re-Sale Contract and the Brickfields Contract was 19th December 1994.

The completion(s)?

3.3.16 It was decided that in order to avoid Stamp Duty there would be only one transfer of the Property from Mr Underwood to Brickfields and that the obligations to make

[18] Special Commissioners' Decision at para 664

payments arising under the '93 Contract and the Re-Sale Contract would be netted off so that Mr Underwood would pay £20,000 (£420,000 - £400,000) to Rackham Ltd.

3.3.17 On 30th November 1994 Mr Underwood executed a transfer of the Property to Brickfields in consideration of the sum of £600,000. On the same day Brickfields mortgaged the Property to the Second Building Society and received £353,000 from them. At 'about the same time' Mac Estates mortgaged its property to the First Building Society and received a mortgage loan from it 'of which £250,000 was available to redeem the loan on the Property'. £640,000 was paid to the Bank with Mr Underwood finding the balance of £37,000 (£640,000 - £353,000 - £250,000) from his own resources. The Bank then released its charge on the Property.

3.3.18 Mr Underwood did not pay the £20,000 to Rackham Ltd until 4th December 1996, Rackham Ltd's books showing a debtor for that amount in the meantime.

The 1993/1994 and 1994/1995 Returns

3.3.19 Mr Underwood made no chargeable gains in 1993/1994 and therefore claimed to carry forward the unrelieved 1993 losses to 1994/1995. In that year his return showed a gain on the disposal to Brickfields of £176,962 (£600,000 - £420,000 less, presumably, the incidental costs of disposal and acquisition). He set the brought forward 1993 loss against this gain and against other gains arising in the year of £327,428. This appears to have left a small amount of the brought forward 1993 loss to be carried forward to future years.

The assessments

3.3.20 An oddity of the case is that the assessments against which Mr Underwood appealed were estimated assessments which bore no relation to the amounts which would be assessable under the Revenue's view of the transactions. The Revenue had assessed tax of £1680 on chargeable gains of £10,000 in respect of the tax year 1992/1993 and tax of £237,608 on an amount of chargeable gains which is not specified in the Special Commissioner's decision in respect of the tax year 1994/1995. The Revenue's position, accepted by both the Special Commissioners and the High Court, although on different grounds, was that there was no disposal under the '93 Contract but only under the Brickfields Contract. The result of that, presumably, was that Mr Underwood did not make a capital loss in 1992/1993 and was therefore assessable on the gains he had realised in that year of £659,095. In 1994/1995, on the Revenue's position, Mr Underwood would have made a loss of £800,000 (£1.4m - £600,000) plus an amount equal to the applicable indexation relief and the incidental costs of acquisition and disposal. This loss, however, was a loss on a disposal to a connected person and therefore, by virtue of TCGA 1992 s.18, was only off-settable against other disposals to Brickfields. Therefore, Mr Underwood would have been assessable on the other gains realised in the year of £176,962.

WHAT IS A DISPOSAL?

The Special Commissioners' Decision

3.4.1 The Special Commissioner's decision was a decision in principle with the actual assessable amount to be agreed between the parties within one month or, failing agreement, by the Special Commissioners.

3.4.2 Although the Special Commissioners accepted that full payment had been made under the '93 Contract and under the Re-Sale Contract of the sale considerations of £400,000 and £420,000 respectively provided for by those contracts, in their view there had been no disposal by Mr Underwood and no acquisition by Rackham Ltd under the '93 Contract and, by implication of that decision, that there had been no disposal by Rackham Ltd under the Re-Sale Contract and no acquisition under that contract by Mr Underwood.

3.4.3 They did so, on the basis that the question at issue was whether Rackham Ltd ever acquired the Property as beneficial owner. The Commissioners concluded that it had not because:-

> "… there was no moment in time when the rights in the Property vested in Rackham Ltd because the very event which constituted payment by Rackham Ltd of the consideration under the contract also constituted payment by [Mr Underwood] under the [Re-Sale] Contract made … in exercise of the option. The payment being by set-off there was not and could not be a moment in time

when Rackham Ltd paid the appellant but the appellant had not paid Rackham Ltd."[19]

3.4.4 The Special Commissioners did not specifically say that a disposal for Capital Gains Tax purposes is a transfer of beneficial ownership in an asset from one person to another but that is plainly their assumption.

<u>Transfer of beneficial ownership in an asset</u>

3.4.5 Mr Justice Briggs in the High Court made that assumption explicit and adopted it:-

> "The capital gains tax legislation does not define what is meant by a disposal, but s.60 of the 1992 Act does have the effect of directing attention away from the transfer of bare legal title to an asset and towards the transfer of beneficial ownership. In the words of Lord Nicholls in *Kirby (Inspector of Taxes) v Thorn EMI Plc* [1987] STC 621 at 625, [1988] 1 WLR 445 at 450:
>
> > '… the basic structure of the tax is of a charge on gains accruing to a person on disposal of an asset by him. There is no statutory definition of disposal but, having regard to the context, what is envisaged by that expression is a transfer of an asset (i.e. of ownership of an asset), as widely defined, by one person to another …'
>
> This therefore means the beneficial ownership rather than bare legal title."[20]

[19] Commissioners' Decision at page 668

Berry v Warnett

3.4.6 In delivering the leading speech the House of Lords decision in *Berry v Warnett (Inspector of Taxes)*,[21] Lord Wilberforce said that capital gains:-

> "… tax is levied on chargeable gains accruing on the disposal of assets … there is no limitation on the generality of the word 'disposal', which must be taken to bear its normal meaning."

3.4.7 It might be thought that Mr Justice Briggs' understanding of the nature of a disposal does not do justice to Lord Wilberforce's emphasis on the width of the word or on its not being a technical usage. It is quite clear, however, that 'disposal' is used in a narrower sense in the Capital Gains Tax legislation than in general usage. The Second Edition of the Compact Oxford English Dictionary defines 'disposal' as the 'action or process of disposing' and gives as the primary meanings of 'dispose':-

> "(1) get rid of, (2) arrange in a particular position, (3) give, sell or transfer (money or assets), (4) incline (someone) towards a particular activity or frame of mind"

3.4.8 It is clear that (2) and (4) form no part of the definition of a 'disposal' for Capital Gains Tax purposes and (3) encompasses concepts which have been given a technical meaning in the law whilst (1) will surely cover many situations which have never been thought to be Capital Gains Tax disposals.

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[20] High Court Decision at page 1150 and 1151

[21] *Berry v Warnett (Inspector of Taxes)* HL [1982] STC 396 at page 399

TCGA 1992 s.60

3.4.9 If Mr Justice Briggs is correct and a disposal is a transfer of the beneficial ownership of an asset one might wonder what is the function of TCGA 1992 s.60 which treats property held on bare trusts as if the property were vested in, and the acts of the nominee or trustee in relation to the assets were the acts of, the person or persons for whom he is a nominee or trustee (acquisitions from or disposals to him by that person or persons being disregarded accordingly). On reflection one realises that the rule is necessary to deal not with disposals but with other matters, for example, with acquisition costs; so, for example, even if one defines a disposal as being a transfer of a beneficial interest one still has to determine what costs have been given by the disponer for the acquisition of the asset within s.38(1)(a) ibid.

TCGA 1992 s.70

3.4.10 Mr Justice Briggs' views are also consistent with the treatment of transfers into settlement under TCGA 1992 s.70 which provides that such a transfer is a disposal of the entire property thereby becoming settled property, notwithstanding that the transferor has some interest as a beneficiary under the settlement and notwithstanding that he is a trustee, or the sole trustee, of the settlement. That provision is only necessary if disposals are transfers of beneficial interests rather than transfers of legal interests.

Promissory Contracts

3.4.11 More difficult issues are raised by disposals under a promissory contract, that is, a contract which is to be executed at a time after the contract is made.

The doctrine of the estate contract

3.4.12 It is clear from a number of nineteenth century authorities[22] that under the Doctrine of Estate Contract a contract for the sale of land vests an equitable interest in the land in the purchaser before completion and divests the vendor of at least some part of his equitable interest in that land. In *Underwood*, the Special Commissioner specifically stated that:-

> "The fact that Rackham Ltd acquired an equitable interest in the contract prior to performance did not constitute a disposal or a part disposal, see *Jerome v Kelly (Inspector of Taxes)* [2004] STC 887 at [32] and [45]."[23]

3.4.13 Mr Justice Briggs in the High Court did not explicitly say that the disposal under a promissory contract which is subsequently performed is constituted by the transfer on completion and not at all by the formation of the contract but he did quote Lord Hoffman's words in *Jerome v Kelly* in relation to TCGA 1992 s.28(1) in which Lord Hoffman unequivocally accepted that the contract does not itself 'count as a disposal'.

> "… Whatever may be the explanation, it seems to me clear that the paragraph was intended to deal only with the question of fixing the time of disposal and not with the substantive liability to tax. It does not deem the contract to have been the disposal as the 1962 Act had done. For that reason, it includes no provisions dealing with what happens if the contract goes off. In such a case,

[22] *Paine v Meller* [1801] 6 VES 349, *Broome v Monck* [1805] 10 VES 597, *Wall v Bright* [1820] 37 ER 456 and *Lysaght v Edwards* [1876] 2 ChD 499

[23] Special Commissioners' Decision at page 668

there will be no disposal and nothing to deem to have happened at the time of the contract. The time of the contract is deemed to be the time of disposal only if there actually is a disposal. This assumes that the contract will not in itself count as a disposal and so deals with the academic arguments about the effect of the equitable interest which arises at the time of the contract …"[24]

3.4.14 Why, if a disposal for Capital Gains Tax purposes is a transfer of the beneficial interest, did the House of Lords conclude in *Jerome v Kelly* that a contract is not itself a disposal? Lord Hoffman seems to deduce that principle from the form of TCGA 1992 s.28.[25] In his leading speech in that case, however, Lord Walker seems to base his conclusion on the limited and provisional nature of the interest vested in the purchaser by the formation of a contract:-

"There is a useful summary [of the relevant case law on the doctrine of the estate contract] in the judgment of Mason J in *Chang v Registrar of Titles* [1976] 137 CLR 177 at 184:

'It has long been established that a vendor of real estate under a valid contract of sale is a trustee of the property sold for the purchaser. However, there has been controversy as to the time when the trust relationship arises and as to the character of that relationship. Lord Eldon considered that a trust arose on execution of the contract (*Paine v Meller*

[24] High Court Decision at page 1150
[25] *Jerome v Kelly* HL [2004] STC 887 at page 891

(1801) 6 Ves 349, 31 ER 1088; *Broome v Monck* (1805) 10 Ves 597, 32 ER 976). Plumer MR thought that until it is known whether the agreement will be performed the vendor 'is not even in the situation of a constructive trustee; he is only a trustee sub modo, and providing nothing happens to prevent it. It may turn out that the title is not good, or the purchaser may be unable to pay' (*Wall v Bright* (1820) 1 Jac & W 494 at 501, 37 ER 456 at 459). Lord Hatherley said that the vendor becomes a trustee for the purchaser when the contract is completed, as by payment of the purchase money (*Shaw v Foster* (1872) LR 5 HL 321). Jessel MR held that a trust sub modo arises on execution of the contract but that the constructive trust comes into existence when title is made out by the vendor or is accepted by the purchaser (*Lysaght's* case). Sir George Jessel's view was accepted by the Court of Appeal in *Rayner v Preston* (1881) 18 Ch D 1). It is accepted that the availability of the remedy of specific performance is essential to the existence of the constructive trust which arises from a contract of sale.'

See also the judgment of Jacobs J (at 189-190), concluding that –

'[w]here there are rights outstanding on both sides, the description of the vendor as a trustee tends to conceal the essentially contractual relationship which, rather than the relationship of trustee and beneficiary, governs the rights and duties of the respective parties.'

It would therefore be wrong to treat an uncompleted contract for the sale of land as equivalent to an immediate, irrevocable declaration of trust (or assignment of beneficial interest) in the land. Neither the seller nor the buyer has unqualified beneficial ownership. Beneficial ownership of the land is in a sense split between the seller and buyer on the provisional assumptions that specific performance is available and that the contract will in due course be completed, if necessary by the court ordering specific performance. In the meantime, the seller is entitled to enjoyment of the land or its rental income. The provisional assumptions may be falsified by events, such as rescission of the contract (either under a contractual term or on breach). If the contract proceeds to completion the equitable interest can be viewed as passing to the buyer in stages, as title is made and accepted and as the purchase price is paid in full."[26]

3.4.15 If Lord Walker simply meant that an uncompleted contract for sale does not irrevocably vest an absolute interest in the land in the purchaser then he was obviously correct. But if he meant to say that a contract does not create an immediate equitable interest in the land for the purchaser, albeit limited and subject to contingencies, it is difficult to reconcile his view with the decision in *Lysaght v Edwards* in which Jessel MR held that if a valid contract is cancelled for non-payment of the purchase money after the death of the vendor, his property will still in equity be treated as having been converted into personalty at the time of his death, because the contract was valid at his death, with the result that it would devolve under

[26] *Jerome v Kelly* HL [2004] STC 887 at pages 896 and 897

bequests of personalty. It seems clear, therefore, that a contract vests an equitable interest in the purchaser, albeit a limited one and one which will be terminated if the purchaser does not fulfil his obligation to pay the purchase money or repudiates the contract.

Understanding Jerome v Kelly

3.4.16 How then does one understand the House of Lords' decision in *Jerome v Kelly*? It seems to us that the grounds for Lord Walker's view are to be found in his discussion of the effect of provisions now found in s.28 which were formerly in s.27 of the Capital Gains Tax Act 1979:-

> "Section 27(1) appears to be directed to a single limited issue, that is the timing of a disposal. It does not say that the contract is the disposal, but that a disposal effected by contract and later completion is to be treated, for timing purposes, as made at the date of the contract. Its language is not so clear and compelling as to lead to the conclusion that Parliament must have intended to introduce a further statutory fiction as to the parties to a disposal. The differences between Park J and the Court of Appeal are more complex than that and cannot be resolved by a single knock-down argument."[27]

3.4.17 Here Lord Walker does not say that a disposal is not effected by a contract, but rather that it is effected by the contract and its later completion. If that is the case, the disposal takes place in a two-stage process (or perhaps a three-stage process –

[27] *Jerome v Kelly* HL [2004] STC 887 at page 895

contract, acceptance of title, completion) which is deemed by s.27 to take place at the time of contract.

3.4.18 It may be this view of the decision in *Jerome v Kelly* which is reflected in Mr Justice Briggs' observation that:-

> "It is precisely because s.28(1) of the 1992 Act deems the disposal of the land to have occurred at the date of the contract for its sale that, as Lord Hoffman observed in the passage which I have already quoted, refined analysis of the stages by which the beneficial interest passes from vendor to purchaser in a contract which has completed is unnecessary for Capital Gains Tax purposes."[28]

3.4.19 That view may be helpful in reconciling the decision in *Jerome v Kelly* with Mr Justice Briggs' view of the nature of disposal and with the long established doctrine of the estate contract but it does not explain either why in *Jerome v Kelly* the parties to the disposal were identified by reference only to the beneficial interests in the asset which was the subject of the disposal subsisting immediately before completion or why, in the event that there is no completion, there is no disposal.

Judge made law?

3.4.20 Perhaps *Jerome v Kelly* should be seen, not as resting on an explication of the legal principles governing disposals for Capital Gains Tax, but rather as creating a Judge-made rule specifically modifying those principles that a disposal of the beneficial

[28] High Court Decision at page 1151

interest in an asset which is actually made in a staged process between contract and completion, should be deemed to take place only in the event of completion; a rule which was created for reasons of practical convenience rather than intellectual coherence.

3.4.21 One can only hope that, either on an appeal in *Underwood* or in another case, the House of Lords will take an opportunity to provide a coherent account of the nature of a disposal.

DID BENEFICIAL OWNERSHIP PASS?

3.5.1 Both the Special Commissioners and Mr Justice Briggs having proceeded on the basis that a disposal for Capital Gains Tax purposes involves a transfer of beneficial ownership and that the formation of a contract cannot itself constitute a disposal, the question became whether the transactions which took place on 30th November 1994 resulted in the beneficial ownership in the Property passing to Rackham Ltd.

A logical contradiction?

3.6.1 Mr Justice Briggs differed from the Special Commissioner in his grounds for deciding that it did not. He saw a logical contradiction in the Special Commissioner's finding that payment of the purchase consideration under the two contracts had been made by way of set off. He said:-

"On the hypothesis that Mr Underwood really paid £420,000 under the 1994 contract, [Counsel for HMRC] was unable to explain what asset other than a beneficial interest in the property can have been turned to account by Rackham."[29]

3.6.2 What Mr Justice Briggs seems to have meant is that if Mr Underwood paid money to Rackham Ltd it must have been paid for something and that something could only have been the property. Yet it was equally clear to him that the beneficial interest in the property had not passed to Rackham Ltd:-

"For as long as the present case was argued on the basis of an assumption that the primary facts disclosed a mutual set-off of payments of £400,000 by way of performance of the two contracts, I became increasingly oppressed by the apparently irreconcilable tension between on the one hand, … [Counsel for the taxpayer's] … submission that Mr Underwood could only have paid £420,000 for a beneficial interest in the property that must therefore have passed, however momentarily, to Rackham, and on the other hand the sensible conclusion of the Special Commissioners that it was both in theory and in practice difficult to see how any such beneficial interest did actually pass, in the sense necessary to constitute a disposal of it for Capital Gains Tax purposes. Disposal is, after all, a concept to be addressed by the application of common sense."[30]

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[29] High Court Decision at page 1155
[30] High Court Decision at page 1156

3.6.3 To release himself from this painful contradiction Mr Justice Briggs usurped the function of the tribunal of fact by stating that:-

> "Mr Underwood's objective was not to transfer and re-acquire the property, but simply to remove the 1993 contract as an obstacle to his intended sale of the property to Brickfields for a substantially greater price, an objective which he had the power to achieve by the exercise of the option, at a net cost to him of £20,000. Both Mr Cunningham and Mr Paul Rackham of Rackham Limited gave evidence to the Special Commissioners in the form of witness statements which were not the subject of cross-examination. Neither of them referred to any payment and cross-payment of £400,000 or to any set-off. Both spoke in terms of recognising the obvious commercial reality that, once the option had been exercised by the creation of the … [Re-Sale] … contract, the net effect of the existence of those two contracts was to yield a profit of £20,000 to Rackham, and that all that needed to be done before Mr Underwood could complete his sale to Brickfields for £600,000 was for him to pay Rackham £20,000 (or in the event promise to pay by way of a debt). That is all that was done. Neither the 1993 nor the … [Re-Sale] … contract was performed at all. They were simply settled by way of the payment of the difference between the value of their combined rights and obligations to each of the parties. The Special Commissioners *implicitly* [emphasis added] recognised that this was the real outcome in their finding (see [2007] STC (SCD) 659, para 28):

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‘28 … The position as between the Appellant and Rackham Ltd could be *settled* by the payment of the sum of £20,000 by the appellant to Rackham Ltd, being the *difference* between the sale price for the property of £400,000 mentioned in the contract of 2 April 1993 and the amount due to Rackham Ltd from the appellant for the property under the option agreement (£420,000 …’ (emphasis added)”[31]

3.6.4 From this Mr Justice Briggs concludes that the payment by set off is an artificial and fallacious construct and that neither contract was performed:-

> “Once, however, the set-off analysis is revealed to be an artificial and fallacious construct, and that in reality all that happened was that the two contracts were settled by payment of a £20,000 difference, without any substantial performance of either of them, then the tension disappears. There was no performance of either contract, there was therefore no transfer of the beneficial interest in the property under either contract, at all. There was therefore no disposal of the property under the 1993 contract, so that there was nothing upon which s.28(1) could bite so as to deem there to have been a disposal in the 1993 year of account.”[32]

3.6.5 If the payments were not made and the contracts were not performed then when Mr Justice Briggs says that the contracts were “simply settled by way of the payment of

[31] High Court Decision at pages 1155 and 1156
[32] High Court Decision at pages 1156 and 1157

the difference between the value of their combined rights and obligations to each of the parties" then he can only mean that the contracts were cancelled by mutual agreement.

3.6.6 The case reports, of course, do not contain the witness statements but it is clear from the Special Commissioner's findings of fact that Mr Underwood and his solicitor addressed themselves to the question of how the obligations arising under the '93 Contract and the Re-Sale Contract could be satisfied.[33] There is nothing in the Special Commissioners' Decision to suggest that an agreement was made for the mutual cancellation of the two contracts.

3.6.7 The High Court's decision is surely likely to be reversed because it is based on a substitution of the facts found by Mr Justice Briggs for the facts found by the Special Commissioners and not on an application of the law to the facts found by the fact finding tribunal.

3.6.8 In our view, however, that may not help Mr Underwood because, contrary to Mr Justice Briggs' view, there is no logical contradiction between the fact that Rackham Ltd did not obtain a beneficial interest in the property and that payments were made under the contracts by way of set-off. The concept of payment is a protean one[34] dependent upon the context in which the putative payment is made. Undoubtedly, Rackham Ltd satisfied its obligations under the Re-Sale Contract to make a payment

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[33] Special Commissioners' Decision at page 664

[34] *Barclays Mercantile Business Finance Ltd v Mawson (Inspector of Taxes)* [2004] UK HL 51 and *DTE Financial Services v Wilson* [2001] EWCA Civ 455

to Mr Underwood by set off against Mr Underwood's obligation to make a payment to it arising under the '93 Contract. Similarly, Mr Underwood satisfied his obligation to convey the Property to Rackham Ltd under the '93 Contract by set-off against Rackham Ltd's obligation to transfer the Property to Mr Underwood under the Re-Sale Contract. It seems clear that both contracts were, therefore, performed. Unfortunately for Mr Underwood, the mode of performance did not involve Rackham Ltd acquiring a beneficial interest in the Property for even a *scintilla temporis* except a limited and temporary interest under the doctrine of the estate contract and, on the admittedly rather opaque authority of *Jerome v Kelly,* that did not constitute a disposal.

BED AND BREAKFAST TRANSACTIONS AND SUB-SALES

3.7.1 If Mr Justice Briggs' judgment stands because it is upheld on appeal, the case appears to have significant implications for many bed and breakfast transactions as well as for the light it throws on the nature of a disposal for Capital Gains Tax purposes. If a higher court were to restore the reasoning of the Special Commissioners, the decision will be of significance in relation to any contract the interaction of which with another contract has the result that the purchaser under the first contract does not obtain beneficial ownership of the asset which is its subject.

Bed and breakfast transactions

3.7.2 Both before the Special Commissioners and the High Court, Mr Underwood's Counsel put forward the example of bed and breakfast transactions on the basis that

they clearly were accepted to lead to chargeable disposals and yet would not do so applying the principles contended for by the Revenue.

3.7.3 Before the enactment of the thirty day identification rule in TCGA 1992 s.106A(5), bed and breakfast transactions most commonly involved a person who wished to realise a hither-to unrealised loss or gain on a shareholding contracting with an institution to sell that shareholding to the institution. On the following day the individual would contract with the institution to buy back the same number of the same share. The individual would be exposed to the risk of movements in the value of the share between the time of the two contracts. Under the contracts, in accordance with the normal arrangements for dealing in shares, settlement of both bargains would take place some time after both contracts were concluded. When the time for settlement came, the individual's obligation to deliver shares under his sale contract would be cancelled by his right to receive shares under the purchase contract. Similarly, the amount owing to him under the sale contract would be netted off against the amount payable by him under the purchase contract so there would only be a payment in one direction of the difference between the two prices.

3.7.4 In response to Mr Underwood's Counsel Mr Justice Briggs said, in relation to bed and breakfast transactions:-

> "There is no reported case in which the question whether a claimed bed and breakfast transaction included the necessary disposal and re-acquisition for Capital Gains Tax purposes has been decided. In *MacNiven*, bed and

breakfast transactions were simply identified as an example of transactions which, because of their tax-driven purpose, their circular nature and their artificiality might prima facie attract the *Ramsay* principle, but which were never challenged on that basis because they recognised, and crystallised a real loss (see *W T Ramsay Ltd v IRC; Eilbeck (Inspector of Taxes) v Rawling* [1981] ACT 300). For the purpose of analysis, it was assumed *sub silentio* that the typical bed and breakfast transaction did involve the necessary disposal and re-acquisition.

Where the sale and re-purchase of an asset under a bed and breakfast transaction has been 'properly paid for', and where for however short a period the beneficial interest in the asset has therefore resided with the buyer before resale, as contemplated by the extract from the HMRC Manuals which I have quoted above, there can be no doubt that such a disposal and re-acquisition occurred.

[Counsel for Mr Underwood] pointed to the fact that, far from there being an overnight sale and repurchase, in the present case the two contracts were some 20 months apart. In my judgment that comparison focuses on the wrong event. The requirement in a bed and breakfast transaction for the contracts of sale and repurchase to be separated in time may be a necessary condition but is not a sufficient condition of its effectiveness for tax purposes. The necessary condition is that the two transactions must have involved a disposal and re-

acquisition of the asset, by the passing and repassing of the beneficial interest."[35]

3.7.5 Mr Justice Briggs' comments here are carefully framed to avoid stating the implications of his judgment for bed and breakfast transactions. It is difficult to see, however, why, if the arrangements for the settlement of the '93 Contract and the Re-Sale Contract in *Underwood* did not amount to performance of those contracts, the settlement of the bed and breakfast transactions by set-off of both the obligations to pay and the obligations to deliver securities, should not also be insufficient to amount to performance. One might be able to distinguish the two on the basis that in *Underwood* Mr Justice Briggs found that the intention of the parties was to cancel the contracts whereas in a bed and breakfast transaction their intention would be to complete them but the distinction is surely wafer thin. If the Special Commissioners' reasoning is restored it is clear that it must also apply to bed and breakfast transactions because in such transactions there is no point in time at which the institution can call for delivery of the shares from the taxpayer.

Sub-sales

3.7.6 The following is an example of a typical sub-sale transaction.

3.7.7 On 1st October 2008 A contracts to sell a property to B for £1m with completion to be on 31st October 2008. On 15th October 2008 B contracts to sell the property to C for £1.1m, also with completion on 31st October 2008. On 31st October 2008 both

[35] High Court Decision at pages 1153 and 1154

transactions are completed by A, transferring the property directly to C and C paying £1m to A and £100,000 to B. On the reasoning of Mr Justice Briggs it appears likely that on these facts there would be a disposal from A to B and from B to C. It is difficult to see how a transaction in which C pays £100,000 to B and a further £1m on his instruction could be characterised as the cancellation without performance of the agreements between A and B and between B and C. If the reasoning of the Special Commissioners is restored, however, there would surely be no disposal by A to B. There would be no *scintilla temporis* in which the beneficial ownership of the property would vest in B because at the time that he had a right to call for the property from A he would also be subject to C's right to call for the property from him.

THE APPEAL

3.8.1 So the decision in Underwood potentially has profound effects upon two categories of very common transactions. An appeal to the Court of Appeal was heard on the 19th November 2008 and the decision is awaited. It is to be hoped that the Court of Appeal provides clarity both on the narrower issue of the taxation of contracts where, due to the interaction with another contract, the purchaser does not receive an unfettered right to the subject matter of the contract and on the wider issue of the nature of a disposal for Capital Gains Tax purposes.

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

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